Are Regulatory Mandate and Independence Necessary For Audit Quality?

Abstract

Two key assumptions underlying the regulation of U.S. financial reporting are the need to mandate the certification of financial statements, and to require that this certification be performed by independent auditors. Private incentives to demand (and supply) certification are thought to be insufficient, and independence is thought to be necessary for quality audit. In this study, we collect archival data on certification activity in the economy, and conduct a field experiment on an unregulated online market for certification of baseball cards to investigate the validity of these assumptions.

Our results show that: (1) Private markets for certification services are ubiquitous in the economy, many with potential for conflict of interest; (2) The grading scales used in certification reports vary from pass/fail to scales with 5-100 points with greater use of the former by government agencies; (3) the unregulated market for baseball card certification is dominated by firms who also sell other services; and (4) Certification agencies who cross sell services provide better quality audits than completely independent certification agencies. Our results suggest that the assumption that private incentives are insufficient for a well-functioning audit market may need further scrutiny. In addition, our results suggest that independence is not a necessary condition for obtaining audit quality.

Keywords: Mandatory audit, independence, regulation, certification services, financial reporting, accounting

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