

Current Topics in Auditing

The Economic Role of the Audit in Free and Regulated Markets

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The Economic Role of the Audit in Free and Regulated Markets

■ Research Question:

Why do audits have perceived economic value?

The Economic Role of the Audit in Free and Regulated Markets

- Key concepts
 - * Conflict of interest
 - * Consequence
 - * Complexity
 - * Remoteness

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■ Evidence of economic value

- * 82% NYSE companies audited in 1926
- * 94% NYSE companies audited in 1934
- * “Old world” practice of auditing
- * Non-SEC sectors

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■ Monitoring/Stewardship Hypothesis

* Agency Theory

- ◆ Both parties maximize self-interest
- ◆ Agents do not always act in best interests of principal
- ◆ Principal can adjust the price
- ◆ Agent contracts to perform
- ◆ Agent wants monitoring at lowest cost
- ➔ Auditing

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■ Monitoring/Stewardship Hypothesis

* Rational expectations

- ◆ All information
- ◆ Utilized intelligently, without error

* Principals

- ◆ Expect agents' interest to diverge
- ◆ Estimate the effect
- ◆ Adjust prices

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■ Monitoring/Stewardship Hypothesis

- * Incentives exist for agents to produce financial statements and to provide evidence of their reliability
- * This gives rise to the demand for independent auditing

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■ Information Hypothesis

- * Investors demand audited financial statements for investment decisions
 - ◆ Audits improve their quality
 - ◆ Even if investors cannot contract with agents
- * Benefits of information
 - ◆ Reduced risk
 - ◆ Better decision making
 - ◆ Profits earned

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■ Information Hypothesis

- * Market efficiency
- * Auditors independent
- * Managers forbidden insider trading
- * Information still of value to improve individual's investment decisions
- * "Public good" concerns

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■ Information Hypothesis

* “Public Good”

- ◆ Regulation to curb underproduction of financial information?
- ◆ No clear evidence of underproduction
- ◆ Selling audited financial information could be a remedy?

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■ Insurance Hypothesis

* Why look to auditors for insurance?

- ◆ Managers need to demonstrate due care
- ◆ Legal staff makes them good co-defendants
- ◆ Concern for reputation
- ◆ “Deep pockets”

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- Overlapping hypotheses
- Political insurance

Current Topics in Auditing

Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure

Michael C. Jensen & William H. Meckling

Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure

1. Introduction and summary
2. The agency costs of outside equity
3. Some unanswered questions regarding the existence of the corporate form
4. The agency costs of debt
5. A theory of the corporate ownership structure
6. Qualifications and extensions of the analysis
7. Conclusions