Discussant's response to "The relative importance of auditing to the accounting profession: Is auditing a profit center?";

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Oh, we still have a few national institutions of trust left . . . Lawrence Welk, Walter Cronkite, Roy Rogers, penicillin, Mary Tyler Moore, Price Waterhouse, and hot chicken soup. But everything is under scrutiny, including our own existence.¹

The Walker and Doll paper discusses forces behind, and consequences of, increased competition in the audit services market, using the question—"Is auditing a profit center?" Some might find this question inappropriate, because it appears to undermine the profession's reason for existence. Others might find it curious to question the viability of a service over which the profession has a virtual monopoly. However, I found the question both interesting and useful, even before recent events made it timely.² In my opinion, scrutinizing the role of auditing in the Big Eight's scheme of services can enhance our understanding of the market.

My comments focus on two major areas. First, I comment on what appears missing or only implied in this discussion of competition, specifically some benefits of competition. Here, recognize that I am biased. I view competition as generally a good thing. Of course, this view comes easily since I am removed from the upheavals and uncertainties of life in the trenches. I sympathize with individuals facing difficulties imposed by competitive forces. And, I am curious to understand these forces. But I lack empathy towards laments for "the good old days of auditing"—days of excess demand and fundamental impediments to competition. My comments on the benefits of competition reflect these biases.

Second, my comments focus on issues raised by Walker and Doll relating to quality and pricing of audit services. The profession debates whether auditing is a commodity. Extant empirical research encompasses a similar question—"Are audit services homogeneous or differentiated?" My comments on quality and pricing of audit services reference insights from portions of this research.

Benefits of Competition

Increased efficiencies represent a major benefit of competition. Walker and Doll mention improvements in audit efficiencies, primarily through use of

¹ Bombeck, E., "Will America Regain Its Trust?" Newsweek (November 19, 1979), p. 138
technology. However, their discussion of efficiencies occurs in the context of developments strengthening the career attractiveness of accounting and auditing. The discussion completely ignores any client benefits, including audit fee reductions, from increased efficiencies in auditing. Although Walker and Doll bemoan pressures to reduce fees, such pressures entail positive signs. To some extent, fee pressures reflect current efficiencies and promote future ones.

Regrettably, Walker and Doll (like others outside Big Eight firms) found cost and profit data unavailable for assessing the viability of auditing. Instead, the authors use revenue data. Rather than debate the merits of these data, let me address several issues not in the paper. First, casual evidence suggests that partner reductions in some Big Eight firms during 1983-1987 contributed to growth statistics when using an average revenue per partner measure (Table 4 in Walker and Doll paper). Such partner reductions reflect attempts to enhance efficiencies in audit practices because of competitive pressures (see PAR, April 1985).

Second, in discussing audit revenue growth, Walker and Doll identify segments of the market with expanding demand, particularly initial public offerings (IPO’s). I realize that the paper focuses on Big Eight firms. Nonetheless, from a competitive standpoint, non-Big Eight firms comprise a significant portion of the IPO market. For example, based on data from approximately 3,600 IPO’s, non-Big Eight firms had about 40% of the market throughout the period 1970-1985 [Palmrose, 1987]. In addition, both the type of underwriter and the terms of offerings seem to influence the choice of auditor [Simunic and Stein, 1987].

In addition to increased efficiencies, the availability of information on audit services and fees represents another benefit from changes in the competitive environment. Walker and Doll express some regret that audit committees not only have, but actually use this information. Frankly, I am encouraged that audit committees exercise their oversight responsibilities.

In summary, increased efficiencies and information, both beneficial to clients, represent consequences of competition in the audit services market. However, a fundamental concern regarding any adverse impact on audit quality as a by-product of increased competition remains. This leads to my second area of comments.

Quality and Pricing of Audit Services

Empirical research supports the existence of quality-differentiated audit services in the market as a whole. The evidence suggests not only that quality differences exist but also that higher quality services translate into higher audit fees [Francis and Simon, 1987; Palmrose 1986a].

However, evidence becomes problematic when comparing among Big Eight firms. Studies have found that market participants perceive differences among the Big Eight [Arnett and Danos, 1979; Shockley and Holt, 1983; Simunic and Stein, 1987]. Yet, evidence remains weak when using revealed behavior of market participants via measures including audit fees and auditor litigation. For example, I tested for pricing differentials among Big Eight firms with industry specializations and failed to detect any significant audit fee differences between
industry specialists and non-specialists [see Palmrose, 1986a]. Other studies identify one Big Eight firm [Simunic, 1980], or several Big Eight firms [Balachandran and Simon, 1988], with significantly different audit fees, although this evidence should be viewed as preliminary. Likewise, examination of litigation activities among Big Eight firms reveals some significant differences. However, results appear sensitive to the measure of litigation activities and, therefore, cannot be considered unambiguous [Palmrose, 1988a].

To summarize this area of research, evidence supports quality-differentiation in the audit services market as a whole. However, evidence does not provide clear indications of differentiation within the Big Eight.

Evidence on price cutting behavior represents a somewhat more fruitful area of research in terms of insights. Here the literature provides an economic explanation for low-balling consistent with competition in the market for audit services [see DeAngelo, 1981]. Furthermore, a recent study by Simon and Francis [1988, p. 255] contains the following findings on pricing with auditor changes:

- Significant fee reductions occur in the initial year of auditor change that average 24% of normal fee levels for ongoing engagements.
- In each of the next two years, fee reductions average 15%.
- By the fourth year, fees increase to normal levels for continuing engagements.

Perhaps the central issue in the Walker and Doll paper involves the effect of non-audit services on the pricing and quality of audit services. From the perspective of empirical research, several studies document that audit fees are higher when clients also purchase non-audit services from their auditor [Palmrose, 1986b; Simunic, 1984]. Although not the only interpretation for this result, higher audit fees are inconsistent with auditing as a loss leader for non-audit services.

Furthermore, in comparing the relative importance of audit and non-audit services to the Big Eight, Walker and Doll may be understating the vital role of audit clients in generating non-audit service revenues. In a study of over 350 public and closely-held companies, nearly 80% of the companies purchased some non-audit services (tax or management consulting services) from their incumbent auditors, while only three percent of the companies purchased non-audit services exclusively from other public accounting firms [Palmrose, 1988b]. It appears that much of the Big Eight’s non-audit service revenue is derived from services to audit clients.

However, this begs the question of whether market participants perceive auditor independence (quality) problems in conjunction with the growing importance of non-audit services to the Big Eight. Certainly, the perception of auditors marching to a beat of sell-sell-sell non-audit services while conducting audit engagements is troublesome.

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3 Actually, this test involves intra-firm quality-differentiated audit services.
4 My comments illustrate the economic benefits of joint supply of audit and non-audit services. These benefits include auditor reputation or brand name effects. In discussions at the Symposium, W. R. Kinney, Jr., emphasized the latter.
Concluding Remarks

There remains one, albeit minor, point made by Walker and Doll that requires some attention. It is the following:

In our view, academicians need to do a better job of attracting quality students to their A&A programs. The strong emphasis on research at some universities seems to have reduced the emphasis on teaching. We believe it is important that experienced instructors who are dynamic in the classroom teach at least some sections of "Principles of Accounting" as well as upper division electives.

First, room for debate exists as to whether attracting students to accounting and auditing (A&A) careers represents a legitimate role for educators. I think not. Next, it is a myth that good researchers are in general not good teachers. Frequently, good research and good teaching occur together. Furthermore, the profession is mistaken in assuming that because good teaching will not guarantee tenure at "research institutions," these institutions do not emphasize good teaching. Nonetheless, these comments demonstrate that academicians can improve communication with the profession regarding the value ascribed to undergraduate education.

Improved communication between academics and the profession on teaching likewise extends to research. As my comments on Walker and Doll's paper scrutinizing the role of auditing in the Big Eight's scheme of services indicate, we are trying to understand the same issues. In conclusion, let me emphasize how much I appreciate the opportunity to participate in this Symposium to discuss some of these issues.

References