# Audit Firm Scope and Auditor Independence

Rajib Doogar
University of Illinois at Urbana-Champaign
August 31, 2000

## Executive Summary*

Analysis of a simplified model of the U.S. audit market reveals incentives for auditors to provide levels of non-audit services that investors find excessive. Competition in the market for both audit and non-audit services partially mitigates the potential adverse implications of overly large non-audit practices. However the spinoff threshold at which auditors find it privately optimal to divest their non-audit services is always larger than the spinoff threshold investors prefer.

If the gap between the two thresholds is large, regulatory intervention offers one mechanism for audit firms to internalize investor preferences in choosing the scope of services. Private coordination among auditors to limit the supply of non-audit services may be an alternative. Given, however, that the optimal solution involves auditors voluntarily limiting output, private coordination may be infeasible.

Three key frictions drive the divergence between investors' and auditors' preferences over the amount of non-audit work. First, if auditing is mandated by law, investors' diminished value for audits may not be reflected in audit prices set by price competition among all auditors. In economic terminology, mandating audits makes the demand curve horizontal in price: demand is *completely inelastic* and independent of quality or price. The decoupling of demand from quality removes a crucial link between investor preferences and auditor incentives. Second, not all individual auditors can be relied on to remain independent and skeptical at all times, even though the audit firm would like them to. In economic terminology, *imperfect alignment of incentives* due to career concerns or other contracting costs (or due to imperfect socialization) threatens auditor independence despite audit firms' best efforts to control such opportunistic behavior. Third, when lawsuits can be settled before an adjudication of the suit on merits and no subsequent information is publicly available about the auditor's lack of culpability, individual (and fully rational) investors' actions will reflect public perceptions about lack of auditor independence even if they have some (weak) private information to the contrary. In economic terminology, *information voids* surrounding the auditor's true level of independence engender persistent skepticism among rational investors and affects investment and consumption choices. Therefore assertions that perceptions, being inherently subjective, are not an appropriate basis for regulatory concern (and action) are flawed in the context of the audit market setting.

Two principal conclusions of general interest are a) investor and auditor preferences over the optimal amount of non-audit services may diverge with auditors choosing to provide more services than investors would prefer, and b) investor perceptions constitute an economically legitimate and theoretically sound basis for regulatory intervention.

* Electronic copies of the paper are available from the author (doogar@uiuc.edu).