Both Auditing Firms and Their Clients Need to Look at the Costs and Benefits of Management Consulting by Auditor Companies

During the ’80s there were the “Big Eight” accounting firms—eight giants that dominated the industry. Since then, the number of big certified accounting firms in the United States has dropped from eight in the 1980s to four in 2002. Over the same period the variety and extent of non-audit (management advising) services provided by accounting firms to business clients have exploded. Until recently, all of the “Big Four” firms were major providers of non-auditing services. The Enron scandal is only one of the cases that have prompted the call for government regulations restricting the involvement of accounting firms in management consulting.

There is little doubt that auditing firms that provide both auditing and non-auditing services gain a great deal from the “spillover” of knowledge from the auditing side to the consulting side, and vice versa. However, the total effects of auditing firms providing both auditing and consulting services have not been established. Martin Wu of the Illinois Department of Accountancy recently examined the structure of the market for audit services and found that price changes for auditing in response to market forces in consulting are a significant in these markets and must be taken into consideration by the big firms.

When it comes to pricing, auditing firms react to each other. Changes in productivity and competition for non-auditing services in the consulting market can induce auditors to alter their strategies and how they compete in the market for auditing services in a way that hurts some, or all, auditing firms. Therefore, auditing firms must consider not only the benefits and efficiencies of knowledge gained in the non-auditing consulting market but also the “costs,” in terms of competition, of providing both services. This tradeoff helps to explain a puzzling phenomenon in the pricing of audit fees, helps analyze the effects of restricting the auditing firms from offering both non-auditing and auditing services to the same clients (for example, restrictions imposed by the Sarbanes-Oxley Act of 2002), and helps shed light on the question of auditor independence in appearance.

Research has shown that audit clients who purchased both audit and consulting services from a single auditing firm paid higher auditing fees than did clients who purchased only auditing services. According to Wu, the tradeoff between the benefits of knowledge spillovers and the costs of competition in both realms may prevent auditors from passing the entire “savings” from providing both audit and consulting services to their audit clients. In other words, clients might well be better off purchasing auditing and consulting services separately.

Wu also notes the surprising result that regulations like the Sarbanes-Oakley Act of 2002, which restrict the provision of management consultant services by
auditing firms can have a *positive* effect on the bottom lines of audit firms because such regulation limits the competition in two different markets.

Auditing firms may have to increase fees for auditing services in order to compensate for their loss of benefit from knowledge spillovers. This is consistent with a recent survey of companies by Financial Executives International that reports “Audit Fees Expected to Rise by as much as 35% (June 2, 2003).

Finally, the tradeoff helps to shed light on auditor independence in appearance, through which any situation that threatens the credibility of an auditor’s findings in an investigation is viewed as a threat to auditor independence. If the results of non-auditing services are subject to audit during an audit of the client’s financial statements, there is a strong possibility that an auditing firm would have to sign off (as auditors) on the work of their consulting arms. Rational investors in the capital markets will discount the credibility of such auditor’s reports, and, therefore, the appearance of independence would be threatened or impaired.

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