17 Regulation of accountants

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1. INTRODUCTION

The services provided by the accounting professions (including auditors, accountants and tax advisers) generally include statutory and internal audits, other accountancy services – such as advice on financial controls, due diligence, and insolvency practice – and tax advisory services. Accountants may also participate in a wide range of related business activities, such as business valuation, forensic investigation, strategic planning, sales and marketing, and information technology and human resources management (Competition Bureau, 2007, p. 43). In this chapter the focus will be on statutory audits and other accountancy services reserved to one or more branches of the accounting profession.

In most jurisdictions the provision of statutory audits is an exclusive right reserved for ‘public accountants’, but the names of these professions differ from country to country. Exclusive rights may also apply to the provision of some of the other accountancy services mentioned above. In some countries, for example, the provision of tax advice is an exclusive right that is restricted to a particular profession. Of course, many other forms of entry and conduct regulation can be found in the various jurisdictions. The relevant question from a law and economics perspective is whether this regulation in fact increases the quality of and access to accountancy services.

This chapter first summarizes the theoretical justifications for regulation of accountants, which follow from the public interest approach to regulation. Also the private interest perspective on regulation is presented briefly. It then discusses the literature on some specific forms of regulation, notably licensing and certification, advertising restrictions, price regulation and rules on inter-professional co-operation and business structure. The tradeoff between liability rules and regulation is discussed in a separate section. After that, the chapter deals with some specific issues of (an alleged lack of) competition in accountancy, which are largely based on recent OECD research to which this author contributed (OECD, 2009). A short section on the value of accountancy standards closes the chapter.
2. THEORETICAL JUSTIFICATIONS FOR REGULATION OF ACCOUNTANTS

In most countries, both entry into the accountancy services market and conduct of accountancy services providers are regulated. The degree of regulation differs from country to country. In the law and economics literature, two views of regulation can be found: the public interest approach and the private interest approach (see, for example, Posner, 1974; Faure et al., 1993; Hägg, 1997; Van den Bergh, 1999, pp. 108–16; Philipsen, 2003, pp. 10–27; OECD, 2007). The former looks upon regulation as a possible remedy for market failure. The latter stresses the danger of rent-seeking behavior by special interest groups via lobbying or self-regulation. Both of these approaches will be summarized here with a special focus on their application to accountancy services.

2.1 The Public Interest Approach

The public interest approach to regulation presents a number of potential grounds for regulatory intervention in a market. They have in common the fact that they are derived from perceived shortcomings of the market system itself to deal with certain problems, preventing an economically efficient outcome in a market. The economic literature generally distinguishes between four kinds of market failure: information problems, externalities, the presence of public goods and market power (Van den Bergh, 1999, pp. 108–11; Philipsen, 2003, pp. 10–19; Cooter and Ulen, 2007, pp. 43–47). Intervention in the market, either by the government or in the form of self-regulation, may be necessary to cure these market failures. Such intervention could involve liability rules, taxes and subsidies, or some form of regulation, depending on the particular market failure. The public interest approach to regulation assumes that any intervention in a market is directed towards gaining an improvement in welfare. However, one has to be careful in choosing the optimal form of regulation, as regulation may generate costs by excessively restricting competition that can outweigh the benefits (Ogus, 1994, p. 30; Lazzarini and Carvalho de Mello, 2001, pp. 187–90). It should also be noted that there are other possible justifications for regulation, such as those resulting from distributive purposes or paternalistic arguments (Ogus, 1994, pp. 218–19). These will not be discussed here, as their relevance to the case study of accountancy is limited.

2.1.1 Information problems

Markets for professional services are often characterized by information asymmetry between professionals and their clients: professionals know more
about the quality of the service they provide than their clients. There are several reasons for the existence of this information asymmetry. First, professional services generally involve application of the professional’s human capital in order to judge individual cases; and second, evaluation of the quality of the service itself may be very difficult (Arruñada, 2006, p. 52). In addition, the provision of many professional services does not occur on a regular basis (for example, legal services and medical services), so learning by repeat buying and reputation have only limited impact. Professional services are ‘experience goods’, the quality of which can only be determined after having consumed or used it, or ‘credence goods’, the quality of which cannot be assessed correctly even after consumption of the good (Nelson, 1970; Darby and Karni, 1973).

The information asymmetry may give rise to quality deterioration resulting from adverse selection (Akerlof, 1970; Leland, 1979). If clients cannot evaluate the quality of professional services provided by individual professionals, but can only discriminate on price, professionals have no incentives to provide high quality services. Bad professionals will drive those who provide high quality services out of the market and some form of quality regulation might be needed to convert the market outcome of low quality and low price into one characterized by higher quality and reasonable price. In addition, information asymmetry between a professional and his client could lead to the ‘moral hazard’ problem of demand generation. This occurs when additional services are provided by the professional, which clients would not have wanted if they were fully informed, or when the professional has an incentive to over-supply quality in order to charge higher prices, even if the client would be better served with a lower quality at a more reasonable price (Trautwein and Rönnau, 1993, pp. 294–9; Van den Bergh and Montangie, 2006, pp. 193–4).

When users of professional services are business clients or public sector users rather than individual consumers or households, the information asymmetry problem is likely to be smaller. Big business users and public sector users are often expert users, requiring services that are tailored to their needs. Small business users may not have such expertise, but may nevertheless be repeat users of professional services. Therefore one would expect that in markets for professional services such as auditing and accountancy (but also in architecture and engineering) the information asymmetry is less severe than in, for example, markets for medical services (see also OFT, 2001, pp. 13–14; European Commission, 2005, pp. 3–5; Stephen, 2006). Nevertheless, some European accountancy associations have argued that, because of information asymmetry, even large business clients would be unable to assess the quality of accountancy services or to decide the appropriate level of quality for their needs. This would then be an argument for some regulation, particularly regarding appropriate entry and qualification requirements (European Commission, 2003, p. 4; Philipsen, 2011, pp. 213–14).
In accountancy, reputation can play an important additional role in mitigating information asymmetry problems, in addition to the fact that many clients are repeat users (Gilson and Kraakman, 1984, pp. 607–08; Goldberg, 1988, p. 312). For many years, business clients have relied on the reputation of the former Big Eight (now Big Four) accountancy firms for their statutory audits and other accountancy work, and in turn investors have relied on the reputation of these auditors when assessing the value of a firm in which they want to invest (GAO, 2003; OECD, 2009). In other words: an auditor’s reputation for quality and independence has an impact on perceived audit quality, giving a signal to investors about the reliability of the financial statements of firms who are clients of that particular auditor. In the light of the recent accountancy and corporate scandals, it is clear that reputation effects can also be negative. Arruñada (2004) states that the events following the Enron bankruptcy and the demise of Arthur Andersen have shown that the market is able to punish audit failures. He notes that legislators, however, are keen to use audit and financial crises as excuses to introduce additional regulation into an industry that is already heavily regulated. A book edited by Armour and McCahery (2006) includes various contributions that analyze regulatory responses to corporate scandals in the US and Europe.

Krishnamurthy, Zhou and Zhou (2006), using a sample of former Arthur Andersen clients, show that reputation effects (following Andersen’s criminal indictment in 2002) are significantly more negative when the market also perceived the auditor’s independence to be threatened in addition to audit quality. On a related issue, Autore, Billingsley and Schneller (2009) find that the clients of Andersen and the other big auditors that are characterized by higher information uncertainty experienced relatively larger share price declines compared to clients with lower information uncertainty. Hence, the value of an audit is greater when a firm is harder to value. This would imply that ‘higher information uncertainty firms suffer the most when past audits unexpectedly appear to be less reliable than previously thought’ (Autore, Billingsley and Schneller, 2009, p. 183).

2.1.2 Externalities
A second potential public interest justification for regulation of professional services arises from the presence of externalities (Van den Bergh, 1999, p. 108; Philipsen, 2003, pp. 17–19). Negative externalities appear if the quality of rendered services is poor and affects third parties. In the area of accountancy, poor auditing may negatively affect investors, banks and creditors of the audited company or even society in general, besides the company itself. Because an audited company’s value to some extent depends on the reliability of its audit, negative reputation effects in the market for accountancy are likely to have an impact on other markets, such as the stock and corporate debt markets.
Solutions to the negative externality problem may again be found in regulation of entry and qualification requirements, but also in defining clear accountancy standards (see Section 6) and rules on auditors’ independence. The relationship between regulation and liability rules is discussed below (see Section 4).

2.1.3 Public goods
Public goods have two special characteristics that distinguish them from private goods: nonrivalrous consumption and nonexcludability. Because of these characteristics the market may not (or not sufficiently) generate public goods. The question is whether professional services such as accounting can be considered a public good and whether without regulation there would be an undersupply of such services (see also Van den Bergh and Montangie, 2006, pp. 195–197, on Latin notaries). European accountancy associations have drawn attention to “the role that auditors play in ensuring reliable financial reporting and transparent capital markets” (European Commission, 2003, p. 4). However, according to OECD (2009, p. 52) this would not justify any other restrictions to competition besides those regulating sufficient access to accountancy services for (potential) clients, a reasonable minimum quality level that is also based on clear accounting standards, and auditors’ independence from their clients. Price regulation, advertising bans and quantitative restrictions do not seem to be proper solutions to a public good problem of undersupply (Philipsen, 2011, p. 205).

2.1.4 Market power
Market power in the context of the professions can result either from the existence of monopolies (possibly protected by law) and related market structures, or from cartel-like behavior by a group of suppliers. Regulation in the form of competition law is required in order to combat any cartel-like behavior and abuse of dominant positions by, for example, professional associations. The application of competition law to professional services markets in different jurisdictions is presented in, for example, Fels (2006: Australia), Goldman and Little (2006: Canada), Kolasky (2006: United States) and Philipsen (2010: Europe). Specific problems of lack of competition in the accountancy market are discussed in section 5 below.

2.2 The Private Interest Approach
The private interest approach to regulation has developed from public choice theory, capture theory and the ‘Chicago’ theory of regulation (Philipsen, 2003, pp. 23–7). These theories stress the role of interest groups in the formation of regulation. The basic idea of the private interest approach is that interest
groups are continually influencing political decisions in order to seek rents for themselves, which is unproductive from a social welfare point of view (on rent seeking, see Buchanan, Tollison and Tullock, 1980; McChesney, 1987). Resources are devoted to capturing a wealth transfer from consumers to producers. Interest groups may have such a powerful influence on politicians that their efforts to obtain regulatory failures override general preferences. Professional associations, such as accounting associations, are generally small relative to the public at large, single-issue oriented and well organized. Olson (1965) argued that these are precisely the criteria that are likely to make an interest group successful in lobbying, under the additional condition that information costs for the public at large (of finding out about the detrimental effects of rent seeking) are high.

According to Stigler (1971), regulation is acquired by the industry and is designed and operated entirely for its benefit. He stated that every branch of industry, which is powerful enough to do so, will lobby the government for the erecting of entry barriers such as obligatory training or apprenticeships, product requirements, taxes, and import quotas. Naturally, such rules are favorable to the insiders in a market. Likewise, a prohibition on advertising would lead to a less transparent market where the prices asked can be higher than in a market without advertising bans. Posner (1974, pp. 344–7) showed that there is a link between cartel theory and the theory of professional regulation: because cartels are difficult to organize and to monitor, the stability of cartels can be enhanced by regulation. Peltzman (1976), who formalized and extended Stigler’s model, argues that politicians will distribute favors and disfavors among pressure groups and voters in order to maximize their chances of being re-elected. This to some extent weakens the political power of interest groups. Becker (1983) later pointed to the fact that regulation can be the result of competition for political influence among many different interest groups. He unifies the view that governments correct market failures with the view that they favor the politically powerful: both are produced by the competition for political favors.

In order to analyze the extent to which regulation in a particular profession serves private interests rather than the public interest, one should also carry out quantitative analyses. Although there are definitely some indications in the – mostly US-based – empirical literature backing up the rent-seeking hypothesis, there is no consensus in this literature on the actual incidence and consequence of rent-seeking behavior in the professions. Often lack of data (especially on earnings, but also time-series data on prices and costs) precludes the proper use of statistical and econometric models to assess the effects of restrictive regulation (Philipsen, 2007, pp. 119–20).
3. FORMS OF REGULATION

In this section the most commonly found forms of regulation of accountants will be discussed: licensing and certification, advertising restrictions, price regulation and rules on inter-professional co-operation and business structure.

3.1 Licensing and Certification

Licensing has been defined by Svorny (2000, p. 296) as the set of regulations that limit service provision to individuals who meet certain government-established criteria. These criteria generally include educational requirements (university diploma), practical experience, and registration in a public register. Often there is ex post control on licensed practitioners: the license can then be suspended or revoked if practitioners fail to stay within the prescribed set of permissible activities. Some licenses need to be renewed after a number of years, subject to continuing education requirements, the attendance of professional workshops and courses, the payment of a fee, or a combination thereof.

Whereas licensing excludes certain practitioners from the market, under a certification system non-certified professionals are still allowed to be active on the market. Certification refers to the protection of a title. Those who do not have the certification may not use the protected title (Curran, 1993, p. 53). It facilitates the communication of information about human capital investments, such as training levels (Shapiro, 1986, pp. 852–3). As with licenses, some certifications are valid for a lifetime, while others have to be renewed on a regular basis. Although the state can be involved in the formulation and enforcement of certification systems, they are more commonly found in self-regulation.

The argument for licensing suggests that the average quality level of services is raised by eliminating suppliers who are lowly educated. The validity of this argument depends upon the relationship between the educational level of a practitioner and his or her marginal cost of providing high quality (Curran, 1993, p. 58). Shapiro (1986) shows that if the relationship between human capital and high quality is indeed positive and if suppliers can build reputations over time by providing high quality, consumer welfare can be enlarged by licensing. However, according to Shapiro’s model, this holds only if consumers value high quality significantly compared to the marginal costs of providing quality for suppliers. Moreover, licensing will never lead to a Pareto-improvement, because there will always be consumers who would rather have bought low quality services at a lower price. There is a risk that licensing incites these consumers to substitute the relatively expensive licensed services by cheaper alternatives, do-it-yourself remedies or services offered on the black market (Carroll and Gaston, 1981; Philipsen, 2011, p. 207).
There are other considerations that should be taken into account when analyzing the pros and cons of licensing. Politicians, bureaucrats and incumbent professionals all derive benefits from the administrative requirements set out in licensing systems (Ogus and Zhang, 2005, pp. 138–41). Moreover, it is clear that incumbent professionals benefit from a limitation of the number of new entrants (Friedman and Kuznets, 1945; Moore, 1961; Stigler, 1971). From a private interest perspective, it is therefore not surprising that professional associations actively promote and support licensing. The more conditions potential market entrants have to fulfill to gain their license, the higher the entry costs. If competition is restricted, service providers’ earnings rise and consumers are left with fewer options and higher prices. Leland (1979) showed by means of economic modeling that professional groups are likely to set quality standards too high from a social welfare point of view. His analysis was extended by Shaked and Sutton (1981), who addressed the specific problem of the suppliers that are excluded from the primary market by licensing.

The advantage of certification over licensing is that consumers still have a choice between certified and uncertified services. Certification serves as a signal of good quality, provided that consumers can actually recognize its value. Dingwall and Fenn (1987) state that it is important that consumers can determine which of the private organizations setting up certification systems they can trust. If this is impossible, the problem of information asymmetry is shifted rather than cured. Shapiro (1986) points out that suppliers may be inclined to ‘overinvest’ in education in order to signal high quality levels through certification. Total consumer welfare may in these cases decrease if many consumers consider professionals overtrained and their services overpriced. Consumers should also be ‘smart enough’ to make the right choice between certified and non-certified practitioners. The overall effect of licensing and certification depends on the heterogeneity of consumer preferences for quality, even if educational level (human capital) and quality are positively related. Licensing intervenes further in the market process than certification, but it is better able to insure risk-averse consumers against possible harmful consequences of bad services. As stated above, drawbacks of licenses are that they can be used as entry barriers by interest groups and that they may incite consumers to substitute licensed services by alternative services.

Following Friedman and Kuznets (1945), who first raised the question whether institutional barriers to entry lead to supernormal profits, a rather large body of empirical literature has developed on the effects of licensing and related forms of entry regulation on quality and fees in the professions. Cox and Foster (1990) reviewed several of these studies for the US Federal Trade Commission. They conclude that ‘while a few studies indicate that higher quality levels may result from business practice restrictions, a majority of the
studies finds quality to be unaffected by licensing or business practice restrictions associated with licensing. However, only one of these studies related to accountancy, concluding that the effect of licensing restrictions on service quality is neutral (Young, 1987). Other empirical studies on the effects of professional licensing include Kleiner and Kudrle (2000) on dentists in the US and Pagliero (2005) on lawyers in the US (see for an overview of this literature also Svorny, 2000, and Philipsen, 2011).

In a more recent study, Volkerink, de Bas, van Gorp and Philipsen (2007) address the market for pharmacists in the EU, analyzing the effects of licensing on quality, productivity and allocative efficiency by means of an analysis of variance (ANOVA) analysis. The authors use service variety as a proxy for quality and find that educational requirements (but also regulation of prices and profit margins) are positively correlated with service variety. However, requirements on registration, licensing and obligatory membership of a professional organization are negatively correlated with service variety. Another finding of the study is that productivity is negatively influenced by ‘additional licensing procedures’ such as location requirements, limitations on ownership, and barriers to entry for practitioners from non-EU Member States. Also allocative efficiency was found to be negatively influenced by these additional licensing requirements.

Bortolotti and Fiorentina (1999) address entry restrictions and quality in the market for Italian accountants in the period 1980–91. In that market the same service was provided by two distinct professions: the Commercialisti and the Ragionieri. However, only the Commercialisti were required by law to have a university degree. There were no further constraints in terms of freedom of establishment and no functional differences between the two professions. The authors’ empirical results indicate clearly that entry by the less-qualified Ragionieri and other potential entrants reduced the profitability in the market for Commercialisti. An existing institutional barrier to entry, namely the professional examination administered to some extent by incumbent Commercialisti, was effective in preserving monopoly rents in the market. The authors conclude that ‘this result casts some doubts on the view that professional boards are benevolent institutions who strive to preserve high quality standards of active professionals’ (Bortolotti and Fiorentina, 1999, p. 154).

Paterson, Fink, Ogus et al. (2003), in a report for the European Commission, provide case studies for the accountancy professions in Italy, the Netherlands, Germany and France. These case studies focus on the content of regulation rather than on the effects of this regulation. A distinction is made between entry regulation (which includes licensing) and conduct regulation. The authors also calculate a ‘regulation index’ for all EU Member States. As to licensing, statutory audit appears to be an exclusive right of one or more professional groups in all EU Member States, but market entry regulation for
other financial services differs from country to country. In Austria, Belgium, France, Germany and Luxembourg, the exclusive rights of accountants were found to be much wider than in the other EU countries, because services like non-statutory audits, accounting and bookkeeping (Austria, Belgium) and tax advice and tax representation (Austria, France, Germany) are exclusive rights of the respective professions (Paterson et al., 2003, pp. 33–8). Although the study by Paterson et al. also contains an empirical analysis of the effects of professional regulation in the EU, the results of this empirical analysis must be interpreted very carefully and should be considered primarily as an impetus to further research (Philipsen, 2007, p. 124). Responding to this study and a questionnaire sent out by the European Commission, a majority of the national accounting associations argued that appropriate entry requirements and qualifications for statutory auditors should be maintained, but they disagreed on whether qualified professionals should also have exclusive rights to offer non-audit services such as accountancy and tax advice (European Commission, 2003, pp. 4–5).

Also in the US, all jurisdictions have laws governing the licensing of certified public accountants, including requirements for education, examination and experience. However, while the use of the title ‘certified public accountant’ in each jurisdiction is restricted to individuals registered with the state regulatory authority, the other licensure requirements are not uniform (GAO, 2003, p. 51). Partnoy (2001, pp. 528–33) and Coffee (2004a, pp. 334–7) describe some other aspects of entry regulation in the US, including the role of the Public Company Accounting Oversight Board.

### 3.2 Advertising Restrictions

Advertising restrictions are common in many professions. Regarding accountancy, Paterson et al. (2003, p. 39) state that in most of the original fifteen EU countries ‘only some forms of advertising are forbidden today [2003]. Germany, Spain and arguably France and Belgium still show high regulation in this field.’ According to additional information acquired by the European Commission in 2004, tax advisers in Poland were not allowed to advertise, whereas there were also some comparative advertising restrictions pertaining to accountants. In the Czech Republic, all advertising was forbidden for auditors, while in Hungary and Poland some publicity restrictions existed (OECD, 2009, p. 31). In the US, for many decades public accountants were not allowed to advertise, solicit clients or participate in a competitive bidding process for clients. The legality of these restrictions was challenged by the Federal Trade Commission, Department of Justice and individual professionals through various court actions, beginning in the 1970s. Now the American Institute of Certified Public Accountants (AICPA) and
the state accountancy boards, which set these restrictions, target only false, misleading, or deceptive advertising, while restrictions on solicitation and competitive bidding have been relaxed (GAO, 2003, p. 8). In Canada, the Competition Bureau (2007) found that some accounting designations had advertising restrictions that set parameters on firm names and limited the information accountants may put on their business cards, stationery and business signs. Also restrictions on extravagant or self-laudatory advertising and restrictions that limit the media in which advertisements may appear were found.

While a prohibition on false and potentially misleading advertising can easily be justified from a public interest perspective, advertising of truthful information regarding quality or price (unless this discourages quality competition: Cave, 1985) should not be restricted by regulation. After all, advertising bans may increase information problems. As an instrument to prevent quality degradation that results from adverse selection, advertising restrictions are disproportional (Rubin, 2000; Stephen and Love, 2000, pp. 996–7). Economists have often analyzed the effects of advertising restrictions for professional services and what happens to fee levels when such restrictions are relaxed. Benham and Benham (1975) published a landmark paper on advertising restrictions concerning the US eyeglasses market. The authors found that prices were significantly higher in state markets with greater professional control on information. The increase in price as a result of advertising restrictions was estimated to be between 25 and 40 per cent. Five years later, Bond et al. (1980) found that the average price for certain eye care services in the US was approximately 33 per cent higher in cities where restrictions prevent both advertising and commercial practice. Stephen and Love (2000, p. 997), while referring to a review of 17 studies on advertising, conclude that ‘the general thrust of this empirical literature is that restrictions on advertising increase the fees charged for the profession’s services and that the more advertising there is the lower the fees’. They add, however, that several of these studies have methodological problems.

Hay and Knechel (2006) study the effects of advertising and solicitation on audit fees in New Zealand, in order to test the hypothesis that the crisis in auditing may have had its origin in deregulation. After all, deregulation has allowed firms to advertise their services and solicit new clients, which may have encouraged them to become more commercial by cutting fees and reducing quality, turning the audit into a commodity (for some empirical evidence on this view, see Maher et al. 1992, who studied the US audit market in the late 1970s; and Craswell, 1992, on the Australian audit market in the 1980s). In New Zealand, the removal of restrictions on advertising (1986) and against solicitation of clients (1992) were separated by six years, making it possible to examine the respective effects. The authors find that
advertising is associated with increases in fees, not decreases, which suggests quality-based advertising and not price-based advertising. The Big 8 audit firms can afford to advertise more, and the evidence shows that they received larger increases in fees after advertising was deregulated. However, large companies have more bargaining power and fee increases were not as large for them. Solicitation appears to have increased competition and resulted in lower audit fees: The big audit firms reduced their fee premiums, and larger clients received greater fee reductions. (Hay and Knechel, 2006, p. 2)

Accounting associations in Europe have drawn attention to the need for advertising to be trustworthy and in keeping with ethical standards. The European association *Féderation des Experts Comptables Européens* argued that any additional restrictions on advertising would limit communication with clients and hence hamper competition. Others have argued that more restrictive rules are necessary. A French association, for example, suggested that strict advertising rules are necessary in France to protect small firms and to make sure that consumers are not manipulated (European Commission, 2003, pp. 6–7).

3.3 Price Regulation

Price regulation exists in various forms. Obviously the most restrictive form of price regulation is price fixing, especially when the government implements it or when it is backed by a “generally binding” declaration. However, other forms of price regulation such as minimum prices, maximum prices, fee schedules and recommended prices may in practice have similar effects (see also OFT, 2001). Whereas, in theory, recommended prices could reduce transaction costs for clients – by alleviating the burden of drafting offers and/or negotiating individual fees (OECD, 2007, p. 42) – those clients may also be misled into thinking that the price recommendations are in fact fixed prices. The European Commission apparently followed this line of thinking in 2004, when it imposed a fine of €100,000 on the Belgian Architects’ Association for having adopted a scale of minimum fees (COMP/38.2549, 24 June 2004). This decision related to a procedure under the cartel prohibition of the EC Treaty.

Paterson et al. (2003) found that as a result of deregulation there are few EU countries left with rigid price regulation of accountants. Notable exceptions are Germany (general tariff for tax advisers), Italy (recommended tariffs), Greece and Portugal (fixed prices for statutory audits). In Canada in 2007, only a few rules were found that discourage accountants from lowering the quality of their services for the sake of competing on price. There was a provision stating that Chartered Accountants may only perform engagements for a significantly lower fee than what their predecessors charged when qualified members do the work in accordance with professional standards. The
Canadian Competition Bureau argued that, while this type of restriction may indeed protect the public, ‘it can discourage price competition and therefore restrict competition by cost-efficient firms’ (Competition Bureau, 2007, p. 54).

An obvious effect of price regulation is that it partly or completely excludes price competition, leaving only competition in quality. As a measure to protect business clients from excessive price competition and low-quality services, price regulation seems inappropriate. Rather we should turn to forms of direct quality regulation (OECD, 2009, p. 33). Graf von der Schulenburg (1986) has argued that in the absence of entry restrictions fixed prices increase quality, by changing the focus of competition from price to quality.

Among accounting associations in Europe, it is generally thought that price regulation (including minimum and maximum prices) is inappropriate for both audit and other accountancy services. However, there is no consensus among those associations as to the question whether recommended prices are needed or acceptable. The European-wide association Fédération des Experts Comptables Européens commented in 2003 that ‘recommended prices hinder competition and are not in the interest of the profession’ (European Commission, 2003, pp. 5–6). A related question is whether contingency fees should be allowed. Many European accounting associations argue that contingency fees should not be allowed for statutory audits, in order to safeguard professional independence and the reliability of financial reporting. This argument would probably extend to additional services provided to audit clients. However, whether contingency fees should also be prohibited for other services such as insolvency and corporate finance work is doubtful.

### 3.4 Inter-professional Co-operation and Business Structure

Accounting firms are multi-professional firms where many conflicts of interest could potentially arise, especially when auditing services are combined with other accountancy and consulting services (Fox, 2000; Mullerat, 2000; Partnoy, 2001, pp. 529–31). In the US, the Sarbanes-Oxley Act of 2002 to some extent limited the possibilities for such conflicts of interest (GAO, 2003; Coffee, 2004a, pp. 336–7; GAO, 2008), as did the 2006 Directive on Statutory Audits in the EU (see also Oxera, 2007). The concept of multi-disciplinary practices (MDPs), which are composed of accountants and other professionals such as lawyers, goes one step further. In some countries there are prohibitions on such inter-professional co-operation.

According to OECD (2007, p. 49), prohibiting MDPs is clearly anti-competitive and may cause harm to consumers. […] By bringing together the know-how of members of different professions within the same
partnership professionals can offer ‘full service’ to consumers. The supply of inter-related services may also generate economies of scope. […] An important further benefit of MDPs is that they allow internal risk spreading. […] All these benefits may lead to lower prices for consumers. Finally, MDPs may also promote innovation. Easing restrictions on MDPs may provide easier access to capital which may be needed to invest in equipment and infrastructure to improve consumer services.

The British Office of Fair Trading arrived at a similar conclusion in 2001 (OFT, 2001). The Canadian Competition Bureau recommended in 2007 that ‘regulators should look at ways to allow public accountants to work with non-accountants without jeopardizing the public interest’ (Competition Bureau, 2007, p. 59). Fox (2000), one of several lawyer-critics of MDPs in the US, suggests that this issue is more complicated. According to the author, ‘the accounting firms have hired thousands of lawyers who leave their law firms on Friday and show up on Monday doing the exact same thing for the exact same clients’, but now as employees of the big accounting firms (Fox, 2000, p. 1097). Fox argues that the non-audit work provided by the big accounting firms threatens their independence in conducting the auditing function (see also Mullerat, 2000). One should take into account that professional independence for lawyers – which refers to their independence from the government, other clients and third parties – is a different concept than it is for accountants, who have to be independent from their clients. This makes co-operation difficult.

The economic literature also provides a justification for restrictions on MDPs, which is based on ‘agency costs’. It follows from Carr and Matthewson (1990) and Matthews (1991) that sole practitioners and professional partnerships are the most likely (i.e. least costly, in terms of providing the right incentives) form of organization, because effort in production and quality cannot be judged properly by non-professionals (Garoupa, 2008, p. 483). There is, however, very little empirical evidence that confirms any of the arguments in favor or against restrictions on MDPs (OECD, 2007, pp. 50–51; Philipsen and Olaerts, 2010, pp. 13–14; see also Clementi, 2004).

In addition to rules regulating inter-professional co-operation, many countries have rules that regulate the forms of business that are allowed for accountants or the ownership of accounting firms. In the US, for example, the American Institute of Certified Public Accountants (AICPA) prescribes that under all states’ laws, certified public accountants must make up the majority ownership of all accounting firms, and other owners must be active participants in the firms (GAO, 2008, p. 59). Most accounting firms that audit public companies are therefore organized as partnerships. The goal of these rules is to limit the potential for conflicts of interest. However, prohibiting certain types of firms also makes entry into the accounting market much more difficult for potential competitors of the Big Four accounting networks (see
Section 5). The US General Accounting Office in 2003 found that the partnership structure of most public accounting firms was a factor that limited the ability of those firms to raise capital, in particular for small firms (GAO, 2003, p. 50).

The Canadian Competition Bureau (2007, pp. 56–8) presents an overview of restrictions on business structure and MDPs for its three recognized accounting designations in a number of provinces and territories. These figures reveal a wide range of restrictions. Generally, whereas sole practitioners are mostly allowed, public limited companies are generally forbidden (with some exceptions), and in some cases limited liability partnerships and private companies are also forbidden. The variance in business structure restrictions between provinces led the Bureau to recommend that rules on business structure and ownership that go beyond the minimum necessary to achieve a clearly defined public interest objective should be removed. In addition, it was found that many provinces impose restrictions on who may own accounting practices. For example, when members of an accounting designation wish to set up a professional corporation, they must ensure that one or more members own all the voting shares (Competition Bureau, 2007, p. 59). Regarding MDPs, incorporation was generally forbidden, although in some cases incorporation with comparable licensed professions was allowed.

Paterson et al. (2003) found that incorporation was allowed anywhere in the (then) EU15, except in Italy, where accountants were not allowed to incorporate in the form of a limited liability partnership, public limited company, or private company. However, often additional rules applied with regard to ownership, for example in the Netherlands, where in the case of a corporation, the majority of the owners had to be accountants. Moreover, beyond Italy, incorporation with other professions was forbidden in at least Austria, Belgium, Germany, Luxembourg (tax advisers) and the Netherlands (lawyers and non-liberal professions) (Paterson et al., 2003, p. 41). Currently, the 2006 Directive on Statutory Audits requires that in all EU Member States auditors hold a majority of the voting rights in an audit firm and that the majority of workers control the management board. Oxera (2007) analyzed the effects of these ownership rules on audit market concentration. It concluded that liberalizing these rules, by allowing outside investors to hold audit firms, could help reduce market concentration.

A number of accounting associations in Europe suggested in 2003 that rules on MDPs involving accountancy professionals are necessary in order to ‘organise the relationships between professionals who may not be bound by the same ethical rules on confidentiality, independence or conflicts of interest’. However, none of these associations supports a total prohibition on inter-professional co-operation. Some accountancy associations have suggested that only rules governing ownership of audit companies are
needed. Such ownership rules would be necessary to protect audit companies’ independence and respect for the profession’s ethical standards. The business form of audit or accountancy companies, however, does not need to be regulated (European Commission, 2003, pp. 7–8).

4. REGULATION VERSUS LIABILITY RULES

In the previous section, different forms of regulation of accountants were discussed. It should be noted that a solution to particular market failures in accountancy can sometimes (also) be found in an efficient system of liability rules (for the economic analysis of tort law, see Faure, 2009). This applies in particular to externalities. Applying the theoretical framework provided by Shavell (1984), regulation should be used instead of or in addition to liability rules if:

- governments have better (access to) information than judges in order to determine the optimal level of care that must be taken to prevent negative externalities;
- there is a risk that the potential defendant (such as an accounting firm which provides poor services leading to negative externalities) will be insolvent to pay for the damage caused by the externality. In this case, the duty to compensate under tort law does not have sufficient deterrent effect and we need regulation backed by non-monetary sanctions;
- the damage is widespread or there is no clear causal link.

In these cases, liability rules do not have sufficient deterrent effect to prevent negative externalities. Quality regulation is needed to set standards ex ante rather than ex post. As stated above in Section 2.1.2, examples are licensing, accountancy standards and rules on auditors’ independence.

At least the second and third of Shavell’s criteria have some merit in the market for accountancy services, especially when considering statutory audits. The effects of low-quality audits – and accountancy scandals such as the Enron case – on investors, banks and creditors may after all be so widespread that liability rules (and insurance) alone cannot solve this problem. The accounting scandals and escalating litigation involving accounting firms in the early 2000s also resulted in an increase in insurance costs, because insurance companies saw increased risk and uncertainty from insuring firms that audited public companies (GAO, 2003, p. 49).

In some countries, there is a cap on auditors’ liability, or there is a debate on whether to introduce such a cap. While helping to deal with the increased litigation risk, this could limit the deterrent effect of liability rules. Bigus
(2008) notes that in Germany at the time the cap was €4 million per audit for audits required by law. In the US, there is unlimited auditors’ liability from a legal point of view, but in fact the assets of the audit firm are limited because of the judgment-proofness problem. The author argues that because of special characteristics of auditors’ liability, the potentially negative effects of liability caps are mitigated. Instead, such caps might even induce efficient levels of care taken by auditors. Unlimited liability, on the other hand, would induce auditors to exert excessive care, so he argues. The special characteristics of auditors’ liability, which are central to reaching this conclusion, include: (1) the importance of reputation effects; (2) liability only in cases of negligence; (3) vaguely defined standards of due care; and (4) overcompensation as a result of liability for pure economic loss and wrong assessment of damages.

As one of the Big Four accountancy networks, PricewaterhouseCoopers (2008, p. 3) stresses that potentially disastrous liability claims remain a cause for concern, when auditors face judicial actions that would penalize firms beyond the level of their responsibility, putting their very existence at risk. The organization is therefore glad to see that a system of proportionate liability has recently been introduced in the UK, and that also the European Commission has recommended reform of auditors’ liability.

Some law and economics scholars have addressed the role of liability rules in accounting as part of a debate on gatekeepers in securities markets (see on gatekeepers, for example, Kraakman, 1986; Choi, 1988; and Goldberg, 1988). The concept ‘gatekeeper’ can be defined as a reputational intermediary who provides verification or certification services to investors (Coffee, 2004a; some scholars have used a wider definition which includes attorneys). Legal scholars have long recognized that accounting firms (and investment banking and law firms) can act as private gatekeepers to financial markets. However, according to Partnoy (2001), the questions of when and whether accounting firms should be liable for misrepresentations or fraud by public issuers of securities has not been settled. This is all the more important because accounting firms ‘earn substantial fees but often lack independence and increasingly fail to detect errors in financial statements’ (Partnoy, 2001, p. 492). The author proposes a regime where gatekeepers such as accounting firms are strictly liable for any securities fraud damages paid by the issuer pursuant to a settlement or judgment. Gatekeepers would not have any due diligence-based defenses for securities fraud. Instead, gatekeepers would be permitted to limit their liability by agreeing to and disclosing a percentage limitation on the scope of their liability for the issuer’s damages. This modified strict liability proposal would help to ameliorate the two important and parallel problems of rapidly increasing costs related to gatekeeping and decreasing value of gatekeeper certification.
In response to Partnoy, Coffee (2004a, pp. 349–53) proposes another modified form of strict liability for gatekeepers, which would convert accounting firms into insurers with a cap on their insurance obligations. This cap should be based on a multiple of the highest annual revenues the accounting firms recently had received from wrongdoing clients. Coffee’s proposal differs from Partnoy’s in that it is essentially regulatory, while Partnoy’s system is contractual. Furthermore, whereas Partnoy uses a percentage of the total damages as a minimum floor, Coffee suggests using a multiple of the gatekeeper’s highest annual revenues from the client. Finally, Coffee argues that his system would be less likely to lead to gatekeeper bankruptcies (the debate between Partnoy and Coffee continued in Partnoy, 2004 and Coffee, 2004b).

5. LACK OF COMPETITION?

The auditing and accounting services market for quoted and large companies is now very concentrated, with only four out of the former Big Eight accounting organizations left in the market (KPMG, Ernst & Young, Deloitte Touche Tohmatsu and PriceWaterhouseCoopers). This is a result of a series of mergers since 1989 and the ‘Enron scandal’ of 2001, which led to the criminal prosecution and subsequent downfall of Arthur Andersen (OECD, 2009, pp. 16–21). GAO (2003, pp. 12–15) presents a list of key factors that spurred consolidation, which include: (1) the growing size and global reach of audit clients; (2) greater economies of scale; (3) the need for greater industry-specific and technical expertise; and (4) increasing or maintaining market share. Kolasky (2000) provides a legal analysis of the merger between Price Waterhouse and Coopers & Lybrand, which took place in 1998. He argues that, although each jurisdiction (the US, Canada, Australia, the EU, New Zealand, Switzerland) presented different procedural issues in the assessment of the merger, the substantive analysis applied to the case was nearly identical anywhere. Sullivan (2002) takes an economic perspective, by analyzing the two mergers that took place in 1989 and testing whether they were anticompetitive or efficiency enhancing. The author concludes that these mergers resulted in cost reductions that benefited relatively large audit clients who switched auditors after the mergers. The explanation for this would lie in the fact that the assets of the four merging firms were now combined, making the two merged firms more successful in competing for large audit clients.

Cox (2006) argues that the accounting profession is an oligopoly, adding that the accounting profession’s poor competitive structure likely contributed to the financial and accounting scandals by making it possible to trade off better audits for consulting services. In OECD (2009), the question is posed whether there is sufficient competition and variety of services left in the audit-
ing and accounting services market for large companies. The fact that there is concentration does not necessarily mean that there is no competition. However, the competition originates from a smaller number of players and focuses on reputation rather than prices. Research by the US Government Accountability Office in 2008 suggested that the increase in concentration did not lead to higher prices charged by the Big Four (GAO, 2008). Demand by large clients for auditing services is quite inelastic.

The fact that an auditor’s reputation and size are considered as important makes it difficult for new or existing (networks of) firms to enter the market. Thirty years ago, DeAngelo (1981) – in an often cited paper – even argued that audit firm size is a reasonable proxy for audit quality, because big accounting firms would have more to lose by failing to report a discovered breach in a particular client’s records. The reason for this is that audit technology is characterized by significant start-up costs, and incumbent auditors earn client-specific quasi-rents. Arruñada (1999) argues that when firms have a sufficiently diversified client base, they also encourage independence, because the effect of client-specific assets depends on the degree of client diversification. While the author presents this argument in order to support his conclusion that the provision of non-audit services to audit clients should be left to the market, it could also be interpreted as an argument not to interfere in the market altogether, that is, not to intervene if mergers are based on efficiency reasons.

However, it is highly unlikely that competition authorities would allow another merger between the Big Four accounting firms (this is different for mergers between smaller firms), as that would limit the number of market players to three. Further concentration in the industry could nevertheless occur through a drastic event, like that involving Andersen, resulting in the dismantling of one of the four remaining firms. Even if there is no immediate risk of this, regulators should consider the impacts that such an event could have and adjust their behavior and rules accordingly. For example, the partnership structure mandated for large accounting firms limits their ability to raise capital, so it may be worth considering allowing some form of outside investment in accounting firms (OECD, 2009).

GAO (2003, pp. 45–51) presents four entry barriers into the market for big audit clients, faced by the current intermediate networks of accounting firms. First, the smaller accounting firms generally lack the staff, resources, technical expertise and global reach to audit large multinational companies. Second, public companies appear to prefer the Big Four because of their established reputation (see above and Section 2.1.1). Third, the increased litigation risk and insurance costs associated with auditing public companies generally create disincentives for smaller firms to actively compete for large clients (see also Section 4 above). Fourth, raising the capital to expand their
existing infrastructure to compete with the Big Four is a challenge for the smaller accounting firms, in part because the partnership structure of accounting firms limits these firms’ ability to raise capital. While it is concluded in OECD (2009, p. 15) that there are at least two, and probably more, accounting networks that could potentially be increased in size to challenge the Big Four, they have to deal with some of these entry barriers, notably those relating to reputation and litigation risks (on entry barriers in accounting see also Oxera, 2007).

6. ACCOUNTANCY STANDARDS

To conclude this chapter on the regulation of accountants, this section takes a sidestep by briefly considering accountancy standards. Accountancy standards such as the International Financial Reporting Standards (IFRS) and the US Generally Accepted Accounting Principles (GAAP) may serve to address some of the market failures discussed in Section 2. Notably, such standards may serve to: (1) ameliorate information and transaction costs, by creating a more uniform accounting system; (2) internalize negative externalities, by setting minimum quality standards for accounting services; and (3) increase the reliability and independence of statutory audits.

Naturally, the benefits of accounting standards depend on the content of these standards and their application in practice. OECD (2009, pp. 39–41) points out that the IFRS, US GAAP and other standards in their current form may be unable to serve these purposes, as evidenced by the many recent corporate and accountancy scandals. In addition, the subprime mortgage crisis and the credit crunch have reinforced the importance of a more uniform and more reliable accounting system, especially when taking into account that off-balance sheet vehicles have played a key role in promoting the financial crisis. It is argued that the current standards and practices for off-balance sheet vehicles may therefore need to be improved in order to limit the possibilities for accounting fraud and in order to prevent excessive risk-taking behavior by banks and business firms. Hellwig (2008, p. 62) states that distinctions between on-balance sheet and off-balance sheet positions of banks and other financial institutions should be reduced to a bare minimum, adding that ‘regulatory acceptance of such distinctions until now may have had more to do with political lobbying and regulatory capture than with any substantive argument about differences in risk exposure’.

Another issue of concern about the current accounting standards has been the role of fair value accounting (or mark-to-market accounting). International accounting standards require assets to be valued according to their current and fair value. Because of this fair value accounting, during the market turmoil in
the wake of the subprime mortgage crisis banks were required to revalue their holdings almost on a daily basis for assets that had ceased to trade. These daily write-downs to values taken from completely illiquid markets depressed market confidence in financial institutions even more and drove down their share prices. In addition, fair value accounting is based on the assumption that market prices reflect all available information, which may not be the case if an asset class becomes unduly disfavored (Hellwig, 2008, pp. 41–3; OECD, 2009, pp. 40–41). PricewaterhouseCoopers (2008, p. 11) disagrees with some commentators who have partly blamed fair value accounting for the recent turmoil in the financial markets, stating that this accounting method remains the best available method of accounting for often complex financial instruments and that it ‘makes the impact of market forces on financial performance more transparent’. Brunnermeier et al. (2009), in the eleventh Geneva Report on the World Economy, are more critical. They propose a new accounting rule called mark-to-funding, which is based on the principle that assets should be valued and managed according to the funding capacity of the holder, instead of according to the intention of the asset holder (details in Brunnermeier et al., 2009, pp. 41–6).

Laux and Leuz (2009) provide an overview of the arguments in favor and against fair value accounting. In the authors’ view, fair value accounting is not responsible for the financial crisis (as argued by critics), nor is it merely a measurement system that reports asset values without having economic effects of its own (as argued by proponents). The discussion about fair value accounting centers around the well-known and difficult tradeoff between relevance and reliability. Historical cost accounting is unlikely to be the remedy. Furthermore, accounting standards such as US GAAP and IFRS are not necessarily the source of the problem, because these standards generally allow for deviations from market prices under certain circumstances (Laux and Leuz, 2009, p. 827). Epstein and Henderson (2009), analyzing mark-to-market accounting, note that there is no perfect system of valuing a firm’s assets and liabilities. They show that it may help if standard setters are armed with an understanding of how litigation risk can influence market participants’ behavior under different valuation rules, so that these regulators can modify the existing rules in order to reduce the chance of future market meltdowns.

It is clear now that the IFRS are becoming the global accounting standards. They are already firmly established in Europe, Australasia and Turkey, and are set to be adopted by further jurisdictions, including Canada, Japan and South Korea by 2011. The US is moving in a similar direction, reducing the differences between the US, GAAP and IFRS and allegedly converging on the latter by 2016. The use of a single, universally understood accounting standard would represent a step forward for transparency, not only by making it easier for investors to compare companies’ performance regardless of their regulatory
jurisdiction, but also by making it easier (at least in theory) to tighten the accounting standards and their world-wide application, limiting the potentially adverse effects of excessive risk-taking and off-balance sheet accounting. In addition, it would reduce costs for multinationals that must now prepare multiple books and it would facilitate greater mobility of auditors, which in turn might help reduce market concentration as firms will have access to a wider pool of talent and a greater volume of resources (OECD, 2009, p. 41).

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Further Readings


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