THE MARKETS FOR INDEPENDENCE
AND INDEPENDENT AUDITORS

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Abstract

This paper develops the hypotheses that

1) auditing arose as a voluntarily supplied service and not because it was legally mandated and

2) auditors, operating in their own self-interest face incentives to be independent of the managers of the firms they audit.

The historical evidence from the U.K. and U.S. is consistent with these hypotheses. Voluntarily supplied audits are observed with the earliest forms of companies (merchant guilds) in the thirteenth century and in the forms of company that have evolved since. Furthermore, the evidence is consistent with the second proposition that auditors bear costs if they are not independent of management. Evidence is presented that professional auditors arose to reduce the likelihood of the auditor not acting independently. Finally, recent charges that auditors are not independent are found to be the consequence of assuming an expanded role for the auditor.
I. INTRODUCTION

Auditor independence is usually defined by the profession as "the ability to act with integrity and objectivity" (AICPA, 1979, p. 26). Independence has been a recurring issue for the accounting profession in the United States (U.S.), particularly with respect to the impact on auditor independence when auditors supply non-auditing services.\(^1\) The conclusion of these deliberations has varied. Congressional committees and their Staff Reports (the Metcalf and Moss Committees) conclude that auditors supplying non-audit services impair their independence. On the other hand, the AICPA committees and boards conclude that where these services may appear to impair independence, they generally in fact do not. This paper seeks to explain why the profession and the Congressional committees are reaching different conclusions and what the likely consequences are of this debate.

One conclusion of this paper is that the Congressional Committees and the profession are using different definitions of auditor independence. Moreover, these definitional differences are not just a semantic debate but rather result from different roles assumed for the auditor. The auditor's role as perceived by the Congressional Committees is to help government instill public confidence in the information reported by publicly-owned corporations [see Section V]. The auditor's clients under such a role include not only investors but policymakers and regulators. Under their perceived role, the Congressional Committees claim that government regulation "created a need for...independent

auditors" (U.S. Congress, 1976b, p. 1) and that in the absence of government regulation, auditors will lack independence. (U.S. Congress, 1976b, p. 22) These Congressional Committees ignore the role of the voluntary audit in the capital markets and any market mechanisms that discipline the auditor if he lacks independence. Ignoring the costs and benefits of existing capital market mechanisms in making policy decisions will result in a mis-estimate of the costs and benefits of the regulation of auditor independence. Hence, whether or not market mechanisms exist is important to the policy debate.

An alternative model to the Committee's views, and one that is consistent with the profession's views, assumes that market mechanisms to discipline the auditor do exist. Under this alternative view the auditor's primary responsibility is reporting on management's stewardship and, in particular, whether the firm's contracts (and by-laws) have been breached. The auditor's primary client is not the public, but rather the parties to the contracts the auditor has been hired to monitor (e.g., the shareholders and creditors). This model offers an explanation of voluntary audits prior to government regulation.

Trying to establish if market disciplining mechanisms currently exist is difficult because of the confounding effects of extant regulation on market incentives. However, if market disciplining mechanisms existed prior to the regulation of auditing it is likely that those mechanisms still exist. Consequently to test whether those mechanisms existed before regulation, two sets of alternative hypotheses are formulated.

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1Congressman Moss [1978, p. 49] states "My major concerns stem from two salient characteristics of the accounting profession: (a) the lack of an effective and disciplined process for ensuring the quality of audits..."
The first set of hypotheses are the Market Hypotheses which predict:

1) Voluntary audits will occur (before government mandate) whenever conflicts-of-interest within the firm are sufficient to warrant audits.

2) Professional auditors will be used voluntarily instead of amateurs if professionals are more efficient (including the costs of informing the market as to their independence).

If the Market Hypotheses are consistent with the evidence so that the model underlying the Market Hypotheses can explain audits prior to government regulation, it is likely that modern corporate audits are the result of both market and regulatory incentives.

The alternative set of hypotheses, the Regulatory Hypotheses, predict:

1) Voluntary audits in the absence of government regulation will occur infrequently.

2) Professional auditors (as opposed to amateurs) were required by government regulation and would not exist (or would occur infrequently) had government not required audits by professionals.  

These two Regulatory Hypotheses predict that voluntary audits and audits by professionals prior to government mandated audits are not widespread and those that are observed are aberrations. Although the Congressional Committees do not make the above predictions explicitly, the Regulatory Hypotheses are consistent with the implication (by the Congressional Committees ignoring them) that market mechanisms to discipline auditors do not exist.

1Stettler [1977], p. 20-21, for example, holds this view:

"One of the earliest steps in recognition of the need for audits occurred in England with the passage of the Registered Companies Act of 1862. The Act required that the financial statements of joint stock companies be audited by a person independent of management, and thereby greatly enhanced the status of professional auditors as well as the growth of that profession."

The statement that the 1862 Companies Act required independent auditors is false, see Section IV.

2In order to test the Congressional Committees views, testable implications must first be inferred from their writings. This is at best risky since one is vulnerable to charges that an unrealistic, obviously refutable strawman was chosen. This paper overcomes this problem by not just testing the Regulatory Hypotheses, but also by testing the two (refutable) Market Hypotheses.
Section II develops the Market Hypotheses including a definition of auditor independence. Sections III and IV present tests of the hypotheses. Section III traces the history of company auditing, primarily in the United Kingdom (U.K.), prior to the development of professional audit firms in the late nineteenth century. This historical evidence is consistent with the first Market Hypothesis—company audits are widespread and continuously observed from the twelfth century onward and were not required by government statute or regulation.

Section IV examines the development of the professional audit firm. The evidence is consistent with the second Market Hypothesis and inconsistent with the second Regulatory Hypothesis. Government regulation did not require professional audits. But rather, professional auditors replaced amateur auditors in response to changes in the market for auditors—in particular, the reduction in the costs of informing the market regarding the auditor's independence.

Using the different definitions of auditor independence as embodied in the Regulatory and Market Hypotheses and having shown that market incentives exist for auditors to be independent, Section V offers an explanation as to why the profession and the Congressional Committees are adopting these different definitions. Moreover, the likely consequences of replacing the profession's (the Market Hypotheses') definition of independence with the Congressional committees' definition are examined. Section VI presents a summary and conclusion.

II. THE MARKET HYPOTHESIS FOR AUDITING AND INDEPENDENCE

1. The Market Demand for Auditing

Recent economic analyses of the theory of the firm [Alchian and Demsetz, 1972; Jensen and Meckling, 1976 and 1979; and Fama, 1980] have explored the incentive effects of various organizational forms (e.g., corporations, partner-
ships, etc.) and the costs generated by these organizations. One particular set of costs arise from the conflict-of-interest among the various input owners who are parties to the firm. This research, relying on Coase [1937, 1960], focuses on the voluntary contracts that arise between the various parties as the efficient solution to these conflicts-of-interests. Financial statements and auditing are hypothesized to have arisen as part of this voluntary contracting process and they still serve to mitigate some of the costs of the conflicts-of-interests in modern corporations. [Jensen and Meckling, 1976; Watts, 1977; Watts and Zimmerman, 1979; Fama, 1980].

The literature has tended to focus on debt and management compensation contracts (e.g., Jensen and Meckling, 1976, Smith and Warner, 1979, and Fama, 1980). In explaining the form of those contracts, theorists assume information is produced to the point where private marginal costs equal private marginal benefits and given that information, the market price of securities and the market compensation for managers and auditors incorporates rational (unbiased) expectations of future events.

An important point that emerges from the application of rational expectations is that security holders will not, on average, lose as a consequence of the managers (or auditors) pursuing their own self-interest. In the capital markets the security price incorporates an unbiased expectation of the manager's (and auditor's) actions and the consequences for the value of the security. Hence, the security holder is price protected. In the market for managers and auditors their present and future compensation will incorporate an unbiased expectation of their actions. This, too, will protect the security holder from losing as a consequence of the manager or auditor pursuing their own self-interest.

1See Benston (1980) for a review of this literature.
Price protection leads to another important point in the analysis. Because the contracted price for the services of a factor of production incorporates an unbiased expectation of the performance of the contract, those who are expected to take actions which reduce the value of the service (the manager or auditor), or reduce the payoffs to the service under the contract bear the cost of those reductions, not the other parties. For example, the manager (auditor) bears the cost of any expected divergence in his actions from maximizing the market value of the firm through an *ex ante* reduction in his wage (fee).\(^1\)

Because agents who are expected to take actions which reduce the value of the firm or affect the returns to other parties bear the cost of those actions those agents have incentives to guarantee that they will not take such actions. It is those incentives which provide us with a definition of an independent auditor.

2. **Independence in the Market for Auditing**

A manager will only contract to restrict his actions which reduce the value of the firm (divergent actions) if he values the resultant increase in the present value of his wages more than the foregone utility of the divergent action and the cost of writing, monitoring and enforcing that contract. Likewise, the manager will only contract for an audit as a monitoring device if the marginal value of the audit in terms of reducing the manager's divergent actions is greater than or equal to the cost of the audit (including the foregone utility of the divergent action).

The audit is likely to have value in reducing the manager's divergent actions if the market holds a non-zero probability the auditor will report a breach in the contract(s) the auditor has been hired to monitor, given a breach exists. The probability an auditor will report a given breach can

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\(^1\)Moreover, *ex post* adjustment mechanisms can further reduce the divergence [Fama, 1980]. See Klein and Leffler [1981] and Telser [1980] for expanded discussion of how prices enforce quality in repeat purchase markets.
be written as the product of three probabilities:

\[ P(\text{auditor reports breach | breach exists}) = P(\text{breach exists}) P(\text{auditor discovers a breach | breach exists}) P(\text{auditor reports an existing breach}) \]

The first probability on the right hand side is the probability a breach exists. If this probability is one or zero, there is no reason to engage an auditor. The second probability is the likelihood the auditor discovers a breach, conditional on a breach existing, and this probability depends on how much effort the auditor devotes to the audit, the skill or competence of the auditor, etc. This second probability is defined as the market's expectation of the auditor's "competence." The third probability is the likelihood the auditor reports honestly if he observes a breach. We define this third probability as auditor "independence." For the audit to have value all three probabilities, as perceived by the market, must be non-zero—in particular, the auditor has some independence and competence.

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1. To derive equation (1), let \( P \) denote a probability measure, \( B \) denote a contract breach, \( R \) denote the auditor reports the breach, \( D \) denotes the auditor discovers the breach, and primes denote the compliment. Then, from probability theory,

\[
P(R|B) = P(B)P(D|B)P(R|D \text{ and } B) + P(B)P(D'|B)P(R|D' \text{ and } B)
\]

A priori, \( P(D'|B) \) is probably small and \( P(R|D' \text{ and } B) \) is close to zero; hence their product is approximately zero and the last term on the right drops out leaving equation (1). A necessary condition for the audit to have value is \( P(B|R) \neq P(B) \). This inequality holds if and only if (using Bayes Theorem):

\[ P(R|B) \neq P(R|B') \text{ and } P(B) \neq 1 \text{ or zero.} \]

But \( P(R|B) = P(R|B') \) if \( P(R|B') \approx 0 \) and \( P(B) \approx 0 \). And, \( P(R|B) \approx 0 \) if the market's expectation is non-zero.

2. Notice that our concepts of independence and competence are \textit{ex ante}, continuous variables that can range between zero and one. \textit{Ex post}, the auditor either has or has not been independent and competent. That is, the actual realization is a zero-one observation. There is no inconsistency here. Consider the following analogy: An urn contains a number of red and black balls. The probability of a red ball being drawn can vary between zero and one depending on the number of red and black balls in the urn; but, \textit{ex post}, either a red or black ball is drawn.
If the auditor is not expected to discover existing breaches (competence) and to report any discovered breaches (independence), there is no reason for the manager to change his actions. The market will not expect him to change those actions and it will not reward him for an audit. Thus, the manager has no incentives to contract for an audit. Since audits are costly, they will only be contracted for if there is a non-zero probability the auditor (1) discovers an existing breach (competence) and (2) reports the breaches he discovers (independence). In essence, the market must expect the auditor has some competence and is not completely under the control of the manager.¹

Given this analysis if audits are observed, auditors must have developed mechanisms which induced the market to hold unbiased, non-zero expectations that the auditor had some independence. One such mechanism could be the auditor's reputation. An auditor could build a reputation for competence and independence based on his past performance to fulfill contracts. That prior performance could be in auditing or in other areas of business. Failure by the auditor to

¹Assuming rational expectations (i.e., the market's expectations are not systematically wrong--biased), implies there exists some mechanisms by which the market becomes informed whenever the auditor deviates from the market's expectations of his independence and competence. One possible mechanism is the revelation of previously unreported breaches. This need not require that all (or nearly all) unreported breaches are eventually revealed, only that some of them are. The market can learn of auditor shirking or cheating in other ways including disclosures (or security trading) by disgruntled employees, observing the auditor increasing his investment/consumption plans, etc. As long as the market's expectations are unbiased, the auditor bears the cost of any divergence from the market's expectation of his level of independence and competence. See Klein and Leffler [1981] and Telser (1950).
report a breach would, if it eventually becomes known, cause the market to revise its assessment of the auditor's expected performance and the value it attaches to an audit contract with that auditor. That in turn reduces the incentives of managers to hire that auditor. Likewise, auditors have incentives to devise mechanisms to increase the market's expectations of his competence and independence, if the additional audit fees cover the costs of these mechanisms.

There is no reason to expect the auditor to be perfectly independent (i.e., \( P(R|D \text{ and } B) = 1 \)) and completely competent (i.e., \( P(D|B) = 1 \)). It may be prohibitively costly to design an audit program which would discover all breaches and ensure all discovered breaches are reported, just as it is probably prohibitively costly to build an automobile that has zero defects.

Given competition in the auditing profession, the auditor cannot systematically depart from the optimal level of independence and survive. Managers would hire more efficient auditors. Thus, the auditors who survive will be those who are expected to perform their audits with the optimal level of independence and competence and who systematically supply those levels.

3. The Consistency with the Profession's Definition of Independence

The preceding definition of independence is consistent with the profession's definition of independence as "the ability to act with integrity and objectivity." [AICPA, 1979, p. 26]. Integrity is defined as "equivalent to honesty or to trustworthiness and incorruptability even in the face of strong pressure" [AICPA, 1979, p. 26]. Objectivity is described as the "lack of bias and resistance to any conscious or subconscious influence toward action, inaction, conclusions or statements that are based on anything other than an impartial evaluation of the best available evidence" [AICPA, 1979, p. 26]. Under the Market Hypotheses a competent, independent auditor has incentives to resist pressure to deviate from performing the extent of the audit, and reporting

\(^{1}\)See Alchian [1950] for a discussion of economic survivorship.
known breaches with the frequency expected of him because if he did not resist he would not survive as an auditor.

An examination of the history of the voluntary auditing of corporate firms provides evidence regarding the Market Hypotheses and the associated definitions of competence and independence. For example, the analysis in this section predicts that given sufficient demand, mechanisms would evolve which encourage auditors to be independent (e.g., their brand-name). Evidence of the existence of such mechanisms are consistent with the Market Hypotheses. Hence, we begin by examining the history of company auditing prior to the development of the professional audit firm.

III. AUDITING PRIOR TO THE DEVELOPMENT OF THE PROFESSIONAL AUDIT FIRM

The first Market Hypothesis predicts given sufficient conflicts-of-interest within a firm, audits are likely to be a frequently used monitoring device. Moreover, the analysis in this last section predicts that if company audits were not governmentally mandated, then (given rational expectations) the auditor will devise mechanisms that assure the market the auditor has a non-zero probability of reporting a contract breach if one exists—that is, the auditor has some competence and independence. If only governmentally mandated audits are observed then we can conclude that auditors were unable to devise cost effective devices that assure the market of their competence and independence. If voluntary audits are observed in the fourteenth century only and not again until the nineteenth century, then several logical possibilities can explain this observation including: auditors were unable to devise assurances that they would not cheat or shirk. Thus, the first Market Hypothesis is refutable.¹

¹The first Market Hypothesis is also very narrow: given sufficient demand, audits will be a continuously observed (i.e., widespread) phenomena in firms and will not be mandated by government. How audits changed is not being investigated, nor is it claimed that the scope, intensity, or techniques of the audit process remained constant over the period 1300 to 1900. Large numbers of source documents for such a study are not readily available and detailing how auditing changed over a 600 year period is clearly beyond the scope of this study.
The organization of the various types of early firms, the conflicts of interest they faced, and arrangements which appear to reduce those problems, and the extent to which they were audited are examined in this section. The chronological evolution of the U.S. corporation is presented, starting with the English guilds, followed by the regulated companies, and then the joint stock companies.

1. English Guilds

Merchant guilds appeared in England shortly after the Norman Conquest (1066 A.D.) [Gross, 1890, I, p. 4; Ashley, 1923, p. 71; Scott, 1912, p. 7]. According to Gross [1890, I, pp. 3-4] the guild of merchants arose to protect the prosperity of the merchants that followed the Conquest by forming cartels to monopolize trade.\(^1\) Gross further states that merchant guilds did not exist before the Conquest because there was very limited trade and hence little to protect. A guild was chartered by the Crown and given a monopoly over trade within its own particular town. Members of a guild were not allowed to enter into partnership with non-members of the guild. Further, a guildman had to share any purchase with other guild members who wished to participate in the venture, at the same price.\(^2\)

The guilds are among the earliest examples of incorporation. Gross [1890, I, p. 99] suggests the reason is that most guilds held property. If the guild itself was not able to hold property there would be substantial costs in changing title as individual members died and new members were admitted. Hence, the idea that the organization itself was "to continue indefinitely as

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\(^1\) Also see Ekelund and Tollison [1979]. Besides functioning as a cartel, guilds performed other functions including social, religious, and municipal government. Although these other functions for some guilds might be more important than the cartel enforcing, mercantile functions, it is these later functions that are the focus of the subsequent analysis.

\(^2\) In the twelfth through fourteenth centuries the merchant guilds in the larger towns started to specialize by craft or trade. The organization of these craft guilds (sometimes called mercantile societies or companies of merchants) is similar to that of the merchant guilds (see Gross [1890, I, pp. 106-157]; Scott [1912, p. 8]).
the owner of the premises devised" arose [Scott, 1912, p. 3]. The idea that the whole body could act and that the act was separate from that of a member was expressed in the development of the common seal to be used to provide evidence that the corporation itself was acting [Scott, 1912, p. 3]. Guilds were expressly incorporated as early as the reign of Richard II (1367-1400) (see Gross [1890, I, p. 99]).

From examining the historical evidence, the following points emerge.

i) **Conflicts-of-interest existed in the guilds.** The members of the guild provided resources which were administered by the officers of the guild. The major officers generally consisted of an alderman or master and his associates, called stewards, skevins or warden.s. The number of stewards generally varied from two to four and in some places the stewards fulfilled the alderman's role [Gross, 1890, I, pp. 26-27]. The resources which the alderman and stewards administered came from revenues such as entrance-fees, fines and assessments, and tolls. Further, according to Gross [1890, I, p. 28] many guilds had lands and tenements. In addition, the officers often traded on behalf of the members. The alderman had the right to make decisions about resources owned by the members just as the corporate manager makes decisions about resources owned by shareholders. The conflict of interests between manager and owner was present. Given that, it is not surprising the manager's acts were restricted. The alderman and stewards had specific duties and roles to fulfill (see Gross [1890, I, pp. 23-35]). Further, given the restrictions on the guild officers' actions, we would expect to observe that the officers' actions would be monitored.
ii) **Guild officers were monitored and audits were a prevalent monitoring device.** The constitution of the merchant guild at Ipswich in 1200 requires that the alderman "on oath shall make due return, annually before the bailiffs and coroners (or the town) of all profits arising during the year" from the guild's monopoly trading of stone and marble [Gross, 1890, I, p. 25]. The merchant guild at Bury St. Edmund's had, by 1304, provision for an annual audit [Gross, 1890, II, p. 34].

Boyd [1905, pp. 78-88] presents several examples of craft guilds and companies of merchants being audited annually and suggests that there are more examples which might be given. The records of the Worshipful Company of Grocers of the City of London and the Worshipful Company of Pewterers of the City of London indicate, in 1346 and 1546 respectively, that the accounts of those two companies were audited annually. Similarly, the accounts of the retiring Warden of the Worshipful Company of Carpenters were carefully audited each year from the fifteenth century on by a committee of past wardens and other members and based on their report, the balance, if any, of his bond returned to the retiring Warden [Boyd, 1905, pp. 86-88]. The evidence suggests that the audits were not superficial and were not merely counts of cash or assets on hand. Expenditures were examined in detail. Boyd cites several examples of the auditors refusing to certify and disallowing various charges.

The audits of the guilds appear designed to monitor the managers' contracts. It came at the end of their tenure and was designed to check for unauthorized expenditures. Further, it also appears to have been designed to check for other breaches of contract. In at least one case, the auditors of a craft guild

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1 This reference is to the original Latin text of documents supplied by Gross in Volume II to support his statements in Volume I. We obtained the details of the audit by having the Latin translated.

2 Boyd [1905, p. 87]. Bonding is hypothesized by Jensen and Meckling [1976, p. 325] to be a way to reduce the costs, that arise from conflicts of interests.
explicitly fined the master and wardens for breaching certain ordinances (i.e., breaching their contract -- Boyd [1905, p. 81]). The prevalence of guild audits and bonding arrangements supports the Market Hypothesis that conflicts of interest create incentives for bonding and monitoring technologies (including audits) to be devised.

iii) The guild audits conducted by a committee, as opposed to a single auditor, increases the independence of the auditors. It is more difficult for the manager to bribe a whole committee than a single auditor not to report a contract breach. The success of such a side payment requires the collusion of all committee members, each of whom has incentives to break the agreement. Furthermore, the committee members usually consists of four guild members and occasionally public officials.¹

iv) Auditors were penalized for failing to perform the audit as expected. These penalties provide the auditor with an incentive to be competent and independent. An auditor would be heavily fined for not completing the audit in due time (see Boyd [1905, p. 81]) thereby affecting his reputation and in the extreme lose his share of the guilds' monopoly profits. In one case, at least, the guild auditors had to own property [Gross, 1890, II, p. 34]. Presumably this requirement made it easier to recover damages against them if they breached the contract thereby providing the auditors with further incentive to report a breach, if one occurred (i.e., to be independent and competent).

2. Merchant Adventurers/Regulated Companies

Prior to the latter half of the thirteenth century the English export trade was generally conducted by the German Hanse Merchants [Gross, 1890, I,

¹ The development of the incorporated borough is closely related to the development of the merchant guild with the officers of the borough tending to be drawn from guild members (see Gross [1890, I]). Observing borough audits similar to those of the guilds (see Boyd [1905]) suggests the type of audit described above was a widespread phenomena in the fourteenth, fifteenth and sixteenth centuries.

² Initially, the auditors were compensated in goods and later were paid. For example, in the Spanish Company (circa 1600) the eight auditors were paid twenty shillings [Croft, 1973, pp. 79-80].
p. 140]. However, from that time until the seventeenth century the export of English raw products was conducted through English and foreign merchants who were given a monopoly over the export of raw products (principally wool). Certain towns were specified for the shipping and sales of those products, companies of merchants were eventually formed, and the system facilitated the collection of the Royal customs [Gross, 1890, I, p. 144].

In the fourteenth century under Edward III's auspices the cloth industry grew in England and manufactured goods, primarily cloth, began to be exported. In the late fourteenth and early fifteenth century, English merchants involved in this trade applied for charters for organizations to monopolize the trade. In 1391, 1407 and 1408 charters were granted to English merchants trading with Prussia, the Netherlands and Scandinavia respectively. The latter two companies were later known as the Merchant Adventurers of England and the Eastland Company [Scott, 1912, pp. 8-9]. In the sixteenth century companies of merchants trading with other countries were incorporated, including: the Spanish Company, 1577; the Turkey Company, 1581; the Venetian Company, 1583; and the Levant Company (a union of the Turkish and Venetian Companies), 1592. ¹

There is evidence that some of the members of the early regulated companies were also members of companies of merchants. For example, the minutes of the Merchant Adventurers were kept in the same book as those of the Mercers' Company of London and the Mercers' Hall was Adventurers' headquarters until 1666 [Gross, 1890, I, p. 149]. These facts suggest the members of the merchants who began the Merchant Adventurers came from the Mercers' Company. Given this relationship, it is not surprising that the form of organization of the regulated

¹In exchange for granting and enforcing the cartel, the Crown was often made a partner or given low interest "loans" [Ekelund and Tollison, 1979]. The regulated companies passed by-laws governing commerce with the foreign countries. Their rules were specific and governed details of family and social life [Scott, 1912, p. 10]. Breach of the rules could lead to a member losing his freedom to trade with the foreign country.
company is similar to that of the company of merchants, craft guilds and the
merchant guilds.¹

The four conclusions drawn from examining the development of the guilds also
carry over to the regulated companies.

1) **Conflicts-of-interest existed in the regulated companies.** Regulated
companies had corporate property for which the officers would be held liable to
account. Funds were raised by fines for admissions and special levies and were
used to provide loans to British and other sovereigns (in return for increased
privileges) and for "residences" at chief English towns [Scott, 1912, pp. 10-11].
Since conflicts-of-interests existed for the regulated companies, the analysis
underlying the Market Hypotheses predicts it is likely for them to adopt the
bonding and audit mechanisms from the guilds and companies of merchants.

ii) **Officers were monitored and audits were a prevalent monitoring device.**
Most of the regulated companies appear to have been audited.² Before 1632 the
Levant Company elected auditors as required (i.e., when accounts were presented).
After 1632 auditors were elected annually [Epstein, 1908, p. 68]. The Register
Book of the Spanish Company includes an entry that at the meeting of the general
court (shareholders' meeting) on September 7, 1604 the treasurer "brought in his
account" and eight auditors were appointed to examine it [Croft, 1973, pp. 11 and
79].³ Six were assistants (directors) and two were ordinary members. The

¹By the fifteenth century some guilds had developed a system of administration
consisting of a governor and a number of associates, usually a multiple of
twelve. For example, the alderman and four associates of the Ipswich guild
(see p. 17) was replaced by a governor and 24 associates (see Scott [1912,
p. 7]). This change is also reflected in the organization of the Merchant
Adventurers of England which in its 1505 charter called for the election of a
governor and 24 associates [Scott, 1912, p. 9].

²Every regulated company whose original records were available to us was audited.
However, in the commentaries on the records, the fact that they were audited
was often not mentioned. Consequently, non-mention of an audit by an authority
on a particular company does not necessarily imply an absence of audit.

³Apparently, accounts were also presented annually to the company before
the war. Croft [1973, p. xxix] notes that neither the last treasurer,
George Hanger nor his immediate predecessor, Sir John Watts bothered to
present accounts (because the company broke up due to the war). The
accounts presented on September 7, 1604 were Hanger's apparently from
before the war because the register book also records a resolution warning
Watts to present his account with all convenient speed.
Eastland Company also had auditors. A letter from the Company at London to the Company at York in 1674 refers to the auditors being dissatisfied because the details were not supplied for certain charges [Sellers, 1906, p. 97]. The codification of the ordinances and decrees of the Merchant Adventurers of Bristol in 1618 includes a requirement that the treasurer present a statement of receipts and payments at the annual meeting and "yield vpp his accompt before Auditors assigned for that purpose" [Latimer, 1903, p. 69].

As in the guilds, the monitoring mechanism of auditing was supplemented by the bonding of officials. The treasurers of the Merchant Adventurers of Bristol [Latimer, 1903, p. 69], the Spanish Company [Croft, 1973, p. 79], the Levant Company [Epstein, 1908, p. 73] and the Eastland Company [Sellers, 1906, p. 24] were required to post bonds. Further, these bonds were substantial (the Levant Company's was £400, the Spanish Company's £500 and the Eastland Company's 1000 marks sterling -- the Merchant Adventurers do not specify an amount). In addition, officials in towns other than London and in foreign towns were required to post bonds (e.g., see Sellers [1906, p. 25]).

iii) Audits were performed by committees. The form of the audit of the regulated company is similar to that of the merchant and craft guilds and companies of merchants.¹ A committee of members was elected to audit the treasurers' accounts. One difference was the increase in the size of the audit committee which likely was due to the larger scale of the regulated companies. Not only were the general accounts audited but so were the accounts of the company in other towns.

iv) Auditors were penalized for non-performance. As in the craft guilds the auditors could be fined for refusing to act [Sellers, 1906, p. xxiii].

¹Although the composition of the audit committees were similar across guilds and regulated companies, we do not know whether the scope of the audit, its intensity, or techniques were similar. We suspect they were, but for the Market Hypotheses, it is not required that the audit be the same in 1600 as it was in 1300, only that both types of organizations provided for a periodic examination of the accounts.
It appears from the existence and the similarity of the requirements across all the companies whose records we can obtain that auditing of regulated companies was the usual if not the universal practice. Further, the similarities of audit arrangements (e.g., the use of bonding of the officers and the audit to determine how much of the bond to return) and the commonality of membership with the guilds suggests the audit was adopted from the guilds. This in turn suggests the same mechanisms provided the auditor with incentives to be competent and independent (i.e., the use of committees and penalties -- including loss of reputation).

3. **Joint Stock Companies**

In 1553, one and a half centuries after the appearance of the first regulated company, another form of corporate firm appeared in England, the joint stock company. The first joint stock companies, the Russia Company and the African Adventurers, were formed for overseas trade just like the regulated companies. However, a major difference in the two was the method of financing the trade. In the regulated company each member supplied his own capital and traded on his own account or in partnership borrowing or using his own ships [Willan, 1956, p. 19]. In the joint stock company the officers of the company traded on behalf of all the members or shareholders. Initially, capital was raised to finance each separate voyage and the proceeds from the voyage were distributed after the voyage was completed.¹

The majority of members of the Russia Company were London merchants already engaged in foreign trade (regulated companies and Merchant Adventurers -- Willan [1956, p. 21]). Hence, it is not surprising that the 1555 Charter of Russia Company was hard to distinguish from that of a regulated company.

---

¹One popular reason for the changed financing method used in the joint stock companies is that the scale of the voyages were larger and given limited partners' wealth more capital can be raised via stock. However, the first two joint stock companies, the Russia Company and African Adventurers, were smaller ventures than regulated companies. An alternative explanation is that joint stock companies were involved in substantially riskier ventures than regulated companies and joint stock companies were used to diversify the additional risk. (See Epstein [1908] and Willan [1956, p. 22].)
[Willan, 1956, p. 22]. The joint stock character of the company was not explicitly recognized in the charter [Scott, 1951, I, p. 19]. Like a regulated company or a guild of the time, the Russia Company had a governor and 24 assistants [Scott, 1912, I, p. 20].

In the joint stock company conflicts of interest existed between the officers of the company as in the regulated companies. In fact, the problems probably became more acute because the officers performed the trading instead of the members. Hence, the analysis underlying the Market Hypotheses predicts monitoring of the officers' contracts including the use of auditing.

The first joint-stock companies were audited. Sources external to the company indicate that at least in the 1580's, and afterwards the Russia Company, was audited annually [Willan, 1956, p. 23] as was the East India Company for the first four years of its existence (September, 1599 - August, 1603) [Stevens, 1967, p. 107].

The practice of having a committee of shareholders (members) and/or directors audit the joint stock corporation's accounts continued into the eighteenth and nineteenth centuries. DuBois [1938, p. 300] reports that in that century companies frequently had provision for the annual appointment of a committee of shareholders

---

1 The African Adventurers operated without a charter. It was comprised of five chief adventurers who in turn had partners "under" them [Scott, 1912, I, pp. 21 and 30]. The company made calls on its shares to finance each voyage and then distributed the proceeds in accordance with the shares. The company probably never sought a charter because it wished to keep its operations secret to avoid difficulties with the Portuguese [Scott, 1912, I, p. 21]. The company ceased operations in 1566 [Scott, 1912, I, p. 34] and it was not until 1588 that another company was formed to trade with Africa [Scott, 1912, II, p. 10].

2 In the Russia Company at least this apparently led to greater agency problems (i.e., less control) than was the case with the regulated company. See Scott [1912, II, p. 47].

3 The history of the Russia Company before 1666 has to be traced from sources outside the company, since like many of the other companies the Russia Company's own records were destroyed in the great fire of London. Consequently, the statement above is based on outside sources and it is possible that the accounts were audited before 1580.

4 From 1621 on, the East India Company first appointed two paid officials, and then one, with the title "Auditor" [Foster, 1924, p. 9]. This practice appears to be unusual.
to inspect the accounts. Forrester [1980] describes the accounting and control system of a canal company from 1768 to 1816 and that description includes sureties or guarantees provided by officers combined with an audit at the end of an officer's term of employment. Ma and Morris [1980, p. 26] examined the records of Australian and British joint stock banks prior to the 1844 Companies Act and found that those banks "had their accounts audited by the directors or provided for auditors to be appointed from the general body of shareholders."

U.S. corporations also used audit committees. The Bank of Commerce in New York in their Annual report dated May, 1850 reports "The usual quarterly examinations, with the usual satisfactory results have been made during the year by Committees of the Boards of Directors." The 1781 Charter of the Bank of North America specified that at every quarterly meeting of the board, two directors are chosen to every day inspect the books. The Philadelphia National Bank, chartered in 1804 appointed a committee of directors to examine the books (quarterly) and "audit the bank's assets monthly." [Wainwright, 1953, p. 20.] Also, the Union Canal Company of Pennsylvania issued annual reports from 1824 through 1847 that indicated that the accounts were examined by a committee of directors.

4. Summary

The survival of the bonding and auditing practices from the Ipswich merchant guild in 1304 to the British joint stock banks of 1836 and U.S. banks and canal companies of the mid-nineteenth century are consistent with the first Market Hypothesis. We observe mechanisms being devised which supplied the incentives for auditor competence and independence in the guild and regulated companies

---

1 Previts and Merino [1979, pp. 3-4] report that the Massachusetts Bay Company in 1629 used audit committees and that this practice continued through the 1870's.
(committees and penalties including loss of reputation) and in the joint stock companies. In fact, reputation probably increased in importance. In the early joint stock companies and regulated companies a merchant's reputation affected the probability that he would be elected a director or auditor, or even admitted to the company. Voting on such matters tended to be on a one-man-one-vote basis [Croft, 1973, p. 78]. Yet some merchants appear as members of the committees or courts of directors (assistants) of several companies.¹ Further, merchants frequently appear on the audit committees of several companies in that period.²

The effects of reputation on admission as a member or manager of a profitable joint stock company clearly provide the auditor with an incentive to maintain his reputation and to resist collusion with management.³ In such a situation the reputation of the merchants on the audit committee conveys information to the market regarding the competence and independence of the auditor.

¹ Of the 18 directors names in the 1605 Charter of the Levant Company, at least 9 also served on the committees of the East India Company and at least 3 also served as directors of the Spanish Company. Epstein [1908, p. 165], Croft [1973, pp. 3, 4, and 247] and Stevens [1967, pp. 6, 7, 12, 13, 121, 179 and 237].

² For example, William Harryson served on audit committees of the East India Company in 1600 and 1601 while a director of that company [Stevens, 1967, pp. 107, 156 and 156] and on an audit committee of the Spanish Company in 1605 while an ordinary member [Croft, 1973, p. 37]. Nicholas Lyng and Richard Wyche also served on audit committees of both the East India Company and the Spanish Company in 1601 and 1605 respectively [Croft, 1973, p. 37] and [Stevens, 1967, p. 156].

³ See Fama [1980] for an analysis of the effect of a manager's reputation on the manager's actions. That analysis can also be applied to the auditor.
IV. THE DEVELOPMENT OF THE PROFESSIONAL AUDIT FIRM

In the second half of the nineteenth century the committee of auditors composed of shareholders and/or directors, not professionals, that had existed for over 500 years was replaced by professional auditors in the U.K. Furthermore, the substitution of professionals occurred relatively quickly. There is no evidence of professional audit firms being employed by companies at the time of the 1844 Companies Act or even by the time of the 1856 Companies Act. But, by 1881 Pixley [1881, p. 161] reports that

"nearly all the prospectuses of new Companies now include among their officers the names of professional Accountants as their Auditors, while the older Companies are gradually replacing the Shareholders' Auditor by a professional one."

By 1900 most companies were audited by professionals [Hunt, 1935, p. 454]. In the U.S. the substitution of professional auditors for shareholder audit committees did not occur until the period 1900–1920.

The second Regulatory Hypothesis explains the shift to professional auditors as the result of government requiring outside audits. The second Market Hypothesis explains the shift to professionals as being caused by changes in relative costs of amateurs versus professionals thereby affecting the efficiency of the two. This section differentiates between these two competing hypotheses.

---

1 We define a professional auditor as an individual who specializes in, as a full time occupation, the auditing of firms.
By examining the U.K. Company Acts from 1844 to 1900 and not finding any explicit requirement that the auditor be an outside professional or that shareholder auditors are prohibited, this section refutes the second Regulatory Hypothesis. The evidence suggests that the demand for auditing increased as a result of, and a supply of professional accountants was created by, changes in the bankruptcy acts. The establishment of professional societies in response to the new bankruptcy laws is consistent with the second Market Hypothesis and the associated definitions of competence and independence in that these societies were established "in large measure, to distinguish skilled accountants of integrity from self-styled accountants whose competence had not been demonstrated." [Carey, 1969, p. 20.]

1. The English Company Acts and the Professional Auditor

By the time the Companies Act of 1900 required that companies be audited, most companies were already audited by professional audit firms [Hunt, 1935, p. 454]. For convenience in summarizing the legal requirements for auditing, we break the companies acts in the period from the first companies act (1844) to 1900 into five sets: the 1844/1845 Companies Acts; the 1856 Act; the 1862 Act; miscellaneous acts, 1868-1979, mandating audits for specific industries; and the 1900 Act.¹

1) The 1844/1845 Acts. The 1844/1845 Company Acts required directors to keep accounts and required those accounts to be audited by persons other than the directors or their clerks [Littleton, 1933, p. 289]. Furthermore, these Acts required that every auditor shall have at least one share and provided that the auditors could employ outside experts, at company expense, to assist the shareholder auditors. Littleton [1933, p. 296] suggests that the 1844 Act

¹See Dicksee [1892, pp. 156-250], Pixley [1881, pp. 163-194], and Littleton [1933, pp. 302-303] for more comprehensive lists of statutes.
was amended to further the already growing practice of hiring outside accountants to assist the audit committees.

From the evidence in the last section many companies were already audited by committees of shareholders and/or directors prior to the 1844/1845 Acts. Probably, the only significant change introduced by Parliament was the requirement that none of the auditors be directors.

i) The 1856 Act dropped the requirement of a compulsory audit (by shareholders) for companies [Hunt, 1935, p. 453].

iii) The 1862 Act provided an optional model set of articles (Table A of the Act) which provided for the appointment of auditors. However, unlike the 1844/1845 acts, audits were not required, let alone audits by outside professionals.

iv) Miscellaneous Acts from 1868-1879 specifically mandated audits for various industries (e.g., Railway Companies Act, 1867-68, Banking Companies, 1879; water companies, 1871). However, none of these acts required that professional, outside auditors conduct the audits.

v) 1900 Act re-established compulsory audits. However, by this time "the accounts of most of them were not only audited but were in fact audited by chartered accountants. Indeed, practice has generally outrun legal minima." [Hunt, 1935, p. 454.]

Nowhere in the acts summarized above is the requirement that professional, outside auditors be appointed. Hence, the development of the professional audit firm was not the direct result of government fiat via the companies acts and the evidence is inconsistent with the second Regulatory Hypothesis.

---

1See Pixley [1881] and Dicksee [1892].
2. Changes in the Demand and/or Supply of Professional Audits

If the Companies Acts did not require the substitution of professional for lay auditors, then what were the changes in either the supply (i.e., cost) and/or demand (i.e., value) of professional versus lay auditors that produced a new equilibrium--replacing an equilibrium that had existed for over 500 years? And, were any of these changes related to independence and/or competence? The analysis underlying the Market Hypotheses is first used to develop a model of supply and demand that explains the shift from lay to professional auditors. Next, the U.K. and U.S. evidence is used to test if demand and/or supply shifted as predicted by the second Market Hypothesis.

a. A Model of Professional versus Amateur Auditors

There are two costs associated with auditing—the opportunity cost of the auditor (i.e., the wage the auditor can earn in his next best employment) and the information cost of informing the market as to the auditor's competence and independence. To simplify the analysis the opportunity cost of professional and amateur auditors are assumed the same (i.e., they both have the same opportunity set). Given this assumption then professional versus lay auditors only differ by their relative information costs which in turn depend on the auditor's competence and independence. We also assume that for any given probability that the auditor will report a breach, given that a breach exists (see equation 1), professional auditors have lower marginal information costs than amateur auditors; but the professional auditors must incur a fixed start-up cost of organizing the profession.

Given the preceding assumptions, the curves $S_A$ and $S_P$ in Figure 1 represent the supply curves of amateur and professional auditors, respectively. Both amateur and professional auditors have an opportunity cost of $SP$ per audit.
Figure 1
Market for Amateur and Professional Auditors

Price/Cost

D'

P+F+T

D

P+R

P+T

V

S_A

S_P

S'_P

Q_A

Q'

Q''

D'

Number of Audits

DD = Demand for audit.

S_A = Industry supply of non-professional auditors with information costs.

S_P = Industry supply of professional auditors (if the professional society must be established).

S'_P = Industry supply of professional auditors (if the professional society already exists).

P = Opportunity cost of amateur and professional auditors.

F = Fixed cost of establishing the profession.

R = Information cost per amateur audit.

T = Information cost per professional audit.

The amateur must incur an information cost of $R per audit.\(^1\) Hence, the supply curve of amateurs (assuming a perfectly elastic supply\(^2\) at $P$) is $P+R$ or $S_A$.

---

\(^1\) In developing this model we assume for convenience that non-professional audits are conducted by a single auditor. As we have noted they were conducted by a committee of auditors. This assumption could be relaxed without altering the results.

\(^2\) The assumption of unlimited supply is made to simplify the analysis and can be relaxed without altering the results.
The professional auditor also has an opportunity cost of \( P \) per audit, but his information cost (once a profession is established at a fixed cost of \( F \)) is only \( T \) per audit where \( T < R \). The supply curve of professional auditors (assuming that there is a fixed cost of \( F \) to establish the profession) is downward sloping and is denoted as \( S_p \). If the profession does not have to incur the start-up costs (\( F=0 \)), then the supply curve is \( S'_p \).

For simplicity, assume that every corporate firm demands the same type of audit (i.e., the probability the auditor will report a contract breach, given it exists is constant), but that the value of the audit (in reducing divergent managerial actions) varies across corporate firms. Then, the corporate demand for audits can be represented in Figure 1 by \( DD \).

From Figure 1, there are two conditions that can give rise to a shift from all amateur auditors to all professional auditors -- either a shift in demand or the elimination of the fixed cost of establishing the profession (thereby shifting downward the supply curve). In Figure 1, \( Q_A \) denotes the equilibrium number of amateur audits being performed given the demand for audits is \( DD \) and the supply curves \( S_A \) and \( S_p \). This was the situation in the U.K. prior to 1860. The supply curve of professional audits at \( Q_A \) is above \( S_A \) and hence no professional audits are observed.

If demand shifts from \( DD \) to \( D'D' \), then a new equilibrium results at \( Q'' \) where only professional audits are observed. Beyond point \( V \), professional audits are less expensive than amateur audits. Thus, an increase in demand (given positive fixed costs of starting a profession) can induce the shift from amateur to professional audits.

Alternatively, if the fixed costs of starting the profession, \( F \), are eliminated, then the supply curve of professionals shifts from \( S_p \) to \( S'_p \). The fixed costs of starting the profession can be reduced if these costs are incurred for some
Table 1

Values of Companies Traded and Number of Companies in the U.K. and U.S.

A. Nominal Value of Securities Quoted on London Stock Exchange as of January 1 (£-million)

<table>
<thead>
<tr>
<th>Year</th>
<th>1853</th>
<th>1863</th>
<th>1873</th>
<th>1883</th>
<th>1893</th>
<th>1903</th>
<th>1913</th>
<th>1923</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Stocks, Bonds</td>
<td>101.0</td>
<td>347.4</td>
<td>674.7</td>
<td>1340.1</td>
<td>1205.2</td>
<td>3754.7</td>
<td>4334.8</td>
<td>n.a.</td>
</tr>
<tr>
<td>American Railroads</td>
<td>-</td>
<td>-</td>
<td>82.7</td>
<td>307.6</td>
<td>743.7</td>
<td>1107.5</td>
<td>1779.6</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total Foreign</td>
<td>101.0</td>
<td>347.4</td>
<td>757.4</td>
<td>1647.7</td>
<td>4098.9</td>
<td>4862.2</td>
<td>6064.4</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total Domestic (U.K.)</td>
<td>266.5</td>
<td>330.4</td>
<td>571.1</td>
<td>927.5</td>
<td>1401.6</td>
<td>2486.7</td>
<td>3286.8</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total Foreign/Domestic</td>
<td>361.5</td>
<td>677.8</td>
<td>1328.5</td>
<td>2575.2</td>
<td>5350.7</td>
<td>7348.9</td>
<td>9351.2</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

B. Number of U.K. Joint Stock Companies completing Registration in the decade ending January 1

<table>
<thead>
<tr>
<th>Year</th>
<th>1853</th>
<th>1863</th>
<th>1873</th>
<th>1883</th>
<th>1893</th>
<th>1903</th>
<th>1913</th>
<th>1923</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Companies</td>
<td>628²</td>
<td>2,219²</td>
<td>7,530²</td>
<td>12,138²</td>
<td>23,458³</td>
<td>43,386²</td>
<td>56,554²</td>
<td>66,809²</td>
</tr>
</tbody>
</table>

C. The Number of Business Concerns, Listed Shares and Bonds and CPA's Awarded in the U.S., 1853-1923

<table>
<thead>
<tr>
<th>Year</th>
<th>1853</th>
<th>1863</th>
<th>1873</th>
<th>1883</th>
<th>1893</th>
<th>1903</th>
<th>1913</th>
<th>1923</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of U.S. Business Concerns (000's)</td>
<td>200ᵃ</td>
<td>300ᵃ</td>
<td>494</td>
<td>866</td>
<td>1193</td>
<td>1261</td>
<td>1617</td>
<td>1996</td>
</tr>
<tr>
<td>No. of Shares and Bonds listed on NYSE</td>
<td>-</td>
<td>311ᵇ</td>
<td>432</td>
<td>875</td>
<td>1262</td>
<td>1275</td>
<td>1604</td>
<td>2012</td>
</tr>
<tr>
<td>No. of CPA Certificates Awarded in decade ending January 1⁶</td>
<td>-</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>364</td>
<td>1577</td>
<td>4609</td>
</tr>
</tbody>
</table>

¹Source: Morgan and Thomas [1962], Table V, The Stock Exchange.

²Source: Littleton [1933], Table 5, pp. 301-302.

³Source: Central Statistical Office (1866-1926).


⁵Source: New York Stock Exchange (1932).

⁶Source: Edwards [1960], Appendix B.

ᵃInterpolated.

ᵇAs on 1865.
to the bankruptcy statutes.¹ These statutes, by requiring the appointment of assignees by the court or by allowing creditors to appoint trustees or assignees, created a demand for individuals who were skilled in accounting. The Scottish bankruptcy statutes provided for the creditors to appoint a trustee to settle claims in 1772 and the first such English statute was passed in 1825.²

The difference in the timing of the formation of the first professional societies of accountants in Scotland and England has also been attributed to the difference in timing of the bankruptcy statutes [Stacey, 1954, p. 22]. The first Scottish society was formed in 1854 in Edinburgh [Brown, 1905, p. 208], while the first English societies were formed in 1870.³ The professional associations were, according to Littleton [1933, p. 283], formed to enable the public "to discriminate between the qualified and unqualified" accountants. The demand for this discrimination in England was heightened by the increase in the number of unskilled people competing for appointment as trustee⁴ following the 1869 Bankruptcy Act [Littleton, 1933, pp. 282-283].

¹For example, see Littleton [1933, pp. 271-284].

²While the potential role of the professional accountant in the 1825 English act was limited, it was expanded in the bankruptcy statutes of 1849, 1861, and 1869. [Littleton, 1933, pp. 278-281.]

³The "Incorporated Society of Liverpool Accountants" was formed in January, 1870, "The Institute of Accountants" was formed in London in November, 1870 and the "Manchester Institute of Accountants" was formed in February, 1871 [Brown, 1905, p. 235]. In 1880 the existing societies of public accountants in England and Wales were consolidated by Royal Charter into the Institute of Chartered Accountants in England and Wales with an initial membership of 527 [Brown, 1905, p. 237].

⁴One judge in 1875 remarked, "The whole affairs in bankruptcy have been handed over to an ignorant set of men called accountants, which was one of the greatest abuses ever introduced into the law." Littleton [1933, p. 283].
Professional societies arising in England and Scotland in response to the competition for the position of trustee is consistent with the analysis underlying the Market Hypotheses. The creditors in the bankruptcy want a trustee who will administer the agreement in accordance with their expectations (i.e., an independent and competent trustee). However, because information is costly, creditors are unlikely to know the exact competence and independence of each accountant. An average level of each is assigned to all accountants perceived by the creditors to be in the same class. The most competent and independent accountants in this class have an incentive to differentiate (or signal)\(^1\) their group from the least competent/independent group in the class. One way they can do this is to form a professional society which restricts entry to the most competent and independent accountants and establishes a "brand-name" to provide information on their competence/independence. These societies sought to establish their brand-names by establishing standards of conduct and examinations for admission [Stacey, 1954, p. 21] and by adopting the title "Chartered Accountant" for their members.\(^2\)

The professional societies provided a signal as to the competence/independence of their members as trustees in bankruptcy or liquidation not as auditors. The original Scottish petition for incorporation did not even list auditing as one of the public accountants' functions [Brown, 1905, pp. 207-208]. The 1880 Charter of the Institute of Chartered Accountants in England and Wales (which consolidated existing societies in England

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\(^1\)See Ross [1977], Gonedes, Dopuch, and Penman [1976], and Spence [1973] for analyses and applications of the signalling hypothesis.

\(^2\)The suggestion that professional societies of accountants were formed to provide a signal is not original to us. For example, see Carey [1969, p. 20]. Littleton [1933, p. 283] also supports this analysis. "It is not at all surprising, therefore, that the conditions of the times should have introduced a hitherto unknown element of solidarity among the skilled and experienced accountants, or that they should have banded together into professional associations which were to teach the public to discriminate the qualified and the unqualified."
lists the accountants' functions as: liquidators, receivers, trustees and auditors in that order [Robinson, 1964, p. 81]. Once the fixed costs of establishing a society to signal the quality of accountants as trustees have been incurred, it is likely that the same society at low incremental cost can signal the quality of accountants as auditors.

The preceding evidence suggests that the fixed costs of establishing an auditing profession were (nearly) zero since the start-up costs had already been incurred in establishing the public accounting profession. In the U.K. both the demand for auditing had increased and the supply curve of professionals had shifted down. Hence, we are unable to attribute the switch from amateur to professional auditors solely to a shift in demand or supply. However, the U.S. evidence allows us to make the differentiation.

c. Professional Auditors in the U.S.

As described in Section III.3, the early nineteenth century U.S. companies, like their English counterparts, were audited by lay auditors. And again, like their English counterparts, professional auditors came to be substituted for lay auditors. However, there are important differences in the timing of that substitution in the two countries.

By 1900 virtually all traded U.K. companies were audited by chartered accountants [Hunt, 1935, p. 454], yet in 1900 only a minority of U.S. listed companies were audited by professional auditors. A random sample of 51 companies listed on the New York Stock Exchange in 1900 whose annual reports were in the Harvard Baker Library or the Columbia University Library revealed only 11 companies with professional auditors.¹ This difference raises the question as to which condition was missing, the increase in the demand or the changed supply (i.e., the reduction in the start-up costs)?

¹Professor David Fehr of the Harvard Business School was kind enough to provide us with the findings from the annual reports in the Baker Library.
Panel C of Table 1 presents the growth of U.S. business concerns and the number of issues listed on the New York Stock Exchange from 1853 to 1913. Both time series portray virtually identical growth rates. Also, these two growth rates are similar to the growth of domestic U.K. nominal security values. Thus, the increase in corporate firms is common to both the U.S. and England in the period 1844-1900 and alone it cannot account for the much greater use of the professional audit firm in England than in the U.S. ¹

The growth of bankruptcy and liquidation work for the public accountant that occurred in England in the 1860’s did not occur in the U.S. The U.S. accounting firm of the late nineteenth century was not heavily involved with bankruptcies and liquidations. ² Thus, professional societies were not established in the U.S. to certify public accountants as trustees in bankruptcy work. Accordingly, the start-up costs of certifying auditors in the U.S. still remained. Given that the growth in the number of companies was common to both

¹ Although the U.K. and U.S. had similar growth rates, it may still be the case that if the U.K. started from a larger base, then demand could have shifted beyond point V in Figure 1 in the U.K. but not in the U.S. The other factors which could have increased demand in England are increased complexity and liability. The complexity of U.S. accounting lagged English accounting (e.g., depreciation was less likely to be charged in corporate accounts in the U.S. in the 1880's and 1890's, (Watts and Zimmerman [1979]). However, that increased complexity in England follows the development of professional auditors since the debates over depreciation in the U.K. in the 1880's follow the formation of the first professional societies in England (1870) and by the 1880's a substantial part of the substitution of the professional auditor had already occurred (Pixley, 1881, p. 161).

² The work of an Accountant in the United States is carried on under conditions which differ considerably from those prevailing in Great Britain. The scope of business is more limited, being confined chiefly to audits and investigations. Little of the nature of liquidations or administration of trust estate comes the way of the accountants." [Brown, 1905, pp. 278-279.]
countries, it is likely the reduction in start-up costs due to the U.K. bankruptcy laws was primarily responsible for development of the professional auditor in England and the lack of that reduction in cost which delayed the development of the professional auditor in the U.S.

The start-up costs for the U.S. profession were overcome as a result of an influx of British auditors. From 1880 to 1900 there was an unprecedented expansion in U.S. manufacturing firms [Sobel, 1965, p. 127] which had a "heavy dependence on outside sources of capital" [Hawkins, 1963, p. 251]. Much of this capital came from London (see Table 1) and as a consequence British auditors were sent to the U.S. to audit the flotation of new issues in London from the 1880's to 1900 [Moyer, 1951, p. 168; Carey, 1969, p. 27; DeMond, 1951, pp. 10-12; Pixley, 1881, p. 161]. By 1880, the English professional auditor was established (i.e., the brand-name problem was overcome) and this monitoring device was available for export.

Those British accountants who stayed in the U.S. and started their own firms\(^1\) were instrumental in setting up the U.S. professional societies [Carey, 1969, p. 37].\(^2\) The evidence suggests that since the British Chartered Accountant already had acquired the human capital in organizing professional societies, they substantially reduced the start-up costs for the Americans. The first U.S. society was organized in 1887 [Edwards, 1960, pp. 52-57; Carey, 1969, pp. 36-39] and it did not set up an accreditation system until 1896 when the first certified public accountants law in New York State was passed.

\(^1\)The first British firm established in New York in 1883 was Barrow Wade Guthrie & Co., [Carey, 1969, p. 36].

\(^2\)In fact, the American accountants proposed that the professional society confer the title of Chartered Accountant on their members but the English objected, probably because this would reduce the value of their human capital since the most important engagements were given to the British auditors [Edwards, 1956, p. 53].
After the establishment of an accreditation device, the substitution of the professional auditor for the lay auditor occurred rapidly, so that by the 1920's most companies on the New York Stock Exchange were audited by professionals.\footnote{Benston [1969, p. 519] reports that by 1926, 82% of NYSE firms were audited by professionals. The demand for professional accountants undoubtedly increased between 1900 and 1930 not only due to the continued expansion in the number of corporations but also due to the imposition of an income tax in 1913, the efforts of the New York Stock Exchange to increase its level of monitoring listed firms, etc. Note that it was not until 1933 that independent audits were required [Carey, 1969, p. 1: 149].} The growth of Certified Public Accountants is reflected in the last row of Table 1.

3. **Implications for Independence**

In the preceding subsection the evidence is consistent with the development of professional auditors' firms as a response to a demand for information on the independence and competence of auditors and hence is consistent with the analysis underlying the Market Hypotheses.

The analysis in Section II predicts that the professional society will survive only if its (costly) accreditation does, in fact, provide reliable information regarding auditors' competence and independence. Furthermore, professional societies should be concerned with standards for accreditation and with monitoring the performance of its accredited members. We observe these actions. In, or immediately after receiving, their charters the Society of Accountants in Edinburgh (1854), the Institute of Accountants in Glasgow (1855) and the Institute of Chartered Accountants in England and Wales (1880) initiated requirements for admission which depended on experience (including service under articles) and examinations (see Brown [1905, pp. 211...
and 236]). Committees were established to investigate the unprofessional conduct of members [Brown, 1905, p. 237].

If accreditation provides information regarding the auditor's competence and independence and the value of that signal exceeds its cost (following the arguments in Section II), then the professional audit will increase the value of the client firm. There is evidence that is consistent with this prediction. Pixley [1881, p. 161] observes that prospectuses of nearly all new companies included the names of professional auditors and the use of professional auditors in floating the shares of American companies on the London Stock Exchange (see DeMond [1951, p. 11]) in the late nineteenth century certainly suggest a benefit to promoters of new firms contracting for a professional audit.

With the use of professional auditors, the committee of auditors disappeared as a mechanism to encourage independence. Instead the reputation of the auditor became even more important than previously. At first the professional society provided a signal as to the auditor's reputation. However, we suggest that as large audit firms evolved they were able to achieve their own brand-name which provided a signal as to competence and independence.

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1Professional societies adopted standard designations for their members and motos that publicize the competence and independence of their members. The Scottish societies, the English Institute and later institutes in other countries (e.g., the Institute of Chartered Accountants in Australia) used the title "chartered accountant" to distinguish their members. The societies' motos are consistent with the Market Hypothesis that the societies monitored independence; the motto of the English Institute is "Recte Numerare" -- to count correctly; the motto of the Society of Accountants and Auditors (formed in England in 1885) is "Fides atque Integritas" -- reliability and integrity [Edwards, 1956, p. 158]; the motto of the Canadian Institute (formed in 1902 before auditors were required in Canada -- see Zeff [1972, Chapter IV]) is "Frobus et utilites" -- honest and useful; and the motto of the Australian Institute (formed in 1929) is "Nec Timens nec Favens" -- without fear or favor. If the Regulatory Hypothesis were true and professional societies were formed to restrict entry, we would expect motos that publicize the public interest nature of auditing.

2See Benston [1980] for additional discussion of this topic.
Development of a brand-name provided audit firms with an incentive to be independent. Large firms likely exist not only due to economies of scale in auditing and a desire by partners to diversify their risk,\(^1\) but also because large firms provide more efficient monitoring of auditors than small firms or professional societies.

Professional associations monitor only the entry level skill of members and (occasionally) expel members when their conduct has not met certain professional standards (ex post). Professional bodies do not monitor each audit engagement directly, presumably, because such an arrangement is prohibitively expensive. However, audit firms can monitor each audit directly at a lower cost than professional bodies, because monitoring is jointly produced with other activities (workload balancing, continuing education, supervision, etc.).

There is casual evidence that large audit firms have established brand-names. Firms were jealous of their name in the nineteenth century. For example, at the end of the nineteenth century, Price, Waterhouse & Co. was reluctant to allow their first representatives in the U.S. (Jones and Caesar) to use the firm name for fear of damage to their reputation [DeMond, 1951, p. 16].

The evidence in this section is consistent with the second Market Hypothesis prediction that professionals were not required by government regulation but rather were the result of market forces. Moreover, the evidence is consistent with the analysis in Section II that auditors had incentives to be independent in terms of

\(^1\)By audit economies of scale we mean the reduced inputs required to audit the last retail store over the first retail store. Also, there are economies of being able to balance work loads, in continuing education, etc. Audit firm growth is also expected as their clients expand in size if it is cheaper to audit the client's remote activities using employee-auditors rather than contracting with an existing local auditor.
the profession's definition, i.e., "the ability to act with integrity and
objectivity" and that auditors devised mechanisms (e.g., audit committees,
reputation, professional societies and large firms) to increase their
independence. Having provided evidence showing that the Market Hypotheses'
(and the profession's) definition of independence was relevant and probably
still is relevant to the extent there is a market demand for auditors, the
next section seeks to explain why the Congressional definition differs from
the profession's definition; why the current concern over auditor independence;
why is this concern primarily a U.S. phenomenon; and what are the likely
consequences of restricting auditors' ability to supply non-audit services?

V. THE EFFECT OF THE SECURITIES ACTS ON THE AUDITOR'S ROLE AND INDEPENDENCE

1. The Effect of the Securities Acts on Usage of the Term "Independent"

The term "independence" became popular after the securities acts. Prior
to that time it was not commonly used to describe the auditor's reliability
in reporting observed breaches. In fact, Carey [1969, p. 175] hypothesizes
that independence was "first used in the sense of independent contractor"
(i.e., not an employee of the company) and indeed we observe it being used
in that fashion prior to the securities acts.

The 1933 U.S. Securities Act required that firms have examinations
by "independent or certified public accountants." The Federal Trade Commission
(FTC) which administered the Act, specifically required "independent auditors"
not to have any direct or indirect interest in the client [Carey, 1969, p. 198]
and in the following year the American Institute adopted a similar ethics
rule [Carey, 1969, p. 243]. These actions had a pronounced and persistent
impact on the use of the term "independence."
A survey of the number of articles dealing with "independence" listed in each issue of the Accountants' Index[^1] from prior to 1921 to 1978 was conducted. Various subject headings[^2] were examined. In the four indexes issued prior to the 1932-35 Index, only six articles dealing with independence were cited. Of these six, the first two references are to an August 7, 1909 Wall Street Journal editorial that uses "independent audit" to describe an audit conducted by an auditor who will not yield to managerial pressure. The third reference in the Accountants' Index is to an article in The Accountant (10 February, 1923, p. 231), entitled "The Independence of the Auditor." In that article a barrister uses the term in the sense of an independent contractor.[^3] The other references were to independent audits of broker or municipal accounts.[^4] Following the Securities Acts, the 1932-35 Index contains 41 entries on independence.

[^1]: The Accountants' Index, a publication of the AICPA, indexes not only the U.S. literature but also the accounting literature of most of the English-speaking world.

[^2]: To our knowledge, the subject headings "Accountants-Independence of," "Auditing-Independent Audits," "Conflict of Interests," "Independence," and "Independent Audits," are an exhaustive set of categories that have been used to index articles on independence. However, we cannot rule out the possibility that numerous articles were written on independence prior to the 1930's, but were not categorized under one of these four subject headings.

[^3]: The Accountant article also provides a clue as to the origin of this use of the term independent. The optional Table A of the 1862 U.K. Companies Act includes in section 86 the following requirement: "The auditors may be members of the company; but no person is eligible as a member in any transaction of the company; and no director or other officer of the company is eligible during his continuance in office."

[^4]: Several other references before 1933 were found to independent auditors not listed in the Accountants' Index (e.g., Walton and Gilman [1911, p. 171]) and The Banker's Magazine (November, 1925, p. 779), but they are occasional. Also Carey [1969, p. 88 and pp. 240-243] refers to isolated uses of "independence," most notably at the 1931 annual meeting of the American Institute of Accountants where a resolution was introduced requiring an auditor to be independent of his client. The motion failed to pass. In 1932 the New York Chamber of Commerce urged corporations to have independent audits by CPA's (CPA, July 1932).
most of them after 1933, and every index (annual or bi-annual) contained
between 11 and 79 citations. 1

Comparing the U.S. and the U.K. literature provides additional evidence
of the impact of the U.S. securities acts on the use of the term independence.
The British companies acts have not used the term "independent" in setting
the requirements for auditors. The 1971 through 1974 issues of Current
Accounting Literature, published by the Institute of Chartered Accountants
in England and Wales, have no subject headings for "independence," "auditor
independence," "conflicts of interest," or "accountants independence," only
for "independent schools." 2

Much of the popularity of the term "independence" in the U.S. resulted
from the Securities Acts. However, given the evidence in Sections III and IV,
auditors were independent long before the securities acts. The crucial issues
are which parties' pressures should the auditor resist in acting with integrity
and what actions can the auditor take and still maintain independence?

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1 Further evidence of the effect of the securities acts on the usage of
"independence" exists in the leading auditing textbook, Montgomery's Auditing.
Published in seven editions spanning the period 1912 to 1949, up to the fifth
edition (1934) the moral qualities of the auditor were described as having
"a reputation for absolute integrity" (p. 30). The fifth edition, copyright
1934, still discussed the personal qualities of the auditor in terms of
"honesty," "free from bias" and confidentiality of client's affairs (pp. 10-11),
even though the 1934 Securities Act is cited (p. 669). It is not until the
sixth edition, copyright 1940, that Montgomery uses the term "independent
public accountants" (p. 3) and lists independence as a qualification of an
auditor (pp. 17-18). Yet independence is defined as "arriving at an unbiased
opinion in the face of conflicting interests" such as "between management
and stockholders, or between classes of security holders" (p. 18). That
usage is consistent with the personal qualities which Montgomery prescribed
in prior editions and is clearly consistent with the auditor monitoring
contracts between managers and security holders. The only change appears
to be the usage of the word independent itself.

2 In 1977 the British became very sensitive about auditor independence. Several
articles were written and a proposed revision in the Institute's Ethics guide
was issued that addressed auditor's independence. This recent activity has
been attributed to "little more than a reaction to Government pressure"
(Plaistowe, 1978, p. 76) and to events occurring in Europe and America (see
If auditors were independent long before the securities acts, how can the Metcalf Committee Staff Report (U.S. Congress, 1976b, p. 1) assert that a "need" for independent auditors was created by the Securities Acts of 1933 and 1934? The explanation for the Metcalf Committee Staff Report's apparent variance with the evidence is that the Staff Report envisages a role for the auditor which is different to that of monitoring contracts between shareholders, equityholders and managers. Consequently, the Staff Report's concept of independence is different to that which developed in the market place when auditing was not governmentally required. The next two subsections examine how first the Securities Acts and then regulators/politicians altered the concept of independence.

2. **The Role of the Auditor in the Securities Acts**

The stated rationale for the securities acts was that corporate disclosure is necessary to investors to be able to make rational investment decisions [Mundheim, 1964, p. 648]. Congress intended private auditors to monitor managements' disclosure [Weisen, 1978, Chapter 1, pp. 5-19] which was to be used by investors for their investment decision-making.

The role of auditing implied in the securities acts represents a change from the contract monitoring role as it existed for over 600 years. In monitoring contracts the auditor is concerned with determining whether the contracts have been breached. This involves determining whether dividends have been paid out of profits, whether the manager has overpaid himself, etc. Questions as to the correct definition of terms such as "profits" depend on what was written and what was intended in writing the contract [Pixley, 1881, pp. 93-96].
When the auditor is made responsible for accounting information for rational investment decisions, the auditor's role is expanded. Now the auditor's role depends on a model of investor decisions. As a consequence, the auditor's role is not as clear-cut as determining whether a contract has been breached or not. Further, much more information can be considered relevant to the decision, while the data relevant to a breach of contract is much narrower and specific.\(^1\)

The broader role for auditors implicit in the rationale for the securities acts is only broader in terms of the material which the auditor certifies; the parties involved in the process are the same (i.e., managers, shareholders and bondholders). The only parties entitled to sue under the securities acts are purchasers or sellers of securities. And, the rights of creditors were not changed by the securities acts (see Stettler [1977, pp. 36-39]).

The expansion of the auditor's role has an impact on the concept of independence. Before the acts in order to be independent an auditor had to resist pressures from managers and other parties to the contracts being monitored to deviate from the competence and independence expected by the market. And, the auditor had market incentives to resist such pressures. After the acts, the auditor had additional incentives to resist pressures in monitoring the reported numbers that were created by the added legal liability from the 1933 Securities Act.

3. **Expansion of the Auditor's Role Desired by Congressional Committees**

Politicians and regulators have recently reinterpreted the rationale for the securities acts to give the auditor responsibilities to parties other

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\(^1\)The 1933 Act also made the auditor liable to purchasers of securities for untrue statements or material omissions in registration statements filed under the 1933 Act [Rappaport, 1972, pp. 27.1-27.7]. The plaintiff no longer had to prove fraud or privity and negligence [Rappaport, 1972, p. 27.8] as he had to prior to the 1933 Act.
than investors. For example, the Metcalf Staff Report (U.S. Congress, 1976b, p. 1) states:

"The primary purpose of the Federal securities laws is to instill public confidence in the reliability and accuracy of information reported by publicly-owned corporations. Doubts as to the reliability and accuracy of such information impair its usefulness to the public for making efficient economic and social decisions, and defeat the purpose of the securities laws. Independent auditors perform a key function in achieving the goal of the Federal securities laws because they provide the means for independently checking and confirming the information reported by corporations."

The Moss Committee (U.S. Congress, 1976a, p. 30) goes further and includes parties other than investors and the government:

"Disclosure starts from the basic operating unit of the economy, the corporation; provides the body of knowledge describing the operation of that and other units, hence the economy; and yields the factual basis for decisions by a number of economic actors: investors, financial analysts, government policymakers, public administrators, and regulators."

In effect the Moss Committee would give the auditor a responsibility to all users of corporate financial statements and Moss (1978, p. 50) himself, claims that "The public is the 'client' to whom an auditor owes his first loyalty."

Based on an expanded concept of the auditor's responsibilities, it has been argued that auditors who supply advisory services to managers or take an advocacy position on controversial issues impair their independence.

"The 'Big Eight' firms have seriously impaired their independence by becoming involved in the business affairs of their corporate clients, and by advocating their clients' interests on controversial issues." (U.S. Congress, 1976b, p. 8)

Under the Market Hypotheses of independence an auditor could supply management services or take such actions as testifying before Congress in favor of higher natural gas prices or lobbying for a given accounting procedure on

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1 Auditor responsibilities have also been expanded by the 1977 Foreign Corrupt Practices Act which can require auditors to search for and disclose "illegal payments." The auditor must do more than report those illegal payments he finds as a by-product of monitoring contracts, he must design the audit to discover those payments [see U.S. Congress, 1976a, p. 35, U.S. Congress, 1976b, p. 7 and Moss, 1978, p. 49]. Kaplan (1980) predicts that this trend is likely to continue; that auditors will become society's policeman. Also, see Seidler and Carmichael (Weisen, 1978, p. iii).
behalf of a client and still have strong incentives to remain independent. Such actions should increase the value of the corporate firm and as a consequence increase the wealth of the shareholders and bondholders as well as the manager's wealth.\textsuperscript{1} Hence, the actions would not necessarily lead the shareholders or bondholders to change their expectation as to the auditor's independence and competence.\textsuperscript{2}

The auditor's performance of management services or his advocacy does not necessarily impair the auditor's independence even when the auditor's role is expanded as in the securities acts. The same parties are involved as in the market, managers, shareholders and bondholders. If the actions increase the wealth of all parties, there is no necessity that expectations about the auditor's independence changes as a consequence of those actions. If the actions benefit one party at the expense of another, whether or not the actions affect the auditor's independence depends on whether those actions were expected by the market and by Congress (i.e., were not intended to be proscribed as a result of the securities acts).

If the supply of management services or the taking of advocacy positions do not necessarily impair the independence of the auditor in terms of his market role or his role under the securities acts, the conclusion that the supply of services or the advocacy positions, \textit{ipso facto}, impair independence must be due to the role assumed for the auditor by the Congressional Committees. In particular, it is due to the extension of the auditor's responsibility to parties other than the managers or securityholders and to the claimed expectations of the additional parties.

\textsuperscript{1}We are assuming that shareholders, bondholders, and managers are not the firm's principal customers.

\textsuperscript{2}Even if an auditor took an advocacy position (e.g., lobbying for an accounting procedure) which would increase the wealth of the parties to the contract he monitors (e.g., shareholders) at the expense of another party (e.g., bondholders) he would not necessarily affect his independence under the market concept. The issue would depend on whether such actions were expected by the market (in our example the bond market) and impounded in the market price.
Understanding the reasons as to why politicians/regulators claim that non-audit services impair independence can do more than reconcile the politician's position with the observation that auditing has survived for centuries (implying auditors are independent). This analysis also provides insights into the reasons for and the effects of certain proposed actions, such as making it illegal for auditors to supply non-audit services, which are justified by the "need" for auditor independence.

4. The Economic Effects of Restricting Non-Audit Services

Many of the auditor's actions which, it is charged, demonstrate a lack of independence are non-auditing services supplied by the audit firm to the corporate manager -- management consulting services, executive recruiting, expert witness services, tax advice, etc. If the costs imposed on auditors and their clients by politicians charging that auditors are not independent are ignored, the auditor's marginal cost for supplying these services is likely to be below that of alternative non-auditor suppliers to the extent that these services are joint products with the audit. Hence, ignoring the political costs it is in the shareholders' interest for the manager to contract with the auditor to supply those services.

Since the auditor's cost of supplying the non-audit services includes the legal and political costs, if the legal and political costs are low, audit firms will supply those services. On the other hand, non-auditor suppliers of management advisory services, etc., have an incentive to use the political process to increase the legal and political costs of auditors supplying those services. This reduces the supply of those non-audit services and allows existing non-audit suppliers to earn rents. The political concept of independence provides a convenient argument for non-auditors utilizing the political system to restrict competition. Consequently, non-auditors are
expected to lobby to prohibit auditors from performing non-audit services. We observe non-audit firms lobbying in this fashion.\(^1\)

If the politicians or regulators use the independence concept based on their interpretation of the securities acts, thereby raising the legal and political costs to the auditor of supplying these services, the price auditors charge for non-audit services must rise. If auditors are prohibited from supplying certain non-audit services (e.g., executive recruitment), in effect the legal and political costs are infinite, consumers of these services either reduce the quantity they purchase or switch to higher cost (non-auditor) suppliers, or both. The result is a dead-weight social loss from such a prohibition to the extent auditors have a comparative advantage at supplying the eliminated services.\(^2\)

Clearly, if the auditor's independence (under the Market definition) is affected by supplying such non-audit services, the auditor bears a private cost in terms of the value of (and thus, the price he can charge for) his audit. The auditor already has private incentives to only engage in non-audit activities if the net fees are greater than the reduction in the present value of the audit to all his clients. There may, in fact, be additional social costs (externalities) associated with the non-audit services that the auditor does not bear and hence is not reflected in his decision to supply the non-audit services.

\(^1\)See the letters submitted by Half Personnel Agencies, Inc. (pp. 854-857) and numerous consulting firms (pp. 2124-2134) in U.S. Congress (1977) supporting restrictions on auditors' non-audit services.

\(^2\)The SEC's ASR 250 issued June 1978 requires the client to disclose all non-audit services provided by the auditor if they amount to more than 3\% of the aggregate fee. This disclosure requirement reduces the costs to those parties wishing to charge the auditor with a lack of independence by providing outsiders with information on the extent of the non-audit services. Therefore, more such charges will be forthcoming, higher political costs will be imposed on the auditor and client, and less non-audit services will be supplied.
services. Prohibiting the auditor (either by fiat or by raising the political
costs) from supplying non-audit services (i.e., making the auditor more
independent) is likely to raise the prices for non-audit services. The onus
of documenting that the existence of benefits from these restrictions exceed
the costs is placed on those proponents wishing to restrict auditors' actions.
We are unaware of any such evidence.1

VI. SUMMARY AND CONCLUSIONS

This paper has analyzed the evolution of corporate auditing and of the
term "independent auditor." Auditing of firms has existed for over 600 years.
Over the vast majority of that period auditing was not required by law. The
longevity of voluntary auditing suggests (given it is costly) that it provided
benefits. This evidence is consistent with the analysis underlying the

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1 The preceding analysis suggests the following testable implication -- the lower
the costs to non-auditors of excluding auditors in supplying non-audit services,
the greater the number of non-audit services excluded. The 1933 Securities
Act reduced the costs to non-auditors of excluding auditors from supplying
non-audit services by charging auditors with lacking independence. In the
U.K. no such statutory requirement that auditors be independent exists.
Hence, there should be more explicit prohibitions on U.S. auditors than on
U.K. auditors.

The AICPA has issued numerous detailed ethics rulings restricting the
activities of CPAs. The executive committee of the SEC Practice Section of
the AICPA expressly prohibits auditors from supplying psychological testing,
conducting opinion polls, executive searches, and merger and acquisition
work for a finder's fee [AICPA, 1979, p. 12]. The SEC in ASR 264 (June 14,
1979) advised that auditors providing such services as actuarial consulting,
opinion surveys, and psychological testing may be in violation of SEC
regulations. In contrast, the ethics rules in the U.K. are not mandatory
and do not list services that impair the auditor's independence [Plaistowe,
1978, p. 75]. There are no U.K. prohibitions against auditors supplying
specific non-audit services.
Market Hypotheses that holds that auditing arose to monitor contracts between managers and that market mechanisms exist to discipline the auditor if he does not resist managerial pressures (i.e., be independent) and perform the audit competently.

In the late nineteenth century professional auditors came to replace lay, shareholder auditors, without any legal requirements for such replacement. Under the Market analysis, auditor independence is defined as the market's expectation of the auditor reporting breaches of contract given a breach is observed. Market mechanisms provide lay and professional auditors with incentives to be independent (to objectively monitor the firms' contracts) because the audit fee charged depends on the market's expectation of violation of the audit contract terms. Consistent with this analysis, professional societies, first in the U.K. and then in the U.S., developed as an information source for the market regarding the accountant's independence.

With the passage of the U.S. securities acts which required audits by independent or certified public accountants, the term "independence" became common and the concept changed. Government regulation expanded the information to be monitored. More recently politicians and regulators have argued that the auditor's clients should include government officials, consumers, and the "general public" as well as those parties involved with the firm's contracts. The expansion of clients makes it more difficult for the auditor to be "independent." Prior to regulation, the auditor had to be "independent" only from the perspective of the contracting parties, in particular, management. Now, in the view of some, the auditor should be independent from the viewpoint not only of the contracting parties, but also of government regulators, consumers, and the "general public." By contrast, the U.K. has not passed government regulation requiring independence, hence we do not observe the
debates on "independence" nor the wide usage of the term "independent auditor" in the U.K. accounting literature.

One implication of this analysis is that given the existing economic and political institutions and the incentives of voters, politicians, managers, investors, etc., charges that auditors are not independent will continue to be made. That is, individuals competing with auditors in supplying non-audit services have incentives to use the coercive powers of the state to limit competition. "Lack of independence" is a handy excuse non-auditors can use to force auditors to "voluntarily" limit the non-audit services they provide, thereby allowing existing non-auditor suppliers to earn economic rents.\(^1\)

The main conclusion of this paper is that market disciplining mechanisms that provide auditors with incentives to be independent and competent have existed for over 600 years. Moreover, policymakers considering further regulation of auditor independence are likely to ignore important costs and benefits arising from the existing market mechanisms if they continue to assume that there are no market incentives.

\(^1\)For example, in 1979 the AICPA prohibited CPAs from providing executive recruiting services [AICPA, 1979, p. 12].

\(^2\)Quasi-rents may persist even after supply adjusts, if the existing non-auditor suppliers are lower cost suppliers than new entrants.
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