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And Auditing**

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ABSTRACT

Failures in corporate governance of many major US corporations in 2002 suggest that it may be useful to fundamentally rethink the structure of institutions of accounting, auditing, corporate governance and executive compensation. Replacement of the system of authoritative standards by a competitive, common law approach to accounting principles and rules may help shift the focus of financial reporting from form to substance. Following some key Supreme Court rulings, the quality of auditing declined under the governmental push to increase competition in that industry beginning with the late seventies, pushing audit firms to peddle audit services to their clients for economic survival. Restoring the high quality of audit may require radical reorganization of the audit function, such as bundling it with insurance. The protection of minority interest by the board of directors and the control of runaway executive compensation are two other problems whose solution may require structural, not just procedural, changes.

¹ This is a revised version of the keynote address delivered at the Indian Accounting Association Research Foundation's Sixth International Accounting Conference, at Calcutta on January 11, 2003. The paper is also available at: <http://www.som.yale.edu/faculty/sunder>.

Rethinking the Structure of Accounting and Auditing²

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Accounting and auditing are important components of the system of corporate governance that has evolved over the four centuries since the Dutch and the British East India Companies were chartered. These companies were organized as joint stock companies to gather large amounts of capital from investors to finance trade with the rich countries to the East along the ocean routes discovered in the preceding century.

These companies were immediately confronted with what is referred to today as the *agency problem*: when one person entrusts his wealth to another for investment using the information and skills of the latter, the former bears the risk of the latter's malfeasance. Much experimentation to find a satisfactory arrangement to balance the interests and incentives of the principal and the agent has been occurred in these four centuries. Accounting and auditing are important components of our attempts to solve the corporate governance problem. As the events relating to many large U.S. corporations in the year 2002 have shown, the solutions developed are not entirely satisfactory. I propose some alternatives that may help us develop a more satisfactory system of corporate governance, especially as it relates to its accounting and auditing components.

CORPORATE GOVERNANCE IN THE UNITED STATES

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I begin with an outline of the four main elements of the U.S. system—accounting rules, organization to set accounting rules, audit requirement along with a mechanism to control the quality of audit work, and the involvement of the board of directors in audit and financial reporting of the firm. We should also mention a fifth element—executive compensation—which is crucial for analyzing of the problem of governance.

The law requires the management of publicly-held corporations and not-for-profit organizations to prepare and publish financial reports, at least once each year, and to vouch for their accuracy. While a great deal of the content and format of these reports is discretionary, the U.S. requires that these published reports be supported by a system of accounting and internal controls to safeguard the resources of the organization. In addition, the reports must meet some minimum standards of disclosure, detail, definitions, and measurement. We refer to these as *accounting rules*.

The statutory authority for setting the accounting rules lies with the Securities and Exchange Commission (SEC), an independent regulatory body set up by the government. The SEC delegates the work of developing the accounting rules to a privately financed organization—the Financial Accounting Standards Board (FASB)—retaining for itself the discretion to overrule the FASB. The publicly-held corporations are required to follow these accounting rules through the statutory enforcement power of the SEC.

The SEC also requires the publicly-held corporations to obtain a certificate from a Certified Public Accountant that their financial reports fairly present their

financial status and performance during the reporting period. The CPAs are held liable to the shareholders and other third parties if they are found to have been negligent in issuing such certification without a reasonable basis. The American Institute of CPAs has developed elaborate rules to guide its members in their audit work. In July 2002, the U.S. Congress passed a law to replace a private oversight board with a government appointed oversight board to oversee the functioning and disciplining of the audit firms with a view to ensure their diligence in checking the financial reports for their fairness before certifying them.

The New York Stock Exchange requires the listed firms to have a majority of their board members to be independent in the sense of not being the employees of the corporation. It also requires the audit committee of the board to consist of independent directors and carry the responsibility for dealing directly with the outside auditors.

A significant part of the compensation of corporate executives is contingent on corporate performance as measured by accounting numbers (e.g., income, sales, and the rate of return) or stock price returns. The granting of stock options has become an especially popular form of contingent compensation, its popularity fueled by exclusion of the economic value of options from compensation expense recognized in the income statement. The magnitude of the contingent compensation can be large, and in some cases it has reached hundreds of millions of dollars for one person for one year. The decisions about executive compensation are made by the compensation committee of the board

of directors consisting of members who are supposed to be independent of the management.

Let us use this existing structure of accounting and auditing in the U.S. as a point of departure to explore the feasibility and consequences of alternative structures.

ACCOUNTING RULES

Until three decades ago, the dominant accounting paradigm was of Generally Accepted Accounting Principles (GAAP). Accounting was thought of as a natural language that evolves gradually through usage over long intervals of time. The meaning of words and expressions arises from their general acceptance. The multiplicity of meaning associated with words and the multiplicity of words to convey a given meaning endow natural languages with flexibility of expression, and virtually limitless variability. While it is impossible to prove the meaning of any given expression, natural languages can also express a great variety of meanings we wish to convey. Natural languages have their grammar and dictionaries written by those whose authority is derived not from their power to punish but from the recognition of their expertise. No natural language is known to have been designed by man; Esperanto, created to become the universal language, has languished in obscurity.

Ever since the creation of the SEC, efforts were made in U.S. to abandon the evolutionary spirit underlying the GAAP concept in favor of designing accounting rules through a deliberative process, and enforcing them through sanctions. The output of the efforts of the Accounting Research Committee

(ARC) during 1939-59 was modestly labeled as *Accounting Research Bulletins*, implying that they were tentative suggestions at most, of some experts who had researched the matters. While the intent of ARC was clearly to nudge the evolution of GAAP, and perhaps even codify some of the extant accounting practice, the labels of the Committee as well as its writings were deliberately modest about the importance, abilities, and attention they deserved.

After some twenty years, the Accounting Principles Board and its *Opinions* replaced the ARC and its research bulletins. Notice the greater assertiveness in the name of the organization—a board that identifies the principles. Though it moved beyond the modesty of research bulletins, it still fell short of claiming anything more for its output than the label of *Opinions*. No matter what opinions others have, one is entitled to one's own. Again, there is no pretense that these opinions are superior to those held by others. Indeed, in practice, CPAs had the freedom to deviate from the published *Opinions* of the Board when they thought it appropriate for fair presentation in financial reports of their clients.

The failure of the APB to gain general acceptance for its *Opinions* on accounting for investment tax credit convinced the SEC and the accountants that more authority to back up the accounting rules would solve the problem. They created the FASB to issue *Financial Accounting Standards*. Corporations and CPAs were required to adhere to the FASB standards at the pain of sanctions and penalties. Armed with a large permanent establishment and budget, the FASB ventured forth to pronounce the rules corporations and CPAs must follow to prepare fair financial reports. The authority vested in the new body discarded

the idea that accounting rules must come to be generally accepted. Its seven members were to legislate, after research and consultation, what the best accounting rules are.

The FASB listed many criteria for the selection of its accounting rules in its *Concepts* statements. Any such list includes criteria, which are necessarily in conflict with one another. An aggregation function, or a method to resolve these conflicts was missing from the *Concepts*. Minimizing the cost of capital, an obvious and strong candidate for a single overall criterion for choosing accounting rules, was also missing from the FASB's list. The Board set up an elaborate and good faith consultative process to elicit suggestions, comments and advice from its constituents before making its pronouncements.

Unfortunately, the authority vested in its pronouncements deprived them of evolutionary organic characteristics necessary for general acceptance implicit in live natural languages.

Instead, the existence of the FASB became an excuse for CPAs to abandon their judgment in favor of requests to the Board to clarify its rules. Worse, the FASB's standards themselves became the opponent to beat in a game of hide-and-seek played jointly by corporate managers and their bankers and auditors. What was intended as *the* solution to the problem of financial reporting had itself become the problem. In the aftermath of the Enron and related controversies, the criticism that the FASB was developing rules rather than principles-based accounting appeared as a cruel joke after three decades of hard work by the Board. What is worse, this criticism came across the Atlantic

from those who would have liked nothing better than to have matched the thickness and the detail of FASB's rulebook if only they had had the time and resources to do so.

The replacement of the concept of generally accepted principles by a rulebook in the U.S. has been promoted around the world for over a quarter of a century as evidence of the advanced system of financial reporting in the U.S. This argument went largely unchallenged, and persuaded governments and accountants in many countries to establish local standard-setting bodies that mimicked the FASB's approach in varying degrees. The evolutionary development of GAAP has fallen in disfavor and been widely replaced by authority-backed rules around the world. The International Accounting Standards Board (IASB), with its 85 member countries, is the biggest and the most consequential adoption of the idea that accounting should be guided by rules framed by a deliberative body, instead of principles that may evolve through practice and their general acceptance.

Standard-setting bodies carry a difficult brief. Even if they know the criteria for desirable rules, it is difficult for them to know which rule or rules best fulfill the chosen criteria. A great deal of advice that they receive is self-serving. Information on the consequences of alternative rules, especially the new ones, is scarce, even impossible to get. Comparative studies from the field require competition among alternative rules. A global monopoly of a single set of standards will make it virtually impossible to gather data from the field to support informed choice of rules. Poorly chosen rules will persist because any challenges

to the choices made by a monopoly rule-maker will become so much more difficult to mount.

The standards approach to accounting has the advantage of speedy action in response to changing conditions and the disadvantage of the risk that the action makes things worse, not better. A standard-setting body stands ready, in the manner of a fire brigade, to deploy its resources of expertise to address any perceived abuses in financial reporting and come up with a rule that will block them in the future. It is not an effective instrument for anticipating how the targets of its blocking actions will react, and whether the ultimate outcome of their behavior after they have adjusted to the new rules will be more or less desirable than the status quo. Many well-intentioned accounting standard-setting projects have foundered on the rocks of this action-reaction sequence between rules and managerial behavior.

Recognizing the economics of this game, managers, investment bankers, and lawyers play with the accounting rules, presenting a dilemma to the rule-makers. The rule-makers can analyze the likely consequences of the game by assigning motives to the players. For example, the managers may be assumed to maximize the present value of their personal compensation over their careers, and the investment bankers may be assumed to maximize the present value of their fees from transactions. While perfectly understandable in private domains, such analyses run into the wall of the appearances of professional image when carried out in public. The rule-makers cannot assign such private motives to their constituents without having their own personal motives subjected to similar

scrutiny. Instead of washing all this dirty laundry in public, both the rule-makers as well as their constituents engage in a ritual dance of nuanced language and actions where everyone pretends that everyone is working in the best interests of the public—especially the investing public—and avoid serious analysis of the real motives, alternative options, and implicit threats of the players in the game.

The existence of a permanent standard-setting establishment weakens the auditor's ability and willingness to use their judgment. Under pressure from the clients, they are pressed to petition the rule-maker for "clarifications" of the rules already on the books. There is no rational basis for the rule-maker to select some of these requests for compliance. Sooner or later the number of such requests that end up on the agenda is limited only by the budget and schedule of the rule-makers. After all, the rule-making organization itself needs items for its agenda in order to survive. A permanent establishment and progressive "clarification" of the rules reinforce each other. The rulebook grows thicker; and the question of whether the financial reports that result from such rules fairly represent the status and performance of any particular firm gets buried deeper under the thicket. Even if the auditor or the manager doubted the fairness of a financial report, he would have to choose between the letter of the concrete rules—which he is required to follow under the threat of sanctions, and their spirit—which is a matter of judgment and vaguely specified consequences. It is hardly surprising that the auditor prefers the letter over the spirit of rules.

After Enron and other financial reporting scandals, there has been much discussion about doing accounting by rules versus principles. A permanent body

for writing accounting standards, which will stick to the principles without getting into the detailed rules, is an oxymoron. Setting up rule-making committees and boards is the easy thing to do. Most countries have followed the U.S. lead in doing so. It is hard to argue against the rule of law in accounting, backed by enforcement authority.

In contrast, letting GAAP evolve through practice and consensus, and without the force of authority, is hard work. It demands judgments from managers, accountants, investment bankers, financial analysts, regulators, and the others; judgments are not as easy to defend, as is compliance with a specified set of the rules. That process is more like the evolution of language. New words and usage arise spontaneously; a few survive and gain broader acceptance while most disappear. Lexicographers, grammarians, and other pundits of language gather data, analyze and summarize it, and offer both this data as well as their personal judgments to others in dictionaries, articles and books. Their authority is derived from the respect they may have earned from their writings. Beyond the teacher in the language class who can brandish her power by giving a C to the term paper or presentation of his pupils, there is no real authority in the world of natural language. Yet, through this messy disorganized process, the users of natural languages develop capabilities of communication unmatched by any known consciously designed alternative.

The concept of common law developed in England through custom, acceptance and judicial precedent. According to Landry, "Common law is law that comes from the common people, vers., legislation, which, comes from the

"experts." "...their Authoritative and Original Institutions are not set down in Writing in that Manner, or with that Authority that Acts of Parliament are, but they are grown into Use, and have acquired their binding Power and the Force of Laws by a long and immemorial Usage, and by the Strength of Custom and Reception in this Kingdom. The Matters indeed, and the Substance of those Laws, are in Writing, but the formal and obliging Force and Power of them grows by long Custom and Use, as will fully appear in the ensuing Discourse." They are available "... for the most part extant in Records of Pleas, Proceedings and Judgments, in Books of Reports, and Judicial Decisions, in Tractates of Learned Men's Arguments and Opinions, preserved from ancient Times, and still extant in Writing." Hale (1713).

For financial reporting this common law approach has been progressively replaced by the statutory approach of rule-making boards and committees over the most recent half-a-century. It is useful to reconsider the merits of the common law approach after the results we have obtained in the recent decades. Even if the common law approach is not acceptable, we should consider allowing at least a few alternative sets of accounting standards to complete within each jurisdiction.

AUDITING

The Securities and Exchange Act of 1933 required the publicly-held corporations to have independent outside auditors certify the fairness of their financial reports. Though an early draft of the legislation assigned this duty to the Government Accounting Office (GAO), an oversight branch of the U.S. Congress,

the American Institute of Accountants (AIA, the predecessor body of the AICPA) persuaded Congress to give the audit franchise to its members—the CPAs. Mandatory audit by CPAs has remained the practice for seven decades. Both components of this audit institution—the mandatory requirement, as well as the exclusive franchise to conduct such audits granted to the members of a private organization—deserve an examination.

Mandatory Audit

Publicly-held corporations often employed independent audits long before the 1933 law made them mandatory for all those who chose this form of business organization. It is understandable that audits conducted by independent outside auditors help inform the investors about the integrity of the corporate reports they certify. The imposition of such a legal requirement in the aftermath of the business scandals of the late nineteen twenties, and the stock market crash of 1929 may have helped restore investor confidence. Whether such a requirement imposed on a permanent basis creates a better-informed market is not obvious.

In the pre-1933 regime, the directors and the managers of each firm decided whether to undertake an independent audit with its attendant costs, effort, and the potential modification of the financial reports, even with the possibility of embarrassment if the auditors discovered something that should not have happened in the firm. They had to weigh these negatives to the firm and to themselves against the potential benefits of convincing its shareholders, lenders and tax collectors of the reliability of the representations made in the financial reports. It is reasonable to conclude that when these benefits exceeded the

costs, the firm would find it in its own best interest to undertake the independent audit. On the other hand, if the managers and the directors concluded that the cost or risk of the audit was not worth the benefits of higher investor confidence, they would have decided not to undertake the audit.

This cross-sectional variation in whether or not a firm subjects itself to an independent audit is valuable information to the investors. All things being equal, the investors can logically conclude that the firms that choose to have their financial reports audited by independent auditors have nothing to hide from the investors; that the managers of such firms are relatively more confident about the status, performance and prospects of their business; and that they deserve the trust of the investors. On the other hand, the investors may logically conclude that the firms which choose not to have their financial reports audited by independent auditors, even though they could have done so, are less deserving of the investors' trust and money.

When we make independent audit a statutory requirement, we shut the door on the ability of the better managers to distinguish themselves from the less competent managers in the eyes of the investors. The decision to engage an outside auditor is a costly signal that only the better managers will find worth buying. For the less competent managers, the cost of the independent audit is not worth the benefits; their fear of exposure would keep them from subjecting themselves to an independent audit. In the pre-1933 era the better-run firms could signal their status to the investors by engaging outside auditors; the other firms could not. The statutory requirement to have all publicly-held firms engage

such auditors eliminated the signal, and in this sense, reduced the amount of information available to the investors about the firms and their managers. The economic consequences of a well-intentioned change in the law can be at surprising variance with the intent behind the law.

Independence of Auditors

The independence of auditors has been the subject of extensive comment and analysis over the years. The recent debates have focused on the infringement of independence by fees for consulting services rendered by the audit firms to their audit clients. Charges of such infringement are credible, despite the vehement denials by the audit industry, which amount to rejecting the whole basis for independent audit and internal control. If we refuse to accept that no conflict of interest exists between the audit and consulting functions, we might as well stop hiring outside auditors and accept managements' self-audit at its face value. Few people are willing to take the arguments of the audit industry seriously in defense of the auditors selling consulting services to their audit clients. In the U.S., the audit industry is in the process of giving up marketing of consulting services to its audit clients.

However, the independence problem is deeper than the mere abandonment of the sale of consulting services to the audit clients. If the consulting revenues encroach upon the independence of the auditors, so must the revenues from the audit services. If the auditors' judgments are likely to be influenced in the direction favorable to the management by the prospect of gaining consulting services, gaining or retaining the sale of audit services should

also be expected to have a similar effect on their judgments. How do we deal with the problem that, under our current system, managers whose representations are the subject of the audit, are also the paymasters of the auditors?

As already mentioned, an early draft of the Securities and Exchange Act named the GAO to conduct the audit of publicly-held firms. A government monopoly on a statutory audit presents difficult managerial problems of promoting efficiency and improved technology of auditing. Variations on this theme could include an audit by organizations controlled by stock exchanges in which the securities of the firm are listed, or states in which the firm is incorporated.³ Such audits could remain mandatory, and become a part of the package of regulatory services on which the stock exchanges or the states compete with one another. Alternatively, the exchanges or the states could let the firms choose if they wish to be listed as an audited or as an unaudited corporation, and make their choice of audit status known to investors. The ability of firms to choose among the exchanges or the states, and between the audited and unaudited status will minimize the chances that their regulatory auditors will extract large rents from them; or that such auditors will be grossly inefficient, as might be the case with a single nationwide auditor controlled by the government.

Competition Versus Independence

Although the recent debate on auditing has been focused largely on auditor independence, such was not always the case. In the 1970s, the U.S.

³ Unlike most countries of the world, the US allows corporations to be incorporated under the laws of any of the fifty states. This system of “competitive federalism” is referred to elsewhere in this note. See Romano (2002).

Congress subjected the audit industry to intense scrutiny, not for independence, but for competition (see the reports of the Moss and the Metcalf committees). Competition and independence of auditing are closely linked to each other in a complex relationship. Policies based on the insufficient appreciation of these links bear at least a part of the blame for the loss of both competition as well as independence in the audit industry. Let us consider two ways of thinking about the link between independence and competition.

At one level, there is an almost mechanical linkage between audit independence and competition. At one extreme, we could have a single, very large, audit firm for the entire economy. This monopoly auditor would have enough resources to audit all firms. No single client would account for a sufficiently large proportion of its revenue. Thus, the auditor would be maximally independent, but the market for audit services would have no competition, generating potential inefficiencies associated with monopolies. At the other extreme, we could have a very large number of small auditors, even as many as the client firms, with each auditor totally dependent on one client. In such a maximally competitive market, independence will become scarce. Each auditor will be largely dependent on its small number of clients for his livelihood, and be under heavy economic pressure to yield to the wishes of the client. There are many other possibilities between these two extremes. As we move from one possibility to the next, we can gain more competition by sacrificing some independence, or gain more independence by sacrificing some competition. We cannot attain more of both.

Pursuit of Competition

Paradoxically, after a quarter-century long pursuit of competition, the U.S. audit industry is now down to only four major competitors. How did this come about? This takes us to the second level of analysis.

While the antitrust laws to promote competition in trade and industry have been on the books in the U.S. since the late nineteenth century, these laws were not enforced on professionals such as doctors, lawyers and accountants. In their codes of ethics, the professional associations included provisions to proscribe advertising and solicitation of competitors' clients and employees as being unprofessional. The economic rationale for this informal exemption for the professions lay in the asymmetry of information. It is difficult for the clients of the professionals to see the quality of services rendered to them. Indeed, they often rely on the professionals to advise them on what services they should buy. Emphasizing competition in this setting, it was feared, would result in lowering not only the price but also the quality of the professional services, and thus result in collapse of the market for such services. George Akerlof, formalized this idea in his famous model of the "Market for 'Lemons'" for which he received the Nobel Memorial Prize in Economics in 2001.

About the time Akerlof's argument was published in 1970, questions were already being raised about its validity for the markets for professional services. Stigler argued that competition was a robust phenomenon, and that the reputation of the quality of goods or services provided served as an effective antidote for the problems caused by information asymmetries. When sellers can

develop reputations with the customers, we need not fear that the competition will lower the quality of goods or services provided.

The U.S. Supreme Court, which had heretofore sustained the ban on advertising in the market for professional services, ruled in 1977 that the Bar of the State of Arizona could not prevent its members from advertising their services. Though the case was decided on the grounds of (commercial) free speech guaranteed by the First Amendment to the U.S. Constitution, arguments about the opportunity to build reputations played an important role in this ruling. Though not directed at them, it turned out to be a watershed ruling for the auditing profession in U.S.

The Supreme Court ruling led the U.S. government to change its policy on professional competition, and the latter forced the professional associations to drop the anticompetitive provisions from their codes of ethics. The American Institute of CPAs changed its Code of Ethics effective 1979, resulting in major consequences.

Generalization of the reputation argument from the professions of medicine, dentistry, and law to auditing was fundamentally flawed because the results of the medical and legal services are observable, at least ex post, to the customers in a reasonably prompt manner. Since such observations have a reasonable, albeit imperfect, correlation with the quality of services rendered, reputation can keep these markets from collapsing under competition. This is not the case with the market for audit services.

Corporate managers and directors hire the auditors. The real clients of the auditors—the investors—never see the auditors. Even if they could, they could not tell by watching them if the auditors have done their job diligently. Managers who see the auditors hardly have any incentives to make sure that they properly check the representations made by the managers to the investors and others. Only on rare occasions, when a corporation runs into serious financial trouble, questions may be raised about the fairness of its financial reports and the quality of the audit work used to certify the reports. More than 99 percent of the time, no questions are raised about the quality of the audit, and no one looks into what the auditors actually did. In this environment, there is hardly any opportunity for the auditors to build their reputation based on the quality of their work. Thus the reputation argument cannot be generalized from other professions to the auditing profession.

However it was generalized to the auditing profession, and under the pressure of competition, auditing turned into a “market for lemons.” The prices dropped as the corporate controllers solicited new bids from audit firms, year after year, to get a better price from their auditors. At these ever-lower prices, the auditors could not continue to do what they had long done and still earn a decent living. Something had to change, and it did. To survive in this new competitive environment forced upon them, auditors built themselves a new business model. It had three new elements—a new product mix, a new production function, and a new compensation policy.

A New Business Model for Audit Firms

A certain amount of business advisory services or consulting had always been part of the product mix the auditors offered their clients. The auditors knew that they could make money by selling more consulting services to their audit clients. They already had a close business relationship with the top echelons of management, and detailed knowledge of the operations, the financial status, strengths and weaknesses of the business. An established relationship of mutual trust made it easier for management to give the task to the consulting colleagues of the auditor, instead of searching for a competent consultant elsewhere. Management saved the search costs, and the consultants working inside the audit firm saved a large part of their marketing costs. The auditors decided to exploit this cost advantage to sustain the money losing audit operations.

In the recent controversies, the collapse of auditing has often been blamed on these consulting services. Admittedly, the rapid expansion of consulting services they peddled to their audit clients could not have had a salutary effect on the diligence with which they examined the fairness of the financial reports prepared by the managers. However, we must not forget that the expansion of the consulting services to become the tail that wagged the dog of auditing business came about as a consequence of the collapse of the audit market: as the government pushed competition on the audit business, and the audit prices and profitability collapsed, the auditors turned to consulting as a recourse. The expansion of consulting was a consequence—not the cause—of the collapse of the audit market. Unfortunately, most solutions, including the recent legislation that purportedly deals with the collapse of auditing have

misdiagnosed the symptom of consulting to be the cause. Such treatments are not likely to be effective.

The second element of the business model was a new production function for auditing. Audit work consists of two main elements—analytical review and substantive testing. Analytical review is a structural, temporal and cross-sectional comparative evaluation of the financial report to assess its overall soundness. Once the auditor has invested the effort to model the firm and its environment, analytical review becomes essentially an armchair exercise. Substantive testing is the direct verification of the resources and obligations of the firm in the field, and requires costly checking of physical plant, inventories, creditors and debtors of the firm. Although the auditors developed sophisticated statistical techniques to design efficient sampling methods to cut these costs during the third quarter of the twentieth century, substantive testing consumed the bulk of the auditing budgets. Under the pressure of competition, the auditors shifted their production function from expensive substantive testing towards inexpensive analytical reviews. A greater part of the audit work could now be carried out without leaving the office, with less time, labor, and costs.

The third element of the new business model was to lower the compensation of the new entrants to the audit profession. This was reflected almost immediately in the drop in the number of college students choosing to major in accounting, and a few years later, in the number who chose to take the examination for entry into the CPA profession.

Auditors might have hoped that this new business model would sustain the economic viability of their firms. But it couldn't because the shift in the business model had important consequences the model had not accounted for. The cut backs in substantive testing—the auditors visiting the warehouse shelves to count inventories and requesting direct confirmations from those who were supposed to owe money to their clients—meant more opportunities for managers to misrepresent their numbers, if they wanted to, with less chance of the misrepresentations being discovered by the auditors. Increased emphasis on selling high margin consulting services to their audit clients forced even haughty audit partners to become pleading salesmen at the clients' door. Such partners were hardly in a position to stick to their judgments about the fairness of the financial reports in high stakes negotiations with the CEOs and CFOs of the firms; the latter could always throw another consulting project their way. The drop in audit prices forced a change in the production function and the product mix, which in turned cut into the quality of audit services. But the auditors' liability had not been reduced. The consequences followed none too soon.

Liabilities Eat the Profits

By the mid-eighties auditors saw a sharp rise in the number of lawsuits against them, alleging negligence in auditing. The suits worked their way through the in or out-of-court settlements, including some cases where auditors paid over a hundred million dollars in damages for a single audit. The new business model did not yield the hoped for profits, and the auditors had to revise it again. They reinforced all three elements mentioned above, and added a fourth. Consulting

services had already become the mainstay of auditor profitability. They shifted their college recruiting to people who could work on consulting, not auditing projects. Abandoning their long-held policy of pushing the universities to offer courses in advanced accounting skills that could be employed in audit tasks, the major accounting firms financed the Accounting Education Change Commission for the American Accounting Association, urging the universities to train strategic thinkers (read consultants), not accountants. They continued to move the audit production function away from substantive tests to analytical models to reduce the labor costs of audit. The profession was determined to follow its new business model to deal with the consequences of the competition that had been forced upon it. The auditors' liability had become a thorn in their side and an obstacle in their pursuit of this model. They turned their attention to finding a remedy for this problem.

When the courts found that the audited financial reports did not fairly represent the financial status and performance of the firm, the auditors were held jointly and severally liable, along with managers, directors, etc., and asked to pay damages to the plaintiffs. Far too often in such cases, the other parties held liable had little resources, and the auditors ended up paying the share of damages attributable to themselves as well as to the others. The auditors identified this joint-and-several liability doctrine as the main source of their problems, and determined to replace it by proportional liability where they would have to pay only their own share of the damages. How was this change to be accomplished?

A Political Strategy

Physicians and lawyers had financed elections for many years, and benefited handsomely from the political payoffs from their benefactors. Accountants, too, decided to follow suit, and began to organize and raise money to finance elections in order to gain access to legislators. They progressively ramped up financial contributions to the elections in 1988, 1990, 1992, and 1994 and lobbying efforts in Washington and the state legislatures. In 1995, Congress passed the Private Securities Litigation Reform Act, switching the auditors' liability from joint and several to proportional. As a sweetener to the business lobby from the high-tech sector of the U.S. industry, this Act also permitted publicly-held companies to include forward looking statements in their financial reports under a safe harbor provision. As long as such statements were clearly labeled to be forward looking, the management could not be held liable for errors in such statements. It was a measure of the lobbying power of the accountants that this was the only Act passed by Congress overturning a veto during the eight years of Clinton presidency.

The 1995 Act cleared the way for the new business model of audit firms to take effect. They no longer wished to be called auditors or accountants. The new production function did not do much auditing any way. A new term—assurance services—was coined to describe what used to be the audit part of their business. With the revenues from consulting they thought they could pay whatever proportional liability from the assurance services came their way from the courts. At Arthur Andersen & Company, the authority to make the final calls

on matters of accounting principles was transferred from their legendary and tough central office group in Chicago to the engagement partners directly responsible for the audit in the field. The pressures on audit partners to fulfill their quota of consulting revenues from their audit clients rose to a level that forced many old-timers to quit by taking early retirement. The rush for making money in the go-go days of dotcom bubble was on, and the auditors became the perpetrators, the short-term beneficiaries, and ultimately the victims of the bubble.

SEC's Missed Diagnosis

The SEC saw trouble, and tried to stop this race. Like many others, the SEC too, misdiagnosed the consulting revenues of the audit firms as the source of the problem. It also failed to see that the growth of consulting for audit clients was merely a symptom of the competition that had been pushed on auditing through the change in government policy in the late seventies. In any case, the accountants used their political muscle to partially beat back the SEC proposal to prohibit the audit firms from providing consulting services to their audit clients; they settled for public disclosure of the consulting fees.

All major economic and stock market downturns leave behind the detritus of collapsed businesses and failed hopes, including some accounting and auditing scandals. The events of 2002 are different only in the unusually large number of accounting and auditing related surprises, and their magnitude, which rose, in several cases, to many billions of dollars. It did not help that in pushing competition on all professions in the late seventies, the government policy failed

to consider the special susceptibility of the market for audit services to become a “market for lemons.” In pushing for competition, the government not only damaged auditor independence, but paradoxically, it damaged the competition too. After a quarter-century of efforts to promote competition, the number of large audit firms who audit most publicly-held firms has been halved to four.

TIME FOR RETHINKING

This brief overview of the U.S. events in accounting and auditing gives us reasons to reconsider the institutions of accounting and auditing we have come to take for granted. We touch on accounting rules, audit requirements, director’s independence and executive compensation.

It is not clear if the worldwide rush to develop written accounting standards backed by the government’s power of enforcement can improve the fairness of financial reports. We might want to revisit the common law approach to accounting that prevailed until the standards boards came into fashion some half-a-century ago. With the creation of an accounting court, suggested by Leonard Spacek—the former head of Arthur Andersen & Co. and one of the original thinkers in accounting—accounting might develop better in the form of case law instead of the statutory form it has taken under the FASB in the U.S., and will likely take in Europe and elsewhere under the IASB.

While a switch from the current statutory mind set to common law might take a lengthy debate, we can do something in the short run to limit the damage to accounting inflicted by well-meaning boards charged with nonstop production of new rules. Each accounting jurisdiction could choose two or more sets of

accounting standards and declare them to be acceptable within the jurisdiction. Each firm would be asked to choose one set of standards, pay a royalty fee to the body whose standards it chooses, and publish financial reports certified to have met the chosen standards. Such a system will induce the standard-setting bodies to compete with each other while the business firms choose the standards that tend to lower their cost of capital.⁴ Such a competitive system will allow the standard-setters to learn from the corporate choices about which standards are better (in the sense of lower cost of capital), and thus improve them gradually over time. Unfortunately, a monopoly of standards is the reigning norm in accounting jurisdictions across the world, and the likely success of the IASB will only make things worse by replacing the national monopolies with a worldwide monopoly. We still have time to act.

On the other hand, the introduction of competition in the market for audit services has done much damage to the independence of auditors. Even if we could put this genie back in the bottle, persuading Congress to allow a special exemption from the antitrust laws for the auditors would be a difficult political challenge. Congressmen may prefer watching baseball to reading corporate financial reports. We need more radical solutions for the auditing problem.

One possibility is to remove the mandatory audit requirement on publicly-held firms, leaving each firm free to decide if it wishes to have an audit certificate accompany its reports. A second, and more radical version comes from Professor Joshua Ronen (2002) who would have each firm buy for its

⁴ See Dye and Sunder (2000) and Sunder (2002a and 2002b).

shareholders an insurance policy against financial fraud in its reports.⁵ The firm could choose any amount of insurance, and will have to publish both the amount of insurance as well as the premium it pays to the insurance company. Before issuing the insurance policy, and setting the premium, the insurance company will send its own auditors to verify the firm's reports. This solution will merge the insurance and the audit function into one organization, and eliminate the need for the government or any other body to supervise auditing of public firms. The cases of financial fraud would be heard in the specialized accounting courts as suggested by Spacek. The board of directors would have to decide how much insurance they should buy, and monitor the premium demanded by the insurance company as a barometer of the reliability of the management's representations.

As for the board of directors itself, there has been much discussion about making the boards more independent of the management. Instead, what is needed regarding the directors is not just independence but also competence, trust of the management, and alignment with the interests of the minority shareholders. These requirements are often mutually contradictory and irreconcilable. Still, several interesting proposals are on the table for discussion. One is to have a real election for the board in which at least two candidates are nominated for each vacancy on the board. Candidates for the corporate boards would have to make a case for their election, and publish their voting records if they have already served on the board in the past. A second proposal would have a separate slate of directors to represent the minority interests.

⁵ Also see Dontoh et al (2003).

Linking managerial compensation to measured performance has an innocent rationale of aligning the interests of managers to the interests of the shareholders. When this linkage is taken far enough, and the performance contingent part of the compensation rises, the measurement of performance comes under severe managerial pressure. We know of no performance measure, accounting and stock markets included, which is beyond managerial manipulation. Thus the use of contingent compensation and better alignment of interests is not free. When such compensation becomes large, accounting and auditing and the governance systems tend to yield to the managerial pressures. We could learn to stop contingent compensation schemes short of the point where they break the measurement system.

Kolkata has seen these problems of corporate governance for over two hundred years. Ever since its inception, the Court of Directors of the British East India Company had difficulty in getting their agents to follow its orders. Both Robert Clive as well as Warren Hastings were prosecuted upon their return to London after their tour of duty in Calcutta. This company, one of the greatest companies ever (in terms of its revenue relative to the country in which it was chartered) struggled with its efforts to solve the corporate governance problem for its 258 years of existence. Perhaps we needn't be surprised that we still have some more thinking to do on how to solve the agency problem.

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