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The Regulation of Accounting: Some Economic Issues

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COMMENTARY

THE REGULATION OF ACCOUNTING: SOME ECONOMIC ISSUES

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The regulation of accounting has become a very controversial area. My purpose here is to touch briefly on the relevance of principles of economics to three interrelated issues: (1) the function of accountants; (2) the incentives of accountants to remain independent; and (3) the role of liability rules in assuring quality performance by accountants. Without an understanding of relevant economic principles, it is impossible, in my view, to discuss any of these issues in a meaningful way.

I.

Publicly held corporations are characterized by separation of the management from the risk-bearing functions. This separation allows investors to capture the benefits of specialization of function but subjects them to the risk that their funds will be used for managers' personal benefit. Investors also realize that, in most instances, they lack the expertise and the incentive to monitor managers' actions. As a result, investors discount the price they are willing to pay for shares when firms attempt to raise capital. To minimize the size of this discount, those who raise capital have strong incentives to establish institutional arrangements that facilitate the monitoring of managerial performance. Such arrangements minimize the probability that managers will be able to profit at investors' expense.

Independent accountants are one type of monitoring arrangement. By examining a firm's books and records and opining on whether management's representations reflect the true state of the firm, accountants minimize the need for investors to

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engage in costly monitoring activities. Hence, investors are willing to pay a higher price for shares of firms that employ independent accountants. This explains why firms voluntarily contracted with independent accountants long before there was a Securities and Exchange Commission.

Accounting has another related function. If all firms disclosed financial information in different ways, interpreting the information, as well as making inter-firm comparisons, would be difficult. Accounting provides a common language and, thus, lowers the costs of processing information.

II.

Firms are willing to bear the costs of hiring independent accountants because these costs are less than the decrease in the cost of capital. If an accounting firm acquires a reputation for lack of independence, however, there will be no decrease in the cost of capital when it is retained. Rational investors will view the disclosures by a firm that has retained an accounting firm with a dishonest reputation as if no accounting firm were retained. Indeed, the retention of such an accounting firm might be perceived by investors as worse than not hiring any accounting firm because it will be viewed as a signal that the firm intends to mislead investors. This will lead to an increase in the cost of capital.

The above discussion illustrates why accountants have strong incentives to maintain a reputation for independence and why firms have equally strong incentives to retain accountants with such reputations. Accountants are selling monitoring services, and the price that firms are willing to pay for these services is a function of how much investors value the services provided. In other words, unless accounting firms maintain a reputation for independence, they have nothing of value to sell.

This is not to suggest that conflicts of interest never arise. For purposes of analysis, it is useful to identify two potential types of conflicts of interest. The first is where a firm wants to misrepresent its financial situation and tells its accountant, in effect, to go along or lose the business. In this situation, the accounting firm must balance the short-term loss of revenues if it refuses to go along against the damage to its reputation if it participates in the scheme. The possibility that the firm's profit-maximizing strategy is to cooperate with the wrongdoers is largely a function of the amount of diversity in the firm's client base. An accounting firm with one client will be much more willing to make compromises to keep the client than will a firm where no one client represents a large percentage of its revenues. Thus, if all else is equal, large accounting firms will be more independent than small accounting firms, which no doubt helps to explain the popularity of the big eight accounting firms for public companies.

A second type of conflict occurs when an employee of an accounting firm, rather than the firm as a whole, decides to participate in a fraudulent scheme. While reputational concerns also act as a constraint on this type of behavior by individuals, it is more likely that individuals will conclude that it is essential to keep a particular client than for the firm to have this view. The economic fortunes of an individual may be tied to one client even if the same is not true for the accounting firm as a whole. It is important to recognize, however, that accounting firms that want to maintain their reputations for independence will be aware of this concern and will set up internal systems to monitor the performance of its employees. The incentives of the accounting firm in this regard are no different than any other type of firm that makes expenditures to protect the value of its brand name.

Recently, concern has been expressed over the effect of "lowballing" — charging a low price for initial engagements — on auditor independence. The argument appears to be that if the initial price charged is too low, accountants will have to take whatever steps are necessary to keep the client in order to recoup the losses from the initial engagement. To minimize this perceived threat to auditor independence, some members of the Securities and Exchange Commission have proposed regulations limiting price competition among accounting firms.

This concern about the effect of lowballing on independence is misplaced. The flaw in the argument is the assumption that charging a low price in the early period will make it more profitable not to be independent in later periods. The costs (revenue foregone) in the early period, however, are sunk; they do not affect incentives in later periods. Put differently, if it is profitable in the present not to be independent (although note the reasons discussed above while this will generally not be true), it is irrelevant what prices were charged in the past.

In reality, lowballing is probably nothing more than a form of discounting that is common in many markets and is undertaken for the purpose of inducing purchasers to hire a particular firm. Such discounting reflects a competitive market in accounting services and, as emphasized above, has no effect on independence. Any attempt by the SEC to prohibit price competition by accounting firms thus cannot be justified by the need to protect investors. Rather, such an attempt would be more accurately characterized as enforcement of a price-fixing cartel among accounting firms to the detriment of investors who must pay higher prices to hire accountants.

III.

Suits against accountants are becoming increasingly common. It is now commonplace, for example, for accountants to be joined as defendants in securities fraud class action suits. The typical pattern is that, after a decline in a particular industry (energy and computers being the best examples in recent years), securities fraud suits are filed against many of the firms in the industry and their accountants alleging that investors who purchased during the class period did so at artificially inflated prices because of some defect in disclosure.

While some of these suits undoubtedly have merit, the fact that suits are filed against a high percentage of firms in a particular industry (and their accountants) suggests that many are frivolous. Unless there is some amazing coincidence whereby a high percentage of wrongdoers wind up in particular industries, and they are responsible for the timing of declines in stock prices (rather than, say, the decline in the price of oil), it is implausible that the problems of an entire industry are attributable to disclosure decisions by firms and their accountants. Such suits are a perversion of the securities laws, which are designed to deter wrongdoing and compensate victims, not to provide insurance against stock price declines.

Nevertheless, casual empiricism suggests that these suits are almost always settled, and typically for more than nominal amounts. This is hardly surprising given the staggering potential exposure in open market securities cases and the enormous cost of litigation. As a result, the rational strategy will frequently be to settle, even in cases that lack merit.

What must be understood, however, is that use of the securities laws to force accountants to provide insurance against stock price declines is not costless. When calculating the price of their services, accountants will now charge for the insurance being provided. Similarly, accountants will take steps that do not increase the quality of monitoring services but create a paper trail that is of value in litigation. Such "defensive accounting," along with the cost of the insurance premium, will create higher prices. Investors, the supposed beneficiaries of securities fraud actions, will likely bear a large percentage of these increased costs.

From the investors' perspective, these costs are worth bearing if the benefits of securities fraud actions are sufficiently large. The purported benefit of securities fraud suits against accountants is that the threat of liability will cause accountants to provide a higher quality service. There is some truth to this claim. The accounting firm contemplating what to do when a client pressures it to acquiesce in a questionable scheme might be deterred by the threat of liability in some situations where the concern over damage to reputation might not have been enough. But the situation is more complicated.

The deterrent effect of liability rules is the difference between the probability of incurring liability when performance meets the required standard and the probability of incurring liability when performance is below the required standard. Thus, the stronger is the probability that liability will be incurred when performance is adequate, the weaker is the deterrent effect of liability rules. Why offer a higher quality product if you will be sued regardless whenever there is a precipitous decline in stock prices? While it is impossible to quantify exactly how serious this problem of error costs is, the above discussion concerning the industry-wide nature of securities fraud suits suggests the problem is substantial. And if error costs are substantial, it is likely that the claimed deterrent effect of liability rules has been exaggerated.

Thus securities fraud suits against accountants which are justified as a form of investor protection may have precisely the opposite effect. Investors bear increased costs without obtaining any offsetting benefits. Possible reforms include restrictions on the availability of the class action device, modifications of rules governing the awarding of costs in litigation, and clarification of the fault standard so that liability can be imposed only when an intent to defraud has been proved. A fuller understanding of the effects of liability rules in accounting and other contexts, and of the effects of possible reforms, are rich areas for further research.