The Demand for Auditing

Why Have a Financial Statement Audit?
- What is a financial statement audit today?
  - SEC Acts of 1933 and 1934
  - SOX Section 404
  - What do the two of these have in common?
- Audits before 1933, audits of private companies, government, etc.
- Contract between management and outsider – Examples?

Sources of Audit Demand
- Information hypothesis
- Insurance hypothesis
- Monitoring hypothesis (agency theory)

Information Hypothesis
- Financial statements = information
- Information for who?
- Information for what decisions?
- Current earnings → Future earnings → Future dividends. SP = PV of all future Dividends.

Information Hypothesis
- Audit report = information
  - Confirms
  - Disconfirms
  - Reduces information asymmetries
- Audit process → F/S adjustment
- Research: F/S info → stock price, Enron: poor audit quality – mkt tanks

Insurance Hypothesis
- Insurance for who?
- Auditor absorbs risk
- Materially Misstated F/S, no g-c/bankruptcy
- Deep pockets
- Auditor specialization (assurance) vs. insurance companies
- Do big settlements/lawsuits confirm this hypothesis?
Monitoring Hypothesis

- Agency theory
  - Principals (owners) and Agents (managers)
  - Examples?
- Conflict of interest / Information asymmetry
- Align interests – compensation – budgets / SP.
- Monitor F/S under manager control – Principal benefits
- Otherwise – cut manager salary to account for self-interested behavior – Agent benefits b/c audit keep this from happening

Monitoring hypothesis

- So auditee, in addition to users, benefits from audit.
  - Higher compensation / EBC compensation
  - Obtain loans at lower r
  - Contract with suppliers

What Does Research Tell Us?

- Chow (1982) – How do you measure audit demand post-1934?
  - This study has 1926 data and looks at the monitoring hypothesis.
  - More debt, more accounting numbers in debt covenants, more size = voluntary audit
  - Would companies voluntarily get audits today? Internal controls?
  - Are I/C and F/S audits a case of “govt. knows best?” Looking out for unsophisticated investors? Think about where requirements came from!

What Does Research Tell Us?

- Francis and Wilson (1988) – Does brand name matter?
  - B8 vs. NB8
  - More agency problems (less mgt shares, more debt, more EBC) = change to B8.
  - Today, does B4 = higher quality? Setting?
  - Audit = information → stock prices drop after G.C. opinion, but not after adverse I/C.
  - Audit = insurance → Laventhal and Horwith bankruptcy, client share prices, Menon and Williams (1994) - especially IPOs

Future Demand for Audits

- Future markets in information age?
  - Continuous auditing?
  - Fair value auditing?