A salient aspect of the recent round of corporate governance failures has been the publication of misleading financial reports by the management of major corporations; and the failure of their auditors, lawyers, and investment bankers to detect and correct the erroneous reports.

These failures have been widely attributed to greed, negligence, or incompetence from individuals, some of whom are being investigated or prosecuted. These actions are insufficient. The extensive nature of the governance failures suggests that they are not mere isolated incidences; they may have one or more common, systemic causes.

It is difficult, even painful, to examine systemic changes that could have led to the failures of governance. They occur slowly over the years, and have complicated cause and effect relationships. This note examines one possible systemic failure: the removal of certain competitive restraints from the accounting industry.

In the late seventies, the federal government decided to push for greater competition in the markets for professional services provided by doctors, lawyers, accountants, etc.

Until then, the government had been cautious in aggressively implementing the antitrust laws in these markets. The customers of professional services, for the most part, have limited ability to judge their own needs and the quality of services received. It had been feared that a push for greater competition in such markets would lower not only the price but also the quality of the services.

Accordingly, most professions were allowed to govern themselves through their codes of ethics that included many anti-competitive provisions, such as no advertising or solicitation of clients.

Several Supreme Court decisions in the late seventies (e.g., Bates vs. the Bar of the State of Arizona, 1977), led the government to change its policy and push the professional associations to drop the anti-competitive provisions from their codes of ethics. The American Institute of CPAs complied in 1979.

The effect of the removal of competitive restraints on the pricing of audit services was immediate, and severe. Patients of a doctor can easily see if they are better after the treatment; clients of a lawyer can see the results of the trial because there is some nontrivial relationship between the quality of services and the outcomes observable to the customer of such professions. In contrast, the customers of the auditor — the
shareholders — have little chance of learning about the quality of audit services provided before or after the fact. Unlike the customers of doctors and lawyers, the customers of auditors hardly see the service provider and have little basis for judging the quality of services, except in less than one percent of the cases where the courts get involved due to bankruptcy or other reasons. As George Akerlof (later awarded the Nobel Prize in economic sciences) predicted in his 1970 article on such conditions, the market for audit services became a market for lemons.

As the prices of audit services dropped under competitive pressure, auditors scrambled to retain the profitability of their services. They took many steps to revise their business model, cutting costly, substantive testing of inventories and receivables, and aggressively marketing lucrative consulting services to their audit clients. When these steps led to a flood of lawsuits, they sought to limit their legal liability.

Due to intensive lobbying and financing of elections beginning in the late eighties, auditors managed to persuade most state legislatures to permit them to operate audit firms as limited liability partnerships, and persuaded Congress to switch auditor liability from joint-and-several to proportional regime (Private Securities Litigation Reform Act, 1995). PSLRA also permitted the management of public corporations, for the first time since the federal securities laws were passed in the 1930s, to publish unverified and often unverifiable “forward looking” information in financial reports under a safe harbor rule.

These two decades of institutional changes fundamentally changed the environment of financial reporting and auditing. Incentives and restraints that characterized the world of financial reporting until the mid-seventies, hardly perfect itself, had been altered. The motivation behind these changes was to make available to the public the benefits of greater competition in the market for audit and other professional services. Unfortunately, given the nature of audit services, whose own quality must rest more on trust than on verification by another auditor, the gains of competition were accompanied by degradation in the quality of the service itself. Many can debate whether the gains were worth this loss in the quality of audit services.

As the government continues to prosecute the wrongdoings, it would be a mistake to think that the extensive failures of corporate governance were simply isolated instances of individual behavior. We need to carefully examine the policies changes of the recent decades, and their impact on the decision environment of individuals.

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Pp. 16-17 of 24.