

# Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives

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#### INTRODUCTION

Auditing is not romantic. The joke has it that an extroverted auditor is the one who looks at his client’s shoes when he talks to him, rather than at his own shoes.<sup>1</sup> This gray figure, however, plays a key economic role. For markets to allocate capital efficiently, investors need to make informed decisions when they buy shares in public corporations. As those who review and certify the financial information that companies disclose, auditors are, in the words of the United States Supreme Court, “public watchdogs” who must have “complete fidelity to the public trust.”<sup>2</sup>

<sup>1</sup> LOREN FOX, ENRON: THE RISE AND FALL 181 (2003).

<sup>2</sup> *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) (holding that the Internal Revenue Service could compel an accountant serving as an independent auditor to disclose work papers it used in the course of verifying the corporation’s

Somewhat surprisingly, these public watchdogs are hired by the very corporations that they audit. The Supreme Court has cautioned that this does not mean that the auditor “works for” the corporate client. Instead, “by certifying to the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client.”<sup>3</sup> This is a tall order. In this Article, I will argue that it is too tall.

In 1934, Justice Harlan Stone famously remarked that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that “a man cannot serve two masters.”<sup>4</sup>

Even though other eras of financial scandals have now come and gone, auditors are still asked to do that, to treat the public as master, though engaged and paid by another master—the audited corporation. The Sarbanes-Oxley Act of 2002 was Congress’ response to the Enron collapse and other spectacular accounting failures. It stiffened penalties for faulty financial disclosure and improved the supervision of auditors. It left, however, the two-master problem unresolved.

This Article will argue that current securities law sets up the wrong relationships among the auditor, the auditor’s client (the audited corporation), and the public, thereby creating a regulatory structure fundamentally at odds with its regulatory purpose. The structure creates incentives for the auditor to serve the client, while the law’s purpose calls for the auditor to serve the public. Therefore, the law should be reformed so that auditors recognize proper incentives and serve only one master, a master whose own interests are aligned with those of the investing public.

Briefly, securities disclosure auditing works as follows: a corporation’s management generates financial data and prepares the financial statements organizing and analyzing the data. Outside auditors engaged by the corporation spot-test the underlying data

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statement of its contingent tax liabilities and observing that “to insulate from disclosure a certified public accountant’s interpretations of the client’s financial statements would be to ignore the significance of the accountant’s role as a disinterested analyst charged with public obligations”).

<sup>3</sup> *Id.*

<sup>4</sup> Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8 (1934), quoted in Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002).

and evaluate whether the financial statements follow accepted accounting principles.<sup>5</sup> If the auditors are satisfied, they issue an attestation that states: “In our opinion, the financial statements . . . present fairly, in all material respects, the financial position of ABC Company as of [date] in conformity with generally accepted accounting principles.”<sup>6</sup>

Making such an attestation is an elaborate job involving substantial professional judgment. The underlying economic activity of X Corporation is almost surely complex, generating complicated financial data to be reviewed. And, the standards used in the review, the Generally Accepted Accounting Principles (“GAAP”), are themselves complex. No regulatory scheme could possibly govern the entire job. Not only can there never be a policeman at each auditor’s elbow, but even if there were, the auditing standards themselves could not anticipate every situation in which the public interest in good auditing might be threatened. Regulation that would depend on supervision and the threat of punishment simply could not ensure that the thousands of judgment calls involved in an audit would be made with the public’s interest in mind. This is especially true if, in addition to the public’s interest, the auditor must also consider the interests of the audited corporation. Therefore, the law must give auditors their own incentive to do what is in the public’s interest. Even though auditors are subject to regulatory supervision, they are still engaged and paid by a principal. This means that regulators should be certain that this principal has an incentive to want the auditor to do the sort of job that serves the public’s interest in transparency.

Part I discusses how securities disclosure auditors came to serve two masters. Auditing generally involves two distinct roles, which securities law mistakenly has combined into one. Since the Middle Ages, auditors have served as detectives for owners of enterprises, scrutinizing books kept by managers and reporting back to the owners what they discovered. Owners want these reports to be candid so they can monitor their agents. More recently, auditors began to play another role, that of certifying information that the client discloses to a third party. In “certification auditing,” the client is interested in the auditor’s approval of the information, not an exacting assessment of its quality. The Securities Acts of 1933 and

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<sup>5</sup> Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Revisited*, 8 STAN. J.L. BUS. & FIN. 39, 55 (2002).

<sup>6</sup> Erick D. Prohs, *Periodic Financial Reporting—A Relic of the Past?*, 27 J. CORP. L. 481, 493 n.108 (2002).

1934 joined these two very different roles. The auditor is supposed to play the first role, that of scrutinizing the corporation's financial statements in order to give a candid assessment of quality (the auditor as "public watchdog"). The auditor's actual fee-paying client, however, is the audited corporation who hires the auditor to play the second role, that of certifying information. This gives the auditor essentially two clients—the public and the corporation—each with different interests.

Part II addresses developments in recent decades that increased the tension in serving these two masters. Consolidation in the accounting profession and growth of non-audit consulting services increased pressures on individual auditors to defer to their clients' views, while the complexity and flexibility of the GAAP standards supplied the means to do this; auditors may give considerable deference to their clients' analyses and yet still certify that the statements comply with GAAP. These forces helped produce Enron and other recent scandals. The Sarbanes-Oxley Act of 2002<sup>7</sup> improved the auditors' situation somewhat, particularly by protecting their independence from their audit clients while simultaneously giving the clients more incentives to treat their auditors as detectives.

Good reform, however, should go further. Part III looks at auditing regulation from a broader perspective. It is part of a more general scheme of regulation via information disclosure, and there are clear empirical characteristics that distinguish healthy disclosure schemes from those that die on the vine. I assess specific proposals for auditing reform in light of these needs and explain why the best is Financial Statement Insurance ("FSI"). It meets the criteria for a healthy disclosure scheme, and it returns clarity to the auditor's role. In an FSI regime, auditors will have one role: they will be detectives, working for a client whose financial fortunes depend on their good detective work.

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<sup>7</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, 28 & 29 U.S.C.).

I. HOW AUDITORS CAME TO WEAR TWO HATS:  
A BRIEF JOURNEY THROUGH TIME

A. *Traditional Auditing*

1. The Auditor as Detective

Modern American auditing traces its roots to medieval England. Lords would appoint bailiffs to manage their lands, crops, and cattle. They would then appoint auditors to keep tabs on the bailiffs. These auditors served as detectives. They reviewed the bailiffs' written accounts and other records and examined their managerial decisions.<sup>8</sup> Auditing was not just available to aristocrats. In an early version of mandatory information disclosure, anyone whose property was being held by another person could demand an accounting, and auditors would be appointed by a court to test the validity of the accounting. After 1285, court-appointed auditors could even send a person to prison if the accounting showed that money was missing.<sup>9</sup>

Continuing in this vein, nineteenth-century British pioneers of modern auditing advertised their services as a way to ferret out fraud. In the 1840s, William Deloitte, founder of the firm known today as Deloitte & Touche, famously exposed fraudulent practices in the operations of the Great Northern Railway and Great Eastern Steamship Company.<sup>10</sup>

As recently as the early twentieth century, this original role of the audit held sway in the United States. Because businesses tended to be small and closely held, owners would hire auditors mainly to compare cash holdings with the records to see if the treasurer or cashier was honest.<sup>11</sup> Indeed, this remains a core auditing function. The standard task of what is now called internal auditing is to inform owners of the activities of their agents and employees. In the words of a basic accounting textbook: "Whatever the organization, all audits have a similar purpose, namely to provide some independent assurance that those entrusted with resources are made accountable to those who have provided the resources."<sup>12</sup>

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<sup>8</sup> S.F.C. MILSOM, *HISTORICAL FOUNDATIONS OF THE COMMON LAW* 275–97 (2d ed. 1981).

<sup>9</sup> See Statute of Westminster II, 1285, 13 Edw. 1, c. 11.

<sup>10</sup> Jonathan Weil, *Behind Wave of Corporate Fraud: A Change in How Auditors Work*, WALL ST. J., Mar. 25, 2004, at A1, A14 [hereinafter Weil, *Behind Wave of Corporate Fraud*].

<sup>11</sup> WALTER A. STAUB, *AUDITING DEVELOPMENTS DURING THE PRESENT CENTURY* 9–10 (1942).

<sup>12</sup> JOHN ARNOLD ET AL., *FINANCIAL ACCOUNTING* 19 (2d ed. 1994).

## 2. The Accounting Standard Set by the Auditor's Client

The nature of the standard the auditor uses to assess the quality of the audited financial information constitutes another variable influencing the success or failure of auditing. The standard itself can introduce distortions, as will be discussed later. Logically, the standard should be suited to—if not actually dictated by—the needs of the third party information user. This is easily achieved when the owner is the only information user. The method used in financial records to classify items such as income and expense and value of assets can be idiosyncratic to the owner.<sup>13</sup> The detective-auditor need only confirm internal consistency in accordance with the owner's accounting methods, not those set by anyone else.

## 3. Employment as Motivation and the Approval Bias

What motivations can we expect auditors to have and what temptations will they face? Given the premise that regulation of something as complex as auditing must take incentives into account, I will, throughout this Article, address literature on behavioral studies. Biases specific to auditors have been the subject of a series of psychological studies.<sup>14</sup> If auditors predictably can be expected to exhibit particular tendencies in their review of accounts, a good regulatory scheme should take those tendencies into account. Such a scheme should try to set up incentives that fight these biases; it should certainly refrain from *creating* incentives that encourage auditors to be biased.

We start with the incentives of the auditor who plays the role of detective for the client. So far, I have painted a rosy picture of the detective auditor, but certainly the detective auditor is not immune from bias. There may be agency problems such that the auditor puts his or her own interests above those of the client. Auditors might be lazy, accept bribes, or become overly friendly with the people they are supposed to monitor, thereby clouding their judgment and succumbing to “self-serving bias,” in which their judgment is

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<sup>13</sup> STAUB, *supra* note 11, at 10–11.

<sup>14</sup> Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 97, 100–01 (2002). For an extensive discussion of biases and application to auditing, see Robert Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 141–71 (2000) [hereinafter Prentice, *The Case of the Irrational Auditor*].

influenced by their self-interest.<sup>15</sup> In this, however, auditors are no different from any other employees or contract professionals.

Many auditors' biases identified in behavioral studies literature involve modern disclosure auditing rather than traditional detective-style auditing. One of the biases, the "approval bias," is already present, however, even when auditors are asked solely to do detective work. The "approval" bias refers to the tendency of people to approve judgments that others have made. That is, auditors are likely to approve accounts generated by others even if they themselves would have analyzed the figures in a less favorable manner.<sup>16</sup> Notably, this bias is not *inherent* in the relationship between traditional detective-style auditors and their clients. Indeed, if anything, the detective-auditor may seek to please the client by being overly harsh, which mitigates the approval bias.

In short, the detective-auditor–client relationship is relatively straightforward. Audit clients are business owners who will use the auditor's report themselves and who want the truth. As employees or contractors of this owner, auditors can please the client by being candid; auditors have no particular incentives derived from the auditor–client role itself to act otherwise.

#### *B. Auditing for Special-Purpose Disclosure*

##### 1. The Auditor as Certifier

A second role for auditors developed during the last century. Although auditors continued to do internal auditing, companies also asked them to certify financial information for disclosure to third parties, such as banks and sector regulators. Auditors certifying information for third-party disclosure have departed from the old role of doing detective work for the client. Now, as far as the client is concerned, the auditor's function is to approve the information, not scrutinize it.

The third party receiving the information has a different interest. It wants the information to be accurate, and it relies on the auditor's certification as an indication of accuracy. With regard to the third party information user, the auditor is considered a gatekeeper, that is, a "reputational intermediar[y] who provide[s]

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<sup>15</sup> Prentice, *The Case of the Irrational Auditor*, *supra* note 14, at 168–70; Robert A. Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 428 (2003) [hereinafter Prentice, *Enron: A Brief Behavioral Autopsy*].

<sup>16</sup> See Prentice, *Enron: A Brief Behavioral Autopsy*, *supra* note 15, at 423–25.



verification and certification services to investors.”<sup>17</sup> The third party’s reliance on the auditor as gatekeeper is induced by the auditor’s reputation for professional skill and integrity. In economic terms, the company hiring an auditor to certify its financial disclosure “rents” the auditor’s good reputation.<sup>18</sup> The theory of certification auditing is that this reputational bond is reliable because it is too valuable as a professional asset to sacrifice for the interest of any single client.<sup>19</sup>

In addition to relying on the auditor’s reputational bond, the third party can take its own steps to understand the quality of the disclosed information and seek to have it improved. For instance, the third party can insist that the disclosing entity provide additional information or quality assurances by threatening to withhold desired accommodations such as lending or regulatory approval.

## 2. Third-Party Accounting Standards

If, as discussed above, it is helpful for financial information to be presented in a form suitable to the needs of the information user (rather than the information discloser), then logic dictates that the third party (who is requiring the audit) set the accounting standards. This would mean that certification auditing would involve seeing that a company’s financial records live up to an extrinsic standard dictated by others.<sup>20</sup>

Regulatory agencies in fact did promulgate such standards. In 1906, the Interstate Commerce Commission set uniform standards for railroad accounting.<sup>21</sup> State and municipal regulation of electricity, natural gas, street railways, and other public utilities, which began early in the century, also included requirements for accounting.<sup>22</sup> World War I excess profits and war profits taxes encouraged depreciation of asset purchases over time,<sup>23</sup> requiring auditors to examine how the depreciation had been calculated. Firms that provided war material under cost-plus contracts needed to

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<sup>17</sup> John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1405 (2002) [hereinafter Coffee, *It’s About the Gatekeepers*].

<sup>18</sup> Theodore Eisenberg & Jonathan R. Macey, *Was Arthur Andersen Different?: An Empirical Examination of Major Accounting Firms’ Audits of Large Clients*, 1 J. EMPIRICAL LEGAL STUD. 263 (2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=468761](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=468761).

<sup>19</sup> *Id.*

<sup>20</sup> STAUB, *supra* note 11, at 11, 89.

<sup>21</sup> *See id.* at 15.

<sup>22</sup> *Id.* at 34–35.

<sup>23</sup> *Id.* at 13.

identify their costs, further presenting complex judgments for auditors to review.<sup>24</sup> The Federal Reserve Bank enunciated an auditing standard when it directed auditors to examine inventory and accounts receivable of borrowers from member banks, rather than simply relying on the owners' valuation.<sup>25</sup>

There was an exception to this practice of agencies setting the accounting standards. In the case of regulated street railways, accountants successfully lobbied to be the ones to set the standards that would be acceptable to the regulators. Interestingly, in a series of 1941 lectures at the Harvard Business School, a leading accountant advanced the argument for standards set by accountants, rather than government. He detailed a number of technical reasons why government accounting standards were unworkable and why the street railway standards were better. He noted that railroad and utility regulators later abandoned the standards they had set themselves and turned to standards recommended by the accountants.<sup>26</sup>

Logic suggests that accountants are best suited to set accounting standards. They can use their professional expertise to design systems that present financial information in a useful form for third parties. It must be kept in mind, however, that standards invariably skew results. If standard-setters are not themselves the third party information users, they may have incentives to design standards that do not best serve users' interests. As will be discussed in Part II.B, standard setting and the possibility of distortion is an important and controversial issue in current securities disclosure auditing.

### 3. Reputation as Motivation and the Attachment Bias

In certification auditing, incentives become more complicated. The auditor no longer enjoys the simplicity of working for a client (a business owner) who also represents the only user of the financial information (which concerns the management of the owner's assets). Rather, the client is the discloser of the information. The user of the information is a third party. The client and the information user seek different things from the audit.

The information user has reason to hope the audit will be candid—the same sort of audit that the owner employing a detective auditor demands.<sup>27</sup> The auditor's responsibility to this information

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<sup>24</sup> *Id.* at 14.

<sup>25</sup> *Id.* at 10–11.

<sup>26</sup> See STAUB, *supra* note 11, at 16–21.

<sup>27</sup> See discussion *supra* Part I.A.1.

user is, however, limited. An information user who can prove that the auditor failed “to exercise reasonable care or competence in obtaining or communicating the information” can recover damages from the auditor on a theory of negligent misrepresentation.<sup>28</sup> To recover, however, the plaintiff must show that the auditor negligently certified the information, knowing it was being supplied for a particular third party’s benefit and that the third party relied on the negligently certified information to its detriment.<sup>29</sup>

On the other hand, the auditor’s client has more subtle incentives. It wants the auditor to catch errors that the third party might find anyway, since a suspicious third party can challenge the financial data it has received, whether formally as in a utility rate setting procedure, or informally as when banks ask questions and demand back-up documentation from would-be borrowers. The client, however, has no reason to insist that its auditor correct more subtle, hard-to-detect distortions in information presentation if those distortions depict the client in a good light. To the contrary, it has reason to want the auditor to approve such distortions.

What should the auditor do? Personal ethics and professional standards<sup>30</sup> may provide a reason for the auditor to do the sort of candid audit that helps the information user. More germane to this discussion, auditors have a self-interested incentive to abide by professional ethics inasmuch as they wish to achieve a *reputation* for professional integrity. As noted, this is a valuable economic asset worth protecting by continuing to do good work. The auditor, however, also faces powerful contrary incentives to do the sort of less candid audit that the client might prefer. “The reality is that reputation means precious little if a firm has no clients.”<sup>31</sup> Thus,

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<sup>28</sup> RESTATEMENT (SECOND) OF TORTS § 552 (1977).

<sup>29</sup> *Id.*; see also *Bily v. Arthur Young & Co.*, 834 P.2d 745, 752–60 (Cal. 1992) (discussing different state-law treatments of auditor liability to third parties); *Glenn K. Jackson, Inc. v. Roe*, 273 F.3d 1192, 1200 (9th Cir. 2001).

<sup>30</sup> The professional standards of the American Institute of Certified Public Accountants (“AICPA”) provide:

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession’s public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.

AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODE OF PROF’L CONDUCT § 53.01 (1988).

<sup>31</sup> Prentice, *The Case of the Irrational Auditor*, *supra* note 14, at 204.

reputation is constantly pitted against the need to gain and retain business. Accounting firms, in fact, do risk their reputations for business reasons. For example, in the mid-1990s, some of the then-Big Six accounting firms were caught charging their regular fees for tax preparation work actually done by low-paid, part-time and temporary workers.<sup>32</sup> If it were terribly important to protect reputation, the savings would not have been worth the risk (which materialized) of being found out.

There is also an unconscious desire to please one's client that researchers have identified as the "attachment" bias.<sup>33</sup> In different studies, both professional auditors and business students interpreted financial information differently depending on the interests of the "client" they were told to pretend they worked for.<sup>34</sup> In a 2002 study (post-Enron), experimenters asked 193 auditors working for a major United States accounting firm to review ambiguous sets of financial information from Company X. Those told to assume that X was their client were thirty percent more likely to approve the accounting than those playing the role of auditors hired by someone thinking of doing business with X.<sup>35</sup>

In another study, business students were given information about another fictional company and divided into four role-play groups: those selling the company, the sellers' auditors, those buying it, and the buyers' auditors. The "sellers' auditors" valued the company higher than did the "buyers' auditors."

The researchers then asked the students to step out of the assigned roles and simply figure out what the company was actually worth.<sup>36</sup> Strikingly, students were not able to cast off the biases of their earlier roles. Those who had previously taken the part of sellers' auditors still said it was worth more, and those who had played the buyers' auditors said it was worth less. The difference was significant. Even when an actual reward (extrinsic to the experiment) was offered for the best impartial estimate, the different estimates of the company's value did not change.<sup>37</sup> This suggests that working for a client not only can create a tendency for an auditor to make judgment calls that favor the client, but that this inclination is hard to cast off.

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<sup>32</sup> *Id.* at 203–04.

<sup>33</sup> Certification auditors also face the approval bias inherent in reviewing someone else's work. *See supra* note 16 and accompanying text.

<sup>34</sup> Bazerman et al., *supra* note 14, at 97.

<sup>35</sup> *Id.* at 100–01.

<sup>36</sup> *Id.* at 100.

<sup>37</sup> *Id.*

## II. DEALING WITH TWO MASTERS: THE DILEMMA OF THE “INDEPENDENT” AUDITOR

With the passage of the federal securities acts in 1933 and 1934, a third role for auditors arose, namely the review and certification of financial information disclosed by public corporations. This new role effectively caused auditors to have to answer to two masters with conflicting interests.

### A. *The Auditor as Certifier and Detective*

The regulation of securities disclosure auditing must be viewed in its context as part of the general system of federal regulation of securities. The system’s most basic goal is nothing less than a healthy, productive economy in which resources are allocated to their best uses. This is achieved not by centralized planning, but by the protection and promotion of free, efficient capital markets so that resource allocation results from myriad individual decisions.<sup>38</sup> Unlike earlier state Blue Sky laws, federal law does not try to regulate securities offerings on the merits. Shares can be sold regardless of the issuer’s business plan, however unlikely the business is to succeed. Investors are free to take risks, even very great ones.

Regulation simply seeks to ensure that investors have the ability to know what they are getting into. The law requires that corporations selling shares to the public (“issuers”<sup>39</sup>), make substantial disclosure of financial information to the public both when shares are first offered for sale, and continually thereafter, for as long as shares are traded on regulated exchanges. Just as investors privately make investment decisions and issuers privately disclose information, so too independent auditors privately certify the quality of the information. This practice contrasts with, for instance, grain inspection, where the U.S. Department of Agriculture, not the farmer or grain elevator operator, certifies grade and fitness.<sup>40</sup>

The public uses this audited information in two distinct ways. In one sense, the “public” is a third party, analogous to lenders, regulatory agencies, and others who might deal with the corporation. Potential investors review the public financial data to decide whether they want to buy the corporation’s shares and, if so, at what price. But in another sense, the disclosure serves a completely different

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<sup>38</sup> See, e.g., Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 30–31 (2001).

<sup>39</sup> 15 U.S.C. § 77b(a)(4) (2000).

<sup>40</sup> 7 U.S.C. § 79(a) (2000) (section heading—“Grain required to be officially inspected”).

“public,” namely those who *already* own the corporation’s shares. With regard to this group, public financial disclosure is analogous to internal reports created by managers of businesses for the benefit of the business owners. Because share ownership is so widely disbursed, this disclosure must be public. Even if information were only disclosed to shareholders, it would almost certainly become public at some point.

In preparing financial information, the distinction between these two information uses is generally ignored. It even seems a bit silly. Through a call to a broker or a few computer keystrokes, a shareholder can become a non-shareholder, or vice versa, in the blink of an eye. Obviously, corporations cannot, and thus do not, provide different financial information to each group.

When it comes to auditing, however, this distinction is critical. Inasmuch as the corporation as a whole is disclosing information to third parties (potential shareholders), the auditor–client relationship is analogous to certification auditing. The corporation hires the auditor and has reason to want deferential certification auditing, with judgment calls that favor the corporation. The third party is left to challenge the information if it can. But, inasmuch as the information constitutes the report of corporate management to the owners (actual shareholders), the auditor–client relationship is analogous to detective auditing. The auditor should be reporting to the owner and providing a thorough, candid review of the books kept by management.

Auditing regulation has suffered from the failure to recognize this conceptual distinction. On the one hand, the law provides that corporations hire their own auditors, which creates an auditor–client relationship that triggers the incentives of certification auditing—the corporation wants a deferential audit to induce the third parties to deal with it on favorable terms. What has not been appreciated is that this “certification auditing” only makes sense when the third party is strong and able to challenge the data on its own. Members of the investing public, however, do not have the requisite strength and ability. Instead, they rely on the auditor to challenge the quality of the data and not merely to provide a deferential certification. The regulatory *purpose* of the securities laws demands that auditors act like detectives so that investors will have good information to use as the basis for their decisions. The Supreme Court put this succinctly when it called the auditor the “public’s watchdog.” The regulatory *structure*, however, gives the auditor a principal with incentive not to want detective auditing. Thus, the structure is in conflict with the purpose.

Though the original regulatory structure was the same as that used in certification auditing, it was more or less suited for providing the necessary detective auditing for a number of years. Changes in business and accounting practice, however, provided incentives for auditors to defer to their clients' interests while flexible accounting standards provided the means by allowing auditors to certify that a broad spectrum of financial disclosure complied with the required GAAP. These factors contributed to, if not caused, the auditing scandals of 2000–2001. The Sarbanes-Oxley Act of 2002 made a number of reforms and attempted to give the auditor a principal with the proper incentives to demand detective auditing. Nevertheless, it does not change the basic structure with its mismatched incentives. Therefore, further reform is necessary.

#### 1. The Original Certification Model of Securities Disclosure Auditing

Under the 1933 and 1934 Securities Acts, an issuer's shares can be sold or traded on a regulated U.S. stock exchange only if the Securities Exchange Commission ("SEC") first approves a prospectus containing financial statements, and the company continues to disclose financial information in annual and quarterly reports. All of these statements must be audited by "independent accountants."<sup>41</sup>

The basic pre-Sarbanes-Oxley securities regulation scheme contains a number of ways to preserve the independence of these certification auditors. First, as certified public accountants, auditors remain subject to state regulation and to professional discipline through professional organizations and peer review. Second, auditors<sup>42</sup> must be formally independent. They may not share family ties, material financial interests, or common employees with the audited corporation.<sup>43</sup> Third, the law gives the SEC the ability to play the role that the strong third party plays in standard certification auditing. It can review and question suspicious information. When an issuer sells shares to the public for the first time, the SEC is in a very strong position. The issuer cannot sell its shares until the SEC approves the prospectus.<sup>44</sup> Once shares begin trading, however, the

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<sup>41</sup> 15 U.S.C. §§ 77e, 77j, 77aa(26), 78m(a) (Supp. II 2002); 17 C.F.R. § 229.302 (2005).

<sup>42</sup> The defined term "auditor" refers to both individual accountants who conduct an audit and their firms. 17 C.F.R. § 210.2–01.

<sup>43</sup> *Id.*

<sup>44</sup> 15 U.S.C. § 77f.

SEC need not approve in advance the financial disclosures, but may conduct *ex post facto* review.

The private incentives of corporations and auditors helped to make this system work in two respects. First, auditors commonly practiced on their own or in small firms. Their professional reputations for quality auditing were too valuable to destroy by acquiescing in the misleading disclosure of any single client. They had a financial incentive to stand firm. Second, audited corporations had an incentive not to push their auditors too hard because the auditor might quit. Under SEC regulations, if an auditor is dismissed or resigns, the corporation must disclose that fact with an explanation.<sup>45</sup> Auditors willing to risk losing a client rather than compromising their standards can have some clout. Some studies have shown that while a “qualified” auditor’s opinion has little effect on share prices, a change in auditor can result in lower prices,<sup>46</sup> and could possibly incite an SEC investigation.

## 2. Strains on the Regulatory System Skew the Incentives

As technology and the economy evolved over the past seventy-plus years, this regulatory system became less able to ensure the independence of auditors or give them the incentive to be watchdogs.

For one thing, the underlying economic activity described in financial statements has changed drastically since 1934. Public companies are far bigger, creating more financial information to deal with, especially since the advent of computers. “Audit engagement teams” from accounting firms increasingly work for just a few audit clients, or sometimes just one.<sup>47</sup> For instance, Andersen’s lead partner on the Enron account worked only for Enron.<sup>48</sup> Additionally, the change from an industrial to an information-based economy created new problems in basic accounting and therefore in the auditing that controlled the quality of the accounting. Using established methods, accountants could confidently audit records of companies whose assets were mostly physical plant and inventory and whose businesses functioned according to predictable cycles (e.g., complete the “work in progress,” sell it, collect accounts receivable,

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<sup>45</sup> 17 C.F.R. § 229.304.

<sup>46</sup> Prentice, *The Case of the Irrational Auditor*, *supra* note 14, at 207–08.

<sup>47</sup> Eisenberg & Macey, *supra* note 18, at 269.

<sup>48</sup> Jonathan R. Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1170 (2003).



etc.). Now, many assets are intangible, such as projections of future income streams. Their present value is speculative and sensitive to assumptions made by management, making it “extremely difficult, even for a well-intentioned auditor, to dispute and reject the projection of a manager wishing to improve the appearance of his financial statements.”<sup>49</sup>

The accounting profession also changed radically, in a way that compromised the ability of the regulatory scheme to protect the independence of auditors from their clients. Reputation has lost its central position, and auditors’ financial independence from their clients has eroded. The story in a nutshell is that, like lawyers, accountants and auditors were once protected from price competition by professional association rules against advertising, soliciting rival firms’ clients, or bidding for business.<sup>50</sup> Firms engaged in only partial competition, but that competition was in the areas of quality and reputation, a basic premise of certification auditing. In the 1970s, however, the American Institute of Certified Public Accountants (AICPA) dropped the restrictive rules in response to threatened federal antitrust action.<sup>51</sup> This created price competition. The competition eventually led to concentration in the Big Eight, Seven, Six, etc.

The Big Four accounting firms now control more than 60% of the U.S. market for all accounting services.<sup>52</sup> This dominance, however, is far more striking in the field of auditing. A 2003 General Accounting Office (“GAO”) study (mandated by the Sarbanes-Oxley Act) found that the companies for which the Big Four do the auditing represent over 99% of all public company sales.<sup>53</sup> The Big Four audit *all* companies with annual sales of \$5 billion or more.<sup>54</sup> Of the companies with sales between \$250 million and \$5 billion, the Big

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<sup>49</sup> Joshua Ronen, *Financial Statement Insurance*, 4 J. FORENSIC ACCT. 1 (2003), available at <http://pages.stern.nyu.edu/~jronen/articles/Journal%20of%20Forensic%20Accounting.doc>.

<sup>50</sup> Weil, *Behind Wave of Corporate Fraud*, *supra* note 10, at A14.

<sup>51</sup> *Id.*

<sup>52</sup> Eisenberg & Macey, *supra* note 18, at 293. Given the high degree of industry concentration, the authors question the wisdom of the decision to prosecute Arthur Andersen for obstruction of justice. *Id.* at 293–94. They noted that in 1997, when Andersen was still in business, the four-firm concentration ratio for public company auditing was 71%. *Id.* at 294. This figure rose to 99% in 2002, after Andersen’s demise. *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> U.S. GEN. ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 105, available at [www.gao.gov/cgi-bin/gettrpt?GAO-03-864](http://www.gao.gov/cgi-bin/gettrpt?GAO-03-864) [hereinafter GAO STUDY].

Four audit 97%.<sup>55</sup> The GAO report concluded that there are “no significant competitors” for large-company auditing.<sup>56</sup>

In other words, though big corporations depend on the Big Four for auditing, the Big Four do not depend on their auditing business, the importance of which to accounting firms has diminished relative to other services. The flat-fee audit pricing increasingly popular in the 1970s and 1980s drove down what accounting firms could earn from auditing. There is some evidence that the perceived need to keep audit costs down resulted in lower quality auditing, particularly as big firms turned to “risk-based” auditing in which auditors focus on what they anticipated would be problem areas, and relied more on management’s data for presumably low-error areas like cash on the balance sheet. If the auditor’s initial risk assessment is wrong, however, significant problems may be missed.<sup>57</sup>

Another threat to audit quality came from the other services offered by accounting firms. Why should this be so? With auditing less profitable, firms turned to other sources of revenue. They built up their consulting businesses, offering clients numerous other services, including outsourcing internal audit work, tax accounting, and designing computerized financial information systems.<sup>58</sup> Whereas in 1981, fees for management advisory services and similar services provided thirteen percent of revenue for the Big Five accounting firms, by 2000, they provided some fifty percent of revenue.<sup>59</sup>

By 2002, according to one study, companies paid their accounting firms an average of three times for non-audit services what they paid the same firm for audit services.<sup>60</sup> Given this distribution of revenue, the income and career prospects of

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<sup>55</sup> Eisenberg & Macey, *supra* note 18, at 293.

<sup>56</sup> GAO STUDY, *supra* note 54, at 21.

<sup>57</sup> Jonathan Weil, *Fannie Paid Little for Its Audits*, WALL ST. J., Oct. 6, 2004, at C1, C3 (describing “risk-based auditing,” in which auditors give only a cursory review to areas of accounting perceived to have little danger of fraud or error, such as cash on the balance sheet).

<sup>58</sup> Weil, *Behind Wave of Corporate Fraud*, *supra* note 10, at A14.

<sup>59</sup> See Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. 43,148 & 43,153 n.49 (July 12, 2000) (proposing rules subsequently codified at 17 C.F.R. §§ 210.2-01 & 240.14a-101); Mark Allan Worden, *Securities Regulation: Protecting Auditor Independence from Non-Audit Services—An Evolving Standard*, 55 OKLA. L. REV. 513, 516–17 (2002).

<sup>60</sup> Coffee, *It’s About the Gatekeepers*, *supra* note 17, at 1411.

accountants working in auditing came to depend less on their reputations for high-quality auditing and more on their billings.<sup>61</sup>

Furthermore, an unintended regulatory consequence of the growth of non-auditing business was to hand audit clients a powerful weapon. As noted, the original regulatory scheme protected auditor independence by requiring disclosure whenever a change in auditor occurred.<sup>62</sup> Thus, if an auditor insisted that financial statements be changed before signing off on them, a corporation would probably listen because if not, the audit firm would publicly resign as auditor. With the growth of consulting services, however, corporations no longer had to either adhere to the auditor's recommendations or explain why the auditor resigned. Instead, they had a third choice—to threaten to stop buying lucrative non-audit services from the auditor's firm. Such a threat had teeth since it could be carried out in secret. Changes in non-audit service providers did not need to be revealed.<sup>63</sup> In June 2000, the SEC tried to address this problem by substantially restricting the ability of accounting firms to perform non-audit services for a client while the firm was, at the same time, auditing its financial statements for public disclosure. The proposed rule, however, weakened after a "bruising battle" with accounting firms and corporations.<sup>64</sup>

Regulatory action or private lawsuits could have counterbalanced the increased pressures for auditors to simply certify, rather than scrutinize, their clients' financial information. Both of these external monitors, however, lost power. The SEC failed to keep up with the changing economy in terms of its institutional capacity. Between 1991 and 2000, financial statements and other corporate filings increased by nearly 60%, but the SEC's staff available to review them grew by only 29% and its legal and investigative staff by 16%.<sup>65</sup> In another measure, annual volume of

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<sup>61</sup> *Id.* at 1415.

<sup>62</sup> See *supra* note 45 and accompanying text.

<sup>63</sup> Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1237–38 (2002).

<sup>64</sup> *The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?: Hearing Before the S. Comm. on Commerce, Science & Transportation*, 107th Cong. 3 (2001) (testimony of Prof. John C. Coffee, Jr., et al.), available at <http://commerce.senate.gov/hearings/121801Coffee.pdf> [hereinafter *Enron Hearings*].

<sup>65</sup> *Human Capital: Major Human Capital Challenges at SEC and Key Trade Agencies: Hearing Before the S. Subcomm. on Oversight of Government Management, Restructuring and the District of Columbia, Comm. on Governmental Affairs*, 107th Cong. 3–4 (2002) (statement of Richard J. Hillman, Director of Financial Markets and Community Investments, and Loren Yager, Director of International Affairs and Trade, U.S.

trading on exchanges increased almost six-fold from 1993 to 2001, while the SEC's enforcement staff grew by only 15%.<sup>66</sup> The SEC exercised its power to suspend trading of shares only ten to twenty times per year over the last decade.<sup>67</sup> Some commentators have linked this lax enforcement to Enron and associated scandals.<sup>68</sup>

Liability rules also weakened private investors' ability to serve as monitors of corporate auditing. It became harder to recover damages from the auditors themselves after 1994 when the Supreme Court held that auditors could not be held liable, under the Securities Acts, for aiding and abetting.<sup>69</sup> That is, auditors are not liable simply for failing to stop a corporation from making a misstatement. Instead, auditors themselves must affirmatively do something that causes investors harm. What constitutes such affirmative action tends to vary. The United States Court of Appeals for the Ninth Circuit has held that auditors may be liable if they maintained a "significant role" in drafting or editing a misleading document.<sup>70</sup> In contrast, the Second and Eleventh Circuits have imposed auditor liability only if the misleading statement was publicly attributable to the auditor at the time the injured party decided to invest.<sup>71</sup>

Changes in the level of liability that corporations potentially incur for issuing misleading disclosures may have made them less likely to insist on the sort of careful auditing that decreases their exposure. As a matter of Delaware corporate law, directors have a fiduciary duty to see that accurate financial information is disclosed to shareholders.<sup>72</sup> Likewise, under federal securities law, a

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General Accounting Office), *available at* <http://www.gao.gov/new.items/d02662t.pdf>.

<sup>66</sup> Mark Schroeder, *SEC Gets a Raise, But Will It Be Enough?*, WALL ST. J., Aug. 12, 2002, at C1.

<sup>67</sup> Suspensions are reported at <http://www.sec.gov/litigation/suspensions.shtml> (last visited Aug. 24, 2005).

<sup>68</sup> See *Enron Hearings*, *supra* note 64, at 3–4; Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 181–83 (2002); see John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 290 (2004).

<sup>69</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

<sup>70</sup> *Dannenberg v. PaineWebber, Inc. (In re Software Toolworks, Inc. Sec. Litig.)*, 50 F.3d 615, 628 n.3 (9th Cir. 1995), *cert. denied sub. nom. Montgomery Sec. v. Dannenberg*, 516 U.S. 907 (1995).

<sup>71</sup> *Ziamba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

<sup>72</sup> *Anglo American Sec. Fund, L.P. v. S.R. Global Int'l Fund, L.P.*, 829 A.2d 143, 157 (Del. Ch. 2003) ("Under Delaware law, fiduciaries are required, at the very least,

corporation is liable for damages if its financial disclosure is defective, and third parties can prove that, in making a securities sale or purchase, they relied on the disclosure to their detriment.<sup>73</sup> These cases became harder to bring and prove in the 1990s. The Private Securities Litigation Reform Act of 1995 (“PSLRA”)<sup>74</sup> limits attorneys’ fees recoverable in class action litigation.<sup>75</sup> It also increases the level of information that claimants must acquire prior to bringing suit by requiring claimants to plead the details of suspected fraud with particularity in the initial complaint, rather than allowing claimants to plead them generally and flesh them out later with facts learned during pre-trial disclosure.<sup>76</sup> Discovery is now postponed until after a court has determined whether the case may go forward.<sup>77</sup> In 1998, Congress imposed similar limitations on such cases proceeding in state courts.<sup>78</sup> Although some studies show that the number of lawsuits and the average size of settlements increased through 2002,<sup>79</sup> other commentators believe that limits on liability have made misleading financial disclosure more likely.<sup>80</sup>

The upshot of all these changes was to give auditors more incentives to see their job as one of certification auditing. The auditor–client relationship in certification auditing gives the auditor reasons to favor the interest of the client, not the third party information user (in this case, the public). As discussed above in Parts I.A.3 and I.B.3, studies have identified a number of relevant biases: Auditors are prone to approve accounts prepared by managers even if they would have done them differently themselves (the “approval” bias) and are prone to identify with their clients’ interest (“attachment” bias). With the growth of accounting firms and their consulting income, the “self-serving” bias<sup>81</sup> came to the fore. The individual auditor in a large firm can have a personal interest in

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to be honest and truthful when communicating with their principals.” (citing *Malone v. Brincat*, 722 A.2d 5, 10–11 (Del. 1998)).

<sup>73</sup> Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

<sup>74</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified as amended by the Securities Litigation Uniform Standards Act of 1998 in scattered sections of 15 U.S.C.).

<sup>75</sup> 15 U.S.C. § 77z-1 (2000).

<sup>76</sup> *Id.*

<sup>77</sup> 15 U.S.C. § 78u-4(b)(3)(B).

<sup>78</sup> 15 U.S.C. § 78bb(f).

<sup>79</sup> Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 33 n.216 (2002).

<sup>80</sup> William Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders—The Rise of a New Corporate Kleptocracy*, 8 STAN. J.L. BUS. & FIN. 69, 77–80 (2002).

<sup>81</sup> See Prentice, *Enron: A Brief Behavioral Autopsy*, *supra* note 15, at 428.

keeping a client happy, so that the firm can retain both the audit and the substantial non-auditing business.

Non-audit services also change the auditor's psychological work environment. If an accounting firm's only connection with a company is the audit, the external auditor's relations with corporate employees may be somewhat distant and formal even if corporate headquarters pays the audit fee. This formality can erode if the same auditors come back year after year, which is a reason to require auditors and audit firms to rotate. When the accounting firm also does non-audit work, however, the firm and the corporate employees are on the same "team," working together for the good of the corporation. Auditors may find this "team" mentality hard to ignore.

*B. The Trap of Flexible Accounting Standards*

Accounting standards are vital to certification auditing because the third party information user needs some way to evaluate the information received. They are particularly important in securities disclosure auditing. A large number of investors use financial information to assess a multitude of investment opportunities. These investors need to know they are comparing apples to apples. This calls for clear, firm standards. Given the complexity of modern corporations, however, accounting standards must contain sufficient flexibility to cover a variety of circumstances.

Historically, standard-setting in securities financial disclosure auditing took the same path as standard-setting in regulatory certification auditing. The 1934 Securities Exchange Act authorized the SEC, as the representative of the public, to set accounting standards,<sup>82</sup> though it did not direct the agency to do so. The SEC, in fact, has never set accounting standards. Instead, it followed the lead of the street railway regulators and deferred to standards set by accountants. Thus, in 1938, the SEC issued an "Accounting Series Release" directing that financial disclosure statements should follow accounting principles that have "substantial authoritative support."<sup>83</sup> The SEC now recognizes the GAAP standards issued by the Financial Accounting Standards Board ("FASB") as having such support.<sup>84</sup>

If the regulatory structure has given auditors the incentives to favor their clients with deferential certification auditing, then the

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<sup>82</sup> 15 U.S.C. § 78m(b) (2000 & Supp. II 2002).

<sup>83</sup> Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915, 945 (2003) [hereinafter Cunningham, *Sarbanes-Oxley Yawn*].

<sup>84</sup> See, e.g., *Greenstone v. Cambex Corp.*, 975 F.2d 22, 24 (1st Cir. 1992).

accounting standards have provided the means. There are two ways in which the system is susceptible to influence. The first is in the way the rules are made. Before the passage of Sarbanes-Oxley, FASB, the standard-setter, received half of its funding from the large accounting firms. Studies suggest that accounting firms tried to influence the timing and content of accounting standards in ways that favored their clients.<sup>85</sup> For instance, because of the development of new financial vehicles and business forms, it was important in the 1990s for FASB to be able to move quickly in establishing new standards. FASB politicking, however, sometimes delayed this. Notoriously, the extremely important FASB standard for accounting for derivatives was debated and delayed for four years.<sup>86</sup> Sarbanes-Oxley addresses these abuses. It requires that FASB (or any successor) be funded solely by corporations' audit support fees or risk losing recognition as a private standard-setter.<sup>87</sup> Further, FASB board members cannot belong to accounting firms while they are serving on the board or for the preceding two years.<sup>88</sup> Finally, FASB must "promptly" consider rule changes through majority vote.<sup>89</sup>

The second problem with GAAP is more intractable. Given the extreme complexity of the underlying economic activity, standards maintain significant flexibility.<sup>90</sup> Consequently, if a variety of psychological and economic factors provide managers with the

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<sup>85</sup> Prentice, *The Case of the Irrational Auditor*, *supra* note 14, at 205 & n.410; *see also* ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICAN DON'T WANT YOU TO KNOW 111–15 (2002).

<sup>86</sup> CONFERENCE BD. COMM'N ON PUB. TRUST & PRIVATE ENTER., FINDINGS AND RECOMMENDATIONS: CORPORATE GOVERNANCE 41 (2003), *available at* [http://www.conference-board.org/pdf\\_free/757.pdf](http://www.conference-board.org/pdf_free/757.pdf).

<sup>87</sup> Sarbanes-Oxley Act of 2002 § 108(b), 15 U.S.C. § 7218(b) (Supp. II 2002).

<sup>88</sup> 15 U.S.C. § 7218(b)(1)(A)(ii).

<sup>89</sup> 15 U.S.C. § 7218(b)(1)(A)(iv).

<sup>90</sup> Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421 (2002) [hereinafter Cunningham, *Sharing Accounting's Burden*]. Cunningham states:

Untutored lawyers sometimes face arguments from seasoned counterparts that a position is necessary or desirable because it accords with GAAP. The unwashed may find this stance convincing, but it invariably is not. GAAP's conventions authorize a wide variety of treatments for identical economic events, from relatively standard contexts such as inventory and depreciation to more challenging contexts such as derivatives and leases. Accounting requires choices and judgments entailing substantial subjectivity, making compliance with GAAP insufficient. It rarely mandates particular treatments and by no means forecloses massaging numbers, or even committing fraud. Seasoned advocates working with accounting data know this about GAAP.

*Id.* at 1435.

motivation to distort financial reports and auditors with the motivation to approve those reports, then the flexible accounting standards may not stand in the way.

Recall that when an auditor certifies a financial statement, he or she is really saying that it “present[s] fairly, in all material respects, the financial position of [X Corporation] . . . in conformity with generally accepted accounting principles.”<sup>91</sup> This formulation is already somewhat ambiguous: It does not simply aver that the statements are a fair picture but rather that they are a fair picture *according to* GAAP. Taken as a formal system, GAAP has seven broad principles at its core that certainly require fair reporting. But in an effort to provide predictability and comparability among reports, these principles have become the center of a web of more than 140 Statements of Financial Accounting Standards and thousands of Interpretations and Technical Bulletins.<sup>92</sup> The resulting system is not only complex, but provides numerous ways to account for even common items such as inventory and depreciation as well as exotic ones such as derivatives.<sup>93</sup>

Additionally, while GAAP was designed to be responsive to the actual needs of auditors, accountants, and companies, it also has the capacity to cause a race to the bottom when it comes to quality of disclosure. It invites companies to follow each other’s lead, rather than adhere to some fixed standard. “GAAP” stands for “*Generally Accepted Accounting Principles*.” For example, if common practice is to fail to disclose executive stock options as a future contingent liability, why should a company put itself at a competitive disadvantage by being one of a minority that does disclose?<sup>94</sup>

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<sup>91</sup> Prohs, *supra* note 6, at 493 & n.108.

<sup>92</sup> The California Supreme Court has called GAAP an amalgam of statements issued by the AICPA through the successive groups it has established to promulgate accounting principles: the Committee on Accounting Procedure, the Accounting Principles Board, and the Financial Accounting Standards Board. . . . GAAP include broad statements of accounting principles amounting to aspirational norms as well as more specific guidelines and illustrations. The lack of an official compilation allows for some debate of whether particular announcements are encompassed within GAAP. . . . One standard book purporting to comprehensively restate GAAP includes 90 major sections and more than 500 pages.

Biley v. Arthur Young & Co., 834 P.2d 745, 750–51 (Cal. 1992) (citations omitted).

<sup>93</sup> Cunningham, *Sharing Accounting’s Burden*, *supra* note 90, at 1435.

<sup>94</sup> See, e.g., Robert H. Frank, *The Case for Sanctions*, N.Y. TIMES, Aug. 24, 2002, at A13 (“[T]he standards defining acceptable accounting judgments depend on context. When almost all companies issue optimistic earnings reports, such reports come to be viewed as normal. Even the most cautious executives then feel pressure



The upshot of this is that managers can tell their financial story in a favorable way and auditors can legitimately defer to it because of the many different treatments supported by GAAP. Managers of some corporations that crashed in the 1990s were simply mistaken in their optimistic projections about things like the value of leases or accounts receivable; as discussed above in Part II.A.2, these information-based assets are hard to value. Other managers, however, engaged in “creative compliance,” in that they followed GAAP formally while in fact evading the duties that the rules, taken as a whole, impose.<sup>95</sup> An Enron company manual was explicit in preferring technical compliance with GAAP to reporting of economic reality: “Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with underlying economics. However, corporate management’s performance is generally measured by accounting income, not underlying economics. *Risk management strategies are therefore directed at accounting rather than economic performance.*”<sup>96</sup>

To cite just one example, GAAP rules allow use of the off-balance-sheet Special Purpose Entities (“SPE”) as long as three percent of the ownership is not in the parent corporation. Enron employed this device misleadingly to transfer debt off its balance sheet via some three thousand SPEs.<sup>97</sup> This sort of thing suggests that far from serving the needs of the third party information users (the public), the accounting standards sometimes positively disserved the public by making deception easier.

### C. *What Recent Scandals Tell Us About the Divergent Role of Auditors*

As discussed in Parts II.A.2 and II.B, by the late 1990s, several factors were in place that increased the risk that companies would promulgate misleading financial disclosure: complex information-based businesses, consolidation in the accounting profession,

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to report their earnings even more optimistically, in turn creating room for their more aggressive counterparts to push the envelope further.”).

<sup>95</sup> Doreen McBarnet & C.J. Whelan, *Creative Compliance and the Defeat of Legal Control: The Magic of the Orphan Subsidiary*, in THE HUMAN FACE OF LAW 179, 183–93 (Keith Hawkins ed., 1997).

<sup>96</sup> Enron Corp. Risk Management Manual, *quoted in* Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of “May,”* 48 VILL. L. REV. 1245, 1248–49 & n.15 (2003) (emphasis added).

<sup>97</sup> See Coffee, *It’s About the Gatekeepers*, *supra* note 17, at 1404 & n.4; *see also* Partnoy, *supra* note 96 (arguing that financial derivatives, “such as options, futures and other contracts whose value is linked to some underlying financial instrument or index” were more important to Enron’s collapse than were transactions with Special Purpose Entities).

conflicts of interest within accounting firms between auditing and non-audit consulting services, a weakened SEC, increased protection of auditors and their clients from liability for misleading financial disclosure, and finally, flexible accounting standards that gave room for bias to operate. At the same time, stock prices seemed to be going only up during the late 1990s; it was tempting to think that the New Economy did not follow the old business rules, such as the need to link profits and high share prices. This bubble burst in spring 2000.

Was misleading financial disclosure to blame for the bubble and the collapse? If what fuelled the long stock market rise of the 1990s was the “irrational exuberance” of investors willing—if not rushing—to speculate, then no amount of good financial information could have helped. Investors would have ignored it.<sup>98</sup> On the other hand, it is undisputed that many corporations did disclose financial statements inflated by creative accounting, and it is commonly held that these induced some amount of investment. The former chief accountant of the SEC estimated that between 1995 and 2001, faulty audits cost investors some \$100 billion.<sup>99</sup>

Though investors may have brought some of their woes upon themselves, it also seems clear that they failed to receive “watch-dog” protection from auditors. In many instances, auditors’ certifications were not a sign of quality financial disclosure. One indication of this is the large number of times corporations restated their disclosed financial statements after the discovery of accounting irregularities. For example, a key event in the collapse of Enron was the fall 2001 restatement of net income relating back to 1997, a \$586 million reduction.<sup>100</sup> According to a report by the GAO, there were 92 restatements in 1997, more than doubling to 225 by 2001.<sup>101</sup> Furthermore, not just small or new companies issued financial restatements, but large, established ones did so as well. In 1997, the average market capitalization of a company issuing a restatement was \$500 million. By 2001, it had risen to \$2 billion.<sup>102</sup>

Notably, some of the most scandal-ridden corporations, Enron, Global Crossing, Qwest, and WorldCom, all used the large and respected firm of Arthur Andersen as outside auditor. At WorldCom,

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<sup>98</sup> Coffee, *It's About the Gatekeepers*, *supra* note 17, at 1412.

<sup>99</sup> Jane Mayer, *The Accountants' War*, *NEW YORKER*, Apr. 22, 2002, at 64, 68.

<sup>100</sup> LEVITT, *supra* note 85, at 141.

<sup>101</sup> U.S. GEN. ACCT. OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 4, *available at* <http://www.gao.gov/new.items/d03138.pdf> (Oct. 2002).

<sup>102</sup> *Id.* at 17.

Andersen failed to report that management foiled an internal control system and recorded expenses as assets. At Qwest, it approved reports reflecting cash “earned” from swaps of telephone capacity that involved no cash.<sup>103</sup> Andersen’s eventually fatal problem was that its Houston office was entwined with Enron, which provided some twenty-seven percent of that office’s public client audit fees.<sup>104</sup> At one point, one hundred Andersen employees worked in leased space at Enron headquarters.<sup>105</sup> Andersen consultants developed the computer system that generated the information Andersen auditors would review. Enron’s president, vice president, and chief accounting officer were all former Andersen employees.<sup>106</sup>

The decline and precipitous fall of Enron is well known. In 2000, it was the seventh largest company in the United States, with share prices reaching \$90.56. The prices began to plummet in 2001 amid revelations that Enron created paper profits through transactions with its many SPEs. Enron restated its financial statements; share prices fell further. In December 2001, it entered Chapter 11 bankruptcy reorganization. By January 2002, its shares, many held by employees, traded at 36 cents.<sup>107</sup> The collapse led to a government investigation of Enron, during which Andersen personnel destroyed key documents.<sup>108</sup> Andersen was convicted of felony obstruction of justice in June 2002 and dissolved, a disgraceful end to the 89-year-old firm.<sup>109</sup>

Andersen certainly had accountants who were skilled detectives, yet the firm nonetheless certified Enron’s aggressive accounting. For instance, Andersen’s professional standards group partner reviewing the Enron audit complained about the improper recording of some \$150 million in connection with a transaction and commented that “this whole deal looks like there is no substance.”<sup>110</sup> He was, however,

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<sup>103</sup> Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 83, at 932–34.

<sup>104</sup> Krishna G. Palepu & Paul M. Healy, *The Fall of Enron*, 17 J. ECON. PERSPECTIVES 3, 15 (2003).

<sup>105</sup> FOX, *supra* note 1, at 212.

<sup>106</sup> Mayer, *supra* note 99, at 66.

<sup>107</sup> Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 DUQ. L. REV. 69, 146 (2002); *see also* FOX, *supra* note 1, at xiii, 2; Ribstein, *supra* note 79, at 5–6.

<sup>108</sup> Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 83, at 929.

<sup>109</sup> FOX, *supra* note 1, at xiii, 181, 303; *see* Kathleen F. Brickey, *Andersen’s Fall from Grace*, 81 WASH. U. L.Q. 917 (2003) (discussing criminal prosecution of Andersen and the firm’s response).

<sup>110</sup> *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 679 (S.D. Tex. 2002).

removed from his position.<sup>111</sup> In the securities class action suit filed in the wake of Enron's collapse, the court concluded that "[a] number of surviving Arthur Andersen documents reveal that Arthur Andersen was concerned about, yet covered up or ignored fraudulent accounting practices by Enron."<sup>112</sup>

*D. Sarbanes-Oxley's Moderate Reforms*

Public outrage at Enron and its sister scandals created unusual political interest in the arcane area of corporate financial disclosure,<sup>113</sup> resulting in speedy passage of the Sarbanes-Oxley Act of 2002 in July 2002.<sup>114</sup> Particular reforms important to auditing fall into four basic categories: oversight of auditors, enhanced enforcement, auditor independence, and supervision of the audit. Under the Act, however, corporations still engage their own auditors. As this section will discuss, Sarbanes-Oxley improved the current situation, but the basic mis-incentives built into the relationships among the auditor, the audit client, and the public require more radical reform.

1. Increased Public Oversight of Auditing

Sarbanes-Oxley establishes the Public Company Accounting Oversight Board ("PCAOB"), the first quasi-federal body to become involved in professional discipline and regulations of auditors and the promulgation of auditing standards, which were previously left to the states and to professional self-regulation. PCAOB is a non-governmental body with five full-time members appointed by the SEC,<sup>115</sup> only two of whom may be certified public accountants.<sup>116</sup> Its funding comes from an annual "Accounting Support Fee" paid by

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<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> Maryland Senator Paul Sarbanes, the Senate sponsor of the legislation, recalled that much of the testimony taken by the Senate Banking Committee in early 2002 on corporate financial disclosure was highly technical. One member, he said, did not realize that there was an open microphone in the vicinity when he confided, "This is really boring," to Wyoming Senator Mike Enzi. Senator Enzi, the body's only Certified Public Accountant, replied, "It may be boring to you, but I haven't had this much fun since I came to the United States Senate." AM. LAW INST., REMARKS AND ADDRESSES AT THE 81ST ANNUAL MEETING 48, 53-54 (2004).

<sup>114</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.); see Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 83, at 917 & n.2.

<sup>115</sup> Sarbanes-Oxley Act § 101(a) (establishment), § 101(b) (status) & § 101(e) (membership), 15 U.S.C. § 7211(a), (b), and (e). The SEC selects PCAOB board members "after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury." 15 U.S.C. § 7211(e)(4).

<sup>116</sup> Sarbanes-Oxley Act § 101(e)(2), 15 U.S.C. § 7211(e)(2).

corporations.<sup>117</sup> Among PCAOB's duties is the duty to conduct periodic inspections of audit firms (once a year for large firms). Firms may incur fines or lose the right to audit public disclosure statements if they violate either the law or the PCAOB's auditing standards and independence rules.<sup>118</sup>

Can PCAOB provide better auditing? Early indications are good; evidence suggests that it may be expected to act vigorously. For example, although the PCAOB was initially dubbed "peekaboo,"<sup>119</sup> and its first chairman nominee withdrew after revelations that he served on the audit committee of a company charged with mail, wire, and securities fraud,<sup>120</sup> its chief auditor is a former standards writer with a reputation for strictness.<sup>121</sup> PCAOB also broke with the past in its approach to standard-setting. Congress gave it the option of delegating auditing and quality control standard-setting to a private organization (just as the SEC has delegated accounting standard-setting to FASB).<sup>122</sup> PCAOB, however, determined to set its own auditing standards.<sup>123</sup> PCAOB oversight was linked to some twenty-

<sup>117</sup> 15 U.S.C. § 7219(d)(1).

<sup>118</sup> 15 U.S.C. §§ 7212, 7214, 7215.

<sup>119</sup> Judith Burns, *Accounting Board Tackles Its Mission Amid Initial Laughs: PCAOB, Known as Peekaboo to Some, Has Oversight of a Troubled Industry*, WALL ST. J., Jan. 8, 2003, at C5.

<sup>120</sup> John Yozzo, *The Public Company Accounting Oversight Board Disaster: You Can't Make This Stuff Up!*, AM. BANKR. INST. J., Feb. 2003, at 30, 30.

<sup>121</sup> J.D. Glater, *Eager to Be the Auditors' Auditor*, N.Y. TIMES, May 4, 2003; Jerry Ascierio, *New World Order: As the PCAOB Takes Shape, the AICPA's Role Is Blurred*, CALIFORNIA CPA, June 2003, at 6, available at <http://www.findarticles.com> ("Douglas Carmichael, the board's chief auditor, is an outspoken critic of the AICPA, as well as the big auditing firms. Carmichael, an accounting professor at Baruch College, once served as vice president of auditing for the AICPA where he helped develop auditing standards in the early 1980s.").

<sup>122</sup> 15 U.S.C. § 7213(a)(3)(A)(i) (providing that PCAOB may adopt as auditing, quality control, and ethics standards "any portion of any statement of auditing standards or other professional standards . . . that were proposed by [one] or more professional groups of accountants . . .").

<sup>123</sup> William J. McDonough, *The Fourth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law*, 9 FORDHAM J. CORP. & FIN. L. 583, 596 (2004). In the words of PCAOB chairman McDonough:

the [Sarbanes-Oxley] Act gave the Board the power to designate or recognize any professional group of accountants to propose new standards. However, before I arrived in June, my fellow Board members determined not to exercise the authority to delegate, but instead voted to set the standards from within the PCAOB. It was a decision I heartily endorse and clearly was consistent with the intent of Congress. As all of you know, in understanding any act of Congress you have to go look at the legislative history and find out what they really wanted in addition to what they wound up putting on paper. As

five financial restatements in 2004. Debt classification problems on one company's financials prompted examiners to revisit others, in turn prompting those companies to disclose corrected information.<sup>124</sup> PCAOB oversight, however, in no way changes the incentive structure of securities disclosure auditing because auditors still work for the audited corporation. The new oversight gives accounting firms reason to obey its rules to avoid trouble themselves, but the countervailing incentive to do an audit favorable to the audit client remains.

## 2. Enhanced Penalties and Enforcement

Additionally, Sarbanes-Oxley increases the threat of legal enforcement. The SEC now has more muscle—the Act provided a sixty-three percent increase in funding, including some \$98 million to hire two hundred staff members to oversee auditing. The Agency now must review disclosure filings systematically and at least once every three years per corporation.<sup>125</sup> Private liability rules remain essentially unchanged, but fines or civil fraud liability connected to a securities purchase or sale can no longer be discharged in bankruptcy.<sup>126</sup> The securities fraud limitations period has been extended,<sup>127</sup> though Congress resisted calls to repeal the PSLRA, which, as discussed in Part II.A.2, continues to set a very high standard for bringing a securities fraud case. Corporate managers will face increased liability themselves for misleading disclosure. Chief executive officers and chief financial officers must now certify personally that their corporation's disclosed financial reports not only comply with securities law but “fairly present[ ], in all material respects, the financial condition and results of operations of the issuer.”<sup>128</sup> A violation can result in a maximum fine of \$1 million and

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sometimes happen [sic], we had that option, but we shouldn't have used it, and we didn't.

*Id.*

<sup>124</sup> Diya Gullapalli, *To Err Is Human, to Restate Financials, Divine: Companies Redo Reports in Record Numbers, Partly Due to Sarbanes-Oxley*, WALL ST. J., Jan. 20, 2005, at C3 [hereinafter Gullapalli, *To Err is Human, to Restate Financials, Divine*].

<sup>125</sup> 15 U.S.C. § 78kk.

<sup>126</sup> 11 U.S.C. § 523(a)(19).

<sup>127</sup> The statute of limitations for securities fraud claims was extended from one to two years after discovery and a maximum of five years (formerly three years) after the violation. 28 U.S.C. § 1658(b). The earlier limitations period was announced by the Supreme Court in *Lampf v. Gilbertson*, 501 U.S. 350 (1991) (uniform limitations period for private securities actions).

<sup>128</sup> 18 U.S.C. § 1350(b).

up to ten years in prison, or \$5 million and twenty years if the wrongful certification is “willful.”<sup>129</sup>

Will these penalties and enhanced SEC oversight change corporation’s incentives, so that they demand that their auditors ensure that financial disclosure is not misleading? It is too soon to tell. The requirement that CEOs and CFOs certify financial disclosure was generally effective in November 2004 and has been linked to a record number of restatements correcting errors in financial statements.<sup>130</sup> On the other hand, the SEC’s level of commitment to aggressive enforcement of Sarbanes-Oxley may vary.<sup>131</sup> And, as for the deterrence effect of harsh penalties, it bears remembering that mail, wire, and securities fraud statutes already provided significant penalties and prison time at the time of the scandals, but did not serve as a deterrent to managers at corporations such as Enron and WorldCom.<sup>132</sup>

### 3. Stricter Independence Rules—With a Loophole

Furthermore, Sarbanes-Oxley significantly strengthens the rules encouraging the independence of auditors from their clients. It makes clear that an accounting firm auditing a corporation may not also keep the corporation’s books, do its accounting, prepare its financial statements, or design or implement financial information systems. It may not conduct appraisals or valuations for the corporation, perform actuarial services, help outsource the internal audit, recruit personnel, or provide a variety of services, including legal or investment advice, investment banking, or brokerage or expert consultation.<sup>133</sup>

Can these rules remove any incentives an accounting firm might have to soft-peddle an audit report in order to keep consulting business? Perhaps not. The prohibitions are not hard and fast. Although PCAOB may prohibit additional services by regulation,<sup>134</sup> it may also exempt any accounting firm, public company, or even a particular transaction from the independence rules “on a case by case

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<sup>129</sup> 18 U.S.C. § 1350(c).

<sup>130</sup> Gullapalli, *To Err is Human, to Restate Financials, Divine, supra* note 124, at C3.

<sup>131</sup> The SEC has been charged with being both too aggressive in enforcement and too easy on business interests. See, e.g., Diya Gullapalli, *SEC’s Top Accountant Counts on Not Pleasing Everyone*, WALL ST. J., Feb. 14, 2005, at C1, C3; Deborah Solomon, *Tough Tack of SEC Chief Could Relent*, WALL ST. J., Jan. 12, 2005, at C1, C5.

<sup>132</sup> See generally Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937 (2003).

<sup>133</sup> 15 U.S.C. § 78j-1(g).

<sup>134</sup> 15 U.S.C. § 78j-1(g)(9).

basis.”<sup>135</sup> More importantly, the audit committee of the issuer’s board of directors can also grant exceptions from the rules. A variety of non-audit work is permissible with the committee’s approval—or even the approval of a single delegated committee member.<sup>136</sup> Among the non-audit services an audit committee may approve are tax services. The problem is that tax services and auditing are a bad mix. The tax accountant is an advocate. In performing tax services, an accounting firm’s specific task is to advance its client’s interests, as the Supreme Court has recognized:

The filing of a corporate tax return entails much more than filling in the blanks on an IRS form in accordance with undisputed tax principles; more likely than not, the return is a composite interpretation of corporate transactions made by corporate officers in the light most favorable to the taxpayer.<sup>137</sup>

The auditor, in contrast, plays an essentially judicial role.<sup>138</sup> Sarbanes-Oxley, however, allows a single accounting firm to wear both hats: advancing the corporation’s interests on the tax side, while giving its financial disclosure statements a disinterested review on the audit side. It is not difficult to imagine that a firm in such a position would tend to see itself more as a certifier of its client’s financial disclosure than as a vigorous watchdog for the public.

The Act does require that, if the audit committee allows an accounting firm doing the audit to also perform non-audit services, this must be disclosed in the corporation’s regular periodic public report.<sup>139</sup> In theory, disclosure should act as a check on abuse. Auditors would exercise caution to do a good audit knowing that their potential conflict of interest would be made public. Investors who learned that a corporation conducted additional business with its auditing firm would pay less per share due to the increased risk that the auditor’s interest in continued business made the audit less

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<sup>135</sup> 15 U.S.C. § 7231. The exceptions to the independence rules are allowed “to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors . . .” *Id.*

<sup>136</sup> 15 U.S.C. § 78j-1(h) (exemption); 15 U.S.C. § 78j-1(i)(B)(3) (delegation).

<sup>137</sup> *United States v. Arthur Young & Co.*, 465 U.S. 805, 815 (1984) (emphasis added).

<sup>138</sup> Recognizing the quasi-judicial role of the auditor, the Supreme Court noted that an auditor’s review of a tax return could be helpful in an IRS investigation: “It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw ‘light upon’ the correctness of the return.” *Id.*

<sup>139</sup> 15 U.S.C. § 78j-1(i)(2) (“Approval by an audit committee . . . of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 13(a).”).



reliable. Because share prices would reflect the possibility of bias, there would be no need to regulate further.

One study, however, suggests that disclosure would not lead to investor caution. Disturbingly, disclosure might even make things worse by cutting down on auditors' self-monitoring.<sup>140</sup> In this experiment, several jars were filled with coins. Study participants were assigned to pairs. One member of the pair was given the responsibility of estimating the amount of money in the jars, but could only observe the jars from a distance. The other member of the pair played the role of advisor and could study the jars up close. The "advisor," however, was not paid according to how accurate the estimator guessed the number of coins, but rather according to how high the estimator guessed. This gave the advisor every incentive to report a misleadingly large coin count. This pay arrangement was disclosed to the estimators in half of the pairs and kept secret from the other half. In the half where there was full disclosure, the estimators, nevertheless, fully considered the advice they were receiving despite knowing that the advisors had a reason to mislead them. Furthermore, the advisors felt freer to report even more inaccurate estimates than they had before, presumably because they assumed that the estimators would discount them.<sup>141</sup> If this study predicts auditor and investor behavior, it calls into question the idea that disclosure can cure the conflict that arises from simultaneously performing auditing and non-auditing services.

#### 4. Supervision by the Audit Committee: A Return to "Detective Auditing"?

Finally, Sarbanes-Oxley reaches inside the corporate structure of the audited corporation to make the audit committee of the audited corporation's board of directors responsible for overseeing the audit. The executives responsible for preparing the books can no longer be the same people who select and supervise the auditors that review and assess them. Now, the audit committee must preapprove contracts for auditing and any non-audit services,<sup>142</sup> resolve disputes between auditors and management,<sup>143</sup> and establish a confidential anonymous procedure for employees to report questionable accounting procedures.<sup>144</sup> The audit committee must consist of

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<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> 15 U.S.C. § 78j-1(i)(1)(A).

<sup>143</sup> 15 U.S.C. § 78j-1.

<sup>144</sup> *See id.*

independent directors (not company executives) and possess the authority and funding to hire its own lawyers and advisors.<sup>145</sup> If audit committee members do not supervise the audit properly, a corporation could lose its ability to trade on a regulated exchange.<sup>146</sup>

This, for our purposes, is Sarbanes-Oxley's most far-reaching reform of auditing, because it has the possibility of actually changing the incentive structure. Earlier, I discussed two different auditor-client relationships. In detective auditing, discussed in Part I.A.1, the auditor works for the information user, namely, the owner of the resources used in the business, who wants a candid assessment of the actions of the managers. In certification auditing, discussed in Part I.B.1, the auditor works for the corporation as a whole, which is disclosing information to a third party information user. Securities disclosure auditing shares the structure of certification auditing: the auditor works for the corporation that discloses financial reports to the third party information user, namely, the public. This sits uncomfortably with the regulatory purpose, which is to give the public good information. That purpose suggests that auditors should work for the public, not the corporation.

Another way to look at securities financial disclosure, however, is not as disclosure to the amorphous "public," but as disclosure to the owners of the corporation who are so numerous and dispersed that public disclosure is the only practical way to reach them.<sup>147</sup> Seen in this light, an auditing committee of independent directors is a logical principal for the auditor. It represents the shareholders, who are the owners of the corporation. Like any owner, the committee would seek a report from the auditor on what its agents (i.e. management) have been doing with its invested resources. Ideally, having the audit committee in charge would recreate the medieval alignment of roles among the detective auditor, the auditor's employer (the lord of the manor), and the subject of the audit. With the audit committee as the representative of the shareholders, the business "owner" would be the principal hiring the detective auditor. Its goal: a candid report on the doings of management.

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<sup>145</sup> See 15 U.S.C. § 78f(m)(3) (independence); see also 15 U.S.C. § 78f(m)(5) (authority to engage advisors), § 78f(m)(6) (funding).

<sup>146</sup> See 15 U.S.C. § 78j-1(m)(1)(A).

<sup>147</sup> See, e.g., Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 U.C.L.A. L. REV. 413, 414 (2004) [hereinafter Cunningham, *Choosing Gatekeepers*] ("A partial solution to corporate structure's separation of ownership from control requires managers to report the corporation's condition and performance to investors, using a generally recognized accounting system and a third-party auditor vouching for the report's veracity.").

Is the audit committee up to the task? Faith in the audit committee suggests Congress' endorsement of the view that the job of corporate boards of directors is to monitor the company's activities, rather than to focus on other traditional functions such as management, advice, and obtaining resources for the company.<sup>148</sup> Independent directors represent the key to the monitoring board. Because they are outside the corporation, the theory is that they can ensure that it operates in the interest of the shareholders and the public, and fulfills its legal responsibilities, including the duty to promulgate accurate financial disclosure. Empirically, the success of audit committees in improving auditing has been mixed. Studies show that a company with an audit committee of independent directors is less likely to buy potentially compromising non-audit services from the audit firm.<sup>149</sup> Furthermore, it is more likely, when troubled, to disclose a report noting that the company may not continue as a going concern and less likely to dismiss the auditor who gave the "going concern" qualification.<sup>150</sup> On the other hand, these committees did not prevent recent abuses. Enron's board had fourteen independent directors and only two insiders. Its audit committee had a state-of-the-art charter providing direct access to the company's staff and consultants plus the ability to hire its own accountants and lawyers.<sup>151</sup> Nevertheless, it was not able to head off deceptive disclosure.

For audit committees to ensure good auditing, they need both sufficient strength and sufficient motivation. Both are difficult to achieve. The audit committee, even if it meets every month (which is not the rule) cannot participate in corporate affairs to the same extent as executives who tend to the corporation's business full time and whose personal fortunes are at stake. Independent directors are part-timers. Though they may have ultimate oversight of the audit, management still has the day-to-day interactions with the auditors and negotiates and proposes audit contracts for the committee's approval. It is an empirical question just how independent the independent directors are able to be. One aspect of the recent scandals was influence of independent directors by corporations through consulting payments, transactions with directors' businesses

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<sup>148</sup> Gregory S. Rowland, *Earnings Management, the SEC and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 179–86 (2002).

<sup>149</sup> ARNOLD ET AL., *supra* note 12, at 19.

<sup>150</sup> *Id.*

<sup>151</sup> Gordon, *supra* note 63, at 1241.

or contributions to favorite charities.<sup>152</sup> Sarbanes-Oxley now prohibits independent directors from receiving “any consulting, advisory, or other compensatory fee” other than compensation for serving on the board.<sup>153</sup>

Another fear is that independent directors might identify too strongly with managers to monitor them well. Until recently some sixty-three percent of the directors of U.S. public companies were chief executive officers of other corporations.<sup>154</sup> There exist some indications that, in the wake of Sarbanes-Oxley’s heightened director liability and responsibility, fewer CEOs currently serve on outside boards. In 1997, CEOs of Standard & Poors 500 companies served on an average of two outside boards; in 2005, the average decreased to 0.9 outside boards.<sup>155</sup>

Even when audit committee members act in the best of faith to promote shareholders’ interests, there is another potential stumbling block: what are those interests? Shareholders have a variety of interests. Some want the sort of long-term corporate credibility that scrupulous adherence to law and good disclosure can promote; others seek the short-term profit that might be helped by cooking the books.<sup>156</sup> How the directors should weigh these interests is beyond the scope of this Article. The point is only that, when it comes to financial disclosure, it may not be obvious what directors’ fiduciary duties require. If the accounting rules are not crystal clear, and an underlying problem is one that a company prefers to keep hidden this quarter with the hope of correcting next quarter, directors could believe that shareholders are served by less than the most candid disclosure.

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<sup>152</sup> Enron made significant use of all three of these channels. See S. REP. NO. 107-70, at 55 (2002).

<sup>153</sup> Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78f(m)(3) (Supp. II 2002) (“Each member of the audit committee of the issuer [i.e., the audited corporation] shall be a member of the board of directors of the issuer, and shall otherwise be independent. In order to be considered to be independent . . . a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee accept any consulting, advisory, or other compensatory fee from the issuer; or be an affiliated person of the issuer or any subsidiary thereof.”).

<sup>154</sup> Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporations Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1380 (2002).

<sup>155</sup> Anita Raghavan, *More CEOs Say ‘No Thanks’ to Board Seats*, WALL ST. J., Jan. 28, 2005, at B1, B14.

<sup>156</sup> See Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333, 334, 336–37 (2002).

### 5. Conclusion: Structural Mis-Incentives Remain

Sarbanes-Oxley creates a number of incentives for actors in the current information disclosure system to do a better job. PCAOB oversight may give the Big Four accounting firms reason to perform more scrupulous audits, even though the Big Four still retain a monopoly over large-company auditing and do not compete with one another on the axis of audit quality. Enhanced penalties for managers whose corporations issue misleading disclosures may create demand for careful accounting and auditing. The new independence rules, even with their exceptions, should at least diminish auditors' incentives to go easy on an audit in order to preserve their firms' other business ties with the companies being audited. Further, the involvement of the audit committee will insulate auditors from direct pressure by the management whose accounting is being reviewed.

Of course, the improvements have potential costs. Enhanced liability and responsibility may scare off good directors.<sup>157</sup> Compliance with Sarbanes-Oxley, as some have claimed, may prove too costly for small companies.<sup>158</sup> The emphasis on independent directors may harm corporations if these directors are too risk averse,<sup>159</sup> or harm the board's ability to work in a collegial manner at its main task of guiding the corporation.<sup>160</sup> Too much independence could be a problem for auditors as well if it prevents them from gaining the informal working knowledge of the corporation that improves their grasp of its financial records and their potential trouble areas.

More significantly, Sarbanes-Oxley does not resolve the basic schizophrenia in the regulatory structure: Auditors still work for the audited corporations, but are supposed to protect the interests of the public. Rules requiring accounting firms to rotate lead audit partners

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<sup>157</sup> Raghavan, *supra* note 155, at B14.

<sup>158</sup> See, e.g., Solomon, *supra* note 131, at C1, C5.

<sup>159</sup> Peter J. Wallison, *Blame Sarbanes-Oxley*, WALL ST. J., Sept. 3, 2003, at A16 (arguing that independent directors are too risk averse and that Sarbanes-Oxley's requirement that they have greater influence in corporate governance may be to blame for the failure of the economy to rebound despite the aggressive tax cuts, deficits, and low interest rates that usually stimulate business growth).

<sup>160</sup> Troy A. Paredes, *Enron: The Board, Corporate Governance and Some Thoughts on the Role of Congress*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495, 497-99, 520 (Nancy B. Rapoport & Bala G. Dhara eds., 2004) (noting that monitoring boards are not necessarily better for all corporations because of the possibility of harming the board's ability to manage, work in a collegial manner, and provide resources, especially in the case of a start-up corporation).

every five years<sup>161</sup> and to take a year off after one of their auditors becomes a major officer of the audited corporation<sup>162</sup> may make it harder for the individual auditor to protect his or her friends at the client corporation, but this is far from the only problem. An engagement to audit a large public corporation is still a valuable asset to an accounting firm. Though Sarbanes-Oxley takes a step towards giving auditors the means and the motive to be public watchdogs, the client-auditor relationship remains one in which the auditor is “certifying” the client’s financial information. That alone can give auditors a reason to see things from the corporation’s point of view.

### III. ALIGNING AUDITORS’ INCENTIVES WITH THE PUBLIC INTEREST: ELEMENTS OF REFORM

As we have seen, from the audited corporation’s viewpoint, auditors can act as detectives, providing an honest assessment of a financial statement to a client. Or, they can act as certifiers, approving the client’s financial statements before they are disclosed to a third party. Either role on its own makes sense. If the client wants candor, the detective auditor can provide it. If the client wants documents reviewed and certified for a third party, the certification auditor can do that. The problem with U.S. financial disclosure law is that while it assumes the auditor will serve as a detective on behalf of the public, it puts the auditor in a certification relationship with the client.

It might be objected at this point that this problem is hardly unique to auditors. Many professionals must evaluate the actions of their paying clients against an outside, and sometimes unflattering, standard. Lawyers, for instance, often tell clients they cannot lawfully do what they want to do. An appraiser hired to give a valuation is expected to use professional judgment, though the result might disappoint the property owner. Teachers must grade students, inevitably displeasing the half of the class that cannot be above average. The common thread is that the professional is supposed to make an evaluation that furthers a social goal and potentially furthers the client’s *long-term* interests, but that may run contrary to the client’s current desires or *short-term* interests. For instance, an aggressive tax shelter violates the long-term social interest in equitable taxation according to law and may harm a client long-term if it faces a tax audit. On the other hand, it may be a great immediate

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<sup>161</sup> Sarbanes-Oxley Act of 2002 § 203, 15 U.S.C. § 78j-1(j) (Supp. II 2002).

<sup>162</sup> The officers are chief executive, chief financial officer or chief accounting officer or equivalent. 15 U.S.C. § 78j-1(l).

financial benefit to the client. An undeservedly high grade may please a student today, but not advance the student's long-term goal of getting a good education. The auditing analogue is apparent: Approving misleading financial disclosure may temporarily keep share price high, a short-term benefit. However, the duplicity harms the social interest in transparency for investors and puts the company at risk of collapse in the long term when the truth finally comes out.<sup>163</sup>

These observations suggest that auditing is not unique in kind. Professionals often must decide how to respond when a client's immediate interests conflict with its long-term interests and with the dictates of the law, a larger question beyond the scope of this Article. Securities disclosure auditors nevertheless face the problem to a greater degree than others. Many other professionals rely on a system of "adversarial" testing to supplement their work. Their job is to advance the client's position, drawing all legitimate inferences in favor of the client, understanding that their conclusions are subject to attack by an opponent. Lawyers, whether in litigation or transactions, usually face someone on the other side. So do other "evaluative professionals." For example, appraisal reports may be tested in court (e.g., in a tax assessment or eminent domain proceeding) or presented to a third party (e.g., a bank loan department) that can challenge and evaluate them. These situations are like auditing for certification.

In contrast, public company financial disclosure cannot easily be tested by investors, nor is the SEC able to scrutinize every filing. Furthermore, what adversarial checks on financial disclosure do exist have limited time to take effect. The market responds to financial disclosure within minutes. Even when a regulator or analyst evaluates financial information, the evaluation may come too late to protect many investors from loss. This puts great pressure on the auditor to ensure that the disclosure is of good quality in the first place.

It may be morally legitimate for society to demand that auditors be public watchdogs even at the risk of financial loss to themselves (e.g., when a client withdraws lucrative business). That does not mean it is wise policy to depend on professional altruism to guarantee the quality of corporate financial disclosure. A better approach would provide auditors with incentives to do the sort of job the public needs done. At the very least, they should not have incentives to do the opposite. In my view, mis-incentives will pose a threat as long as the auditor's *clients* lack the incentive to demand and

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<sup>163</sup> For example, Enron's \$586 million restatement of four years' of net income lead to its collapse. For further discussion see *supra* Part II.C.

pay for good auditing. Thus, if certification auditing is to remain the model, then the law should give clients the motive to seek out auditors of known integrity. Or, if the auditor is to be a detective, he or she must work for someone who wants a candid report and will share it with the public. Do alternative regulatory schemes exist that will better align the auditor's and client's incentives with the public interest?

A. *Why Do Some Systems of Regulation by Information Disclosure Thrive?*

In assessing the wisdom of changes in any regulatory system, the question is, will they help make the system as a whole better able to achieve the regulatory goal? This system approach is, I believe, especially important in considering regulation of securities disclosure auditing, which can be easy to see as an isolated, narrow topic.

SEC financial disclosure is best analyzed as one of many regulatory regimes that seek to modify behavior not by primary directives and prohibitions but by giving actors information to use themselves. These systems are incentive based. They do not require the desired activity to take place. Rather, they require some actors to disclose information in order to induce others to do what is the goal of the exercise. For instance, the regulatory goal of nutrition labeling is not that every chocolate-chip muffin bear a terrifying calorie count on its label or that every display of oranges tout their high Vitamin C content. The *goal* is healthier Americans. The *means* to the goal is information disclosure based on the assumption that people will respond rationally to the information by choosing more nutritious foods. To take another example, many states seeking to increase hospital safety require hospitals to report medical mistakes, such as "foreign objects left in a patient" or "operation on the wrong body part,"<sup>164</sup> to a state agency. Thus, these states seek to achieve their goal of making hospitals safer by forcing hospitals to identify and confront their errors and provide information to regulators. Minnesota recently began naming individual hospitals and disclosing errors to the public as well.<sup>165</sup> This harnesses a private incentive as a means to the regulatory goal. Hospitals will have an additional reason to avoid errors—they might lose patients.

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<sup>164</sup> Paul Davies, *Minnesota Issues a Hospital Report Card: Tallying of Medical Errors Is Intended to Arm Patients and Spur Better Prevention*, WALL ST. J., Jan. 20, 2005, at D5.

<sup>165</sup> *Id.*; see also Minnesota Department of Health, <http://www.health.state.mn.us/patientsafety/index.html> (last updated Jan. 19, 2005).



Securities regulation is an information disclosure system with the goal of promoting wise investment. The means to effectuating that goal is disclosure of financial information about companies because there is an assumption that, in the aggregate, investors will productively allocate capital if they can correctly assess the risks and benefits of the underlying activity. The job of the auditor is to see that the disclosed information is as faithful a reflection of the underlying economic activity as possible. Scholars often focus on the information itself, noting, for instance, that it must be useable, relevant, and available to its intended beneficiaries when they are making decisions.<sup>166</sup> This alone is too narrow. Empirical research shows that a good regulatory system must also take account of the needs and motives of both the information user and the information discloser.

A Harvard study examined SEC financial disclosure and several other disclosure systems: nutrition labeling, reporting of medical mistakes, toxic release disclosure, publication of patterns of mortgage lending, and disclosure of unions' financial information. The goal of the study was to see why some disclosure regimes succeeded while others degenerated into useless paper exercises.<sup>167</sup> Because regulation by information disclosure depends on incentives, the study found that successful schemes had three characteristics: strong demand for the information by information users, a benefit to information disclosures from good disclosure, and standards that allow information to be understood and compared.

First, strong intermediaries represent the information users.<sup>168</sup> This corrects an asymmetry of power that might otherwise lead the disclosure system to deteriorate. The costs of disclosure are concentrated on the entity providing the information (in our case, public corporations), while the benefits are diffused among many information users (investors). Because disclosers tend to be better organized than users, they can lobby more effectively for favorable rules and enforcement policies. In successful disclosure schemes, users have countervailing force. They also have organizations working on their behalf. For example, environmental groups use data regarding toxic spills, and therefore monitor such data. Other community groups monitor bank lending practices.

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<sup>166</sup> STEPHEN BREYER, REGULATION AND ITS REFORM 161–64 (1982).

<sup>167</sup> Archon Fung et al., *The Political Economy of Transparency: What Makes Disclosure Policies Sustainable?*, (Harvard Univ., John F. Kennedy Sch. of Gov't Faculty Research Working Paper Series, RWP03-039, 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=384922](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=384922).

<sup>168</sup> *Id.* at 38–39.

In the securities markets, a variety of intermediaries such as institutional investors, stock analysts, and stock exchanges are in a position to represent investors. A troubling aspect of the recent scandals was that they did not vindicate investors' interest in good financial information. It was not uncommon for stock analysts, for example, to over-recommend shares underwritten by their employers' investment banking divisions.<sup>169</sup> A good regulatory system must ensure that any entities that represent investors have their own reasons to want financial disclosure to be of high quality. Auditors could serve as these strong intermediaries if they had the incentives of "detective" auditors.

Second, information is usable and comprehensible.<sup>170</sup> This means that the "core metrics" must be (1) relatively simple, (2) relatively comparable, and (3) agreed to by the interested parties. Nutrition labeling, with its uniform method of presenting fat, protein, calories, etc., fits this bill. GAAP satisfies the third of these criteria: all accountants and publicly held corporations use it and sophisticated investors are conversant with it. It is far from simple, however, and the extent to which it produces data that are comparable among companies is open to debate. Worse, because GAAP permits the same economic activity to be reported in different ways, financial statements can appear comparable without actually presenting comparable information. Auditing reform needs to change this.

Third, some information disclosers *benefit* from the information disclosure.<sup>171</sup> This is what keeps the system from stagnating. If some entities gain an advantage from transparency and good disclosure, they will comply with the disclosure requirements or even exceed them. This will then create pressure for their competitors to follow suit in a way that the threat of regulatory enforcement cannot. For instance, when manufacturers were forced to report releases of toxins, some voluntarily curtailed their releases, thereby satisfying the regulatory goal. They then benefited from the disclosure requirement because it allowed them to brag about their clean records, imposing a reputational cost on those who did not stop spilling and had to continue to disclose spills.<sup>172</sup>

In the securities context, the recent stock market scandals clearly imposed high reputational costs on companies like Enron and

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<sup>169</sup> Coffee, *It's About the Gatekeepers*, *supra* note 17, at 1412–13.

<sup>170</sup> Fung et al., *supra* note 167, at 39.

<sup>171</sup> *Id.* at 39–40.

<sup>172</sup> *Id.*

WorldCom on account of their faulty financial disclosure. Conversely, there should be a way for good financial disclosure to help companies stand out in a good way. If this were the case, certification auditing—in which auditors have an incentive to do what their clients want—could be good for the public. Clients would want auditors to ensure that their financial disclosure was first rate. The regulatory challenge here is to create incentives for corporations to compete by offering better financial disclosure.

The following subsections discuss a variety of concrete reform proposals in terms of these three criteria. The first two suggestions would turn auditors into strong intermediaries for investors—better detectives. In the first proposal, auditors would work for the government, not the audited corporation. In the second proposal, they would be more independent and therefore better able to act as public watchdogs. The next two suggestions concentrate on improving the GAAP rules that currently can obscure rather than clarify information. The third proposal is “enforced self-regulation,” in which corporations tell their financial stories in an individualized way. The fourth is its opposite, a plan in which essentially raw financial data is disclosed. The fifth proposal focuses on making good financial disclosure a competitive benefit to firms, so that they would insist on good auditing. The sixth and final proposal is that companies buy Financial Statement Insurance and disclose the premium amount. This achieves all three goals. Auditors would be strong intermediaries for the public because they would work for insurance companies that would demand good auditing. Financial information would improve. And, companies seeking to control insurance premiums would benefit from good disclosure. Of all these suggestions, Financial Statement Insurance deserves the most serious consideration.

### *B. Strategies for Reform*

#### 1. Better Detective Auditing: The Federal Bureau of Audits

An obvious question: If public company auditors are supposed to be *public* watchdogs, why aren't they working for the government? Public auditors could solve many problems. Corporations would not hire their own auditors, so auditors would no longer be certifiers, just detectives. A bureau of government auditors could apply auditing standards more consistently, mitigating problems caused by ambiguous rules. There are also good theoretical reasons for

government to be involved. Corporations face a prisoner's dilemma when it comes to financial disclosure: If all disclose accurate information (even if unfavorable), all benefit in the long run because investors will have confidence in the market and will buy U.S. equities in preference to other investments (e.g., real estate, bonds, foreign securities). However, any one corporation can gain a short-term advantage by distorting its figures since investors will assume they are true. If a significant number of corporations (even a low number may be significant) do this, all will be worse off because investors will distrust disclosures and take money out of U.S. equity markets, thereby making capital more expensive for all.

Investors, too, face a dilemma. If self-interested investors could wave a magic wand, the first choice of those who already own a corporation's shares is for the corporation to disclose inaccurately rosy information so they can sell their shares at a high price. The first choice of the potential buyers would be the opposite: disclosure of overly grim information, so they can buy shares cheaply. Because, by hypothesis, the information is deceptive, and it is impossible to release different information to sellers and buyers in any event, these first choices are unavailable. The second choice of all investors is that someone ensures that all information is accurate. Solving coordination problems such as these is a classic government function.

Another reason for government involvement is to further the public interest. Even though capitalist societies leave investment decisions in private hands, the allocation of productive economic resources to entities that can best use them is a matter of extreme importance literally to everyone, including future generations and those too poor to ever participate in the market directly. This is another reason that the government has a duty to see that investors get high-quality information to use in making decisions.

Government auditing was considered and rejected in setting up the securities regulation regime. Columbia law professor Adolf Berle, a leading member of President Roosevelt's "brain trust," unsuccessfully argued for establishment of a federal agency that would "exact full information about securities sold."<sup>173</sup> Dennis Kucinich, Democratic Congressman from Ohio and candidate for his party's 2004 presidential nomination, introduced legislation in spring 2002, "to establish a Federal Bureau of Audits within the Securities and Exchange Commission to conduct audits of all publicly

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<sup>173</sup> JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 41 (1982).

registered companies.”<sup>174</sup> The proposed bureau would have audited each public company once a year.

The House of Representatives voted down the Federal Bureau of Audits, 39 in favor to 381 opposed.<sup>175</sup> Floor debates raised a number of problems. One had to do with the auditor’s incentives. Instead of seeking to please an owner, as in detective auditing, or the audited corporation, as in certification auditing, auditors would now have the same incentives as any civil servants. Thus, Representative Nancy Kelly predicted that government auditors would “combine the same level of efficiency to accounting that HUD brought to housing . . . the effectiveness of the IRS in its customer service . . . [and] the accounting expertise of the Department of Defense with \$100 hammers.”<sup>176</sup>

Representative Michael Oxley, House sponsor of the Sarbanes-Oxley Act, worried that government auditing could cause too much government involvement in corporate business decision making: “This is a big government solution. . . . I guess his message is, if you have lost faith in the free market, you need to have faith in big government. I do not think people are ready to make that leap.”<sup>177</sup>

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<sup>174</sup> H.R. 3795, 107th Cong. (2002); *see also* H.R. 3763, 107th Cong. (2002) (proposing substantially similar legislation as an amendment to a Sarbanes-Oxley predecessor bill). For a scholarly discussion of the possibility of placing the government in charge of auditing, *see* Mark A. Gullotta, *The SEC’s Auditor Independence Rule: Missing the Boat on Independence*, 42 SANTA CLARA L. REV. 221, 242–44 (2001).

<sup>175</sup> Final Vote Results for H.R. 3763, <http://clerk.house.gov/evs/2002/roll107.xml>.

<sup>176</sup> 148 CONG. REC. H1572 (daily ed. Apr. 24, 2002) (statement of Rep. Kelly) (“[T]he amendment creates the Federal bureau of audits. I guess it is modeled after the FBI so I can see auditors storming into companies with their calculators drawn, demanding individuals to freeze and drop their pencils. The amendment seems to envision that the most efficient and effective auditor would be the U.S. Government. Somehow I just cannot agree with that, and I think this amendment is important for us to take a good look at for its unintended consequences. I think the author is looking to combine the same level of efficiency to accounting that HUD brought to housing, perhaps. I imagine that the author is looking for the effectiveness of the IRS in its customer service. Finally, with the accounting expertise of the Department of Defense with \$100 hammers, I am sure our corporations will be in the best hands possible.”)

<sup>177</sup> *See, for example,* the floor remarks of Congressman Michael Oxley:

This is a big government solution. It is a one-size-fits-all solution. It is essentially the neutron bomb. I guess his message is, if you have lost faith in the free market, you need to have faith in big government. I do not think people are ready to make that leap. I think they understand intuitively, based on their investments, that they trust the free market, and they trust that our markets are the most open and efficient markets in the world, represented by the American marketplace.

One potential problem is possible corruption or misuse of the bureau for political purposes. A more certain problem is that particular auditing standards can favor particular accounting standards, which in turn favor some underlying business decisions over others. If the government sets auditing standards, its influence will trickle down to basic decisions. It is one thing for government tax rules to induce particular underlying business decisions, since tax provisions often have just that goal (e.g., the home mortgage interest deduction encourages home ownership; Individual Retirement Accounts encourage savings). In contrast, it would be perverse for government auditing rules to induce particular business decisions, since the purpose of auditing is to help provide transparency of information about business activity—not to change the activity.

Another question is: Which government would employ government auditors? Since basic corporate law is state law, logically, each state would audit companies incorporated there. State audit bureaus, however, would surely differ in funding, expertise, and interpretations of accounting rules, destroying the comparability that federal regulation offers. Just as state securities regulation (Blue Sky laws) has proven too variable and has been overshadowed by federal securities law,<sup>178</sup> so too government auditing would almost surely have to be federal, but the specter of federal corporate law has always met resistance. This backdoor imposition of uniformity would be no exception.

Finally, if concerns about preserving private enterprise and federalism did not kill government auditing, it would probably run aground on funding. Now, with corporations buying their own auditing services, the cost of auditing is veiled—companies can pass it along, if necessary, in the form of slightly higher prices. Public provision of auditing services would make the cost obvious and bring it into the political arena where funding for economic regulatory agencies (such as the SEC and the Federal Trade Commission) has proven vulnerable. Funding probably would be unreliable, or at the very least, perceived as such. This would threaten, rather than bolster, investor confidence. Funding could be more dependable if the government charged companies an annual fee for their audits. This, however, raises the possibility of inefficiency and expense

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148 CONG. REC. H1573 (daily ed. Apr. 24, 2002) (statement of Rep. Oxley).

<sup>178</sup> Prohs, *supra* note 6, at 482–84.

because the entity paying the bill (the issuer) will not be able to control the service bought with its money from the government.<sup>179</sup>

As seen from the relative obscurity of the Kucinich proposal,<sup>180</sup> not even outrage at Enron and Arthur Andersen led to serious consideration of a Federal Bureau of Audits. Short of an inconceivably worse scandal, it seems that U.S. securities disclosure auditing will remain in the private sector.

## 2. Better Certification Auditing

We now return to the current structure, in which corporations hire their own auditors. Sarbanes-Oxley left this structure in place and made reforms to improve it. As discussed in Part II.D, these reforms did not remove auditors' incentives to favor the client's interest over the public interest. Are there further reforms that might do that?

### a. A Competitive, Independent Auditing Profession

One possibility is a self-conscious return to old-style certification auditing. This produces good auditing because of the auditor's incentive to protect his or her reputation for quality work. If truly reliable certification were available and investors came to seek out this certification, then issuers would have an incentive to use good auditors, creating a race to the top for auditing quality. This can occur only if high-quality certification auditing is available to corporations that want to buy it. Research disturbingly suggests that it is not.

An extensive study of the financial disclosure of one thousand large public firms from 1997 to 2001 found no evidence of competition among the Big Four to offer and market high-quality auditing to their clients. As noted earlier, the Big Four audit all companies with annual sales above \$5 billion and ninety-seven percent of those with sales of \$250 million or more.<sup>181</sup> Researchers used the rates at which audited companies had to restate their disclosed financial statements as a surrogate for auditing

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<sup>179</sup> Peter K.M. Chan, *Breaking the Market's Dependence on Independence: An Alternative to the "Independent" Outside Auditor*, 9 *FORDHAM J. CORP. & FIN. L.* 347, 369 n.117 (2004).

<sup>180</sup> Even the Sarbanes-Oxley position paper of the progressive Consumer Federation of America proposed a corps of government auditors only briefly, then backed off to suggest that stock exchanges hire and fire auditors. *CONSUMER FED'N OF AM., INVESTOR PROTECTION LESSONS FROM THE ENRON COLLAPSE AND AN AGENDA FOR REFORM* 6-7 (2002).

<sup>181</sup> See GAO STUDY, *supra* note 54.

inaccuracies. The theory is that inaccurate financial statements are difficult to cover up forever and eventually need to be corrected.<sup>182</sup> They found different rates of restatement among different years, different industries, and different regions of the country. But they found no significant difference at all among public companies according to which major firm the company employed to audit its financial statements.<sup>183</sup> The study concluded: “[M]anagers of large public companies who want to distinguish themselves from their competitors by choosing a tough, high quality auditor cannot do so. As measured by financial restatement rates, no such auditor is available: one cannot reject the hypothesis that they all are the same.”<sup>184</sup> In short, sellers (accounting firms that do audits) form an oligopoly that offers buyers (the corporations disclosing financial information) little choice when it comes to quality.

The securities laws could help create a market for quality auditing by tightening the independence rules in two ways. The first step would be to require complete independence between auditor and client. Sarbanes-Oxley still allows accounting firms to offer some services contemporaneously with the audit, notably tax advice. As long as accounting firms are doing any additional business with clients, an incentive remains to ease up on the audit to protect the relationship. The second step would be to limit the period during which an accounting firm can audit a corporation, perhaps to a fixed five-to seven-year audit period, followed by the same amount of time off.

Taken together, these rules would significantly change the incentives of accounting firms. Currently, a contract to perform both auditing and permitted non-audit services for a large corporation is a valuable asset to an accounting firm. It can conceivably last forever. The partners in charge have a motive to protect this valuable client relationship. If full auditor independence were mandated, this asset would cease to exist because firms could no longer do auditing and other services on an open-ended basis. Accounting firms would need to choose. They could not do both. Because non-audit services may be more lucrative and would not be time-limited, the Big Four would probably try to keep the non-auditing work, and thus, send their clients to find another auditor. Big corporations will still need audits,

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<sup>182</sup> See Eisenberg & Macey, *supra* note 18, at 272–89.

<sup>183</sup> *Id.* at 264.

<sup>184</sup> *Id.* at 299; see also Coffee, *It's About the Gatekeepers*, *supra* note 17, at 1414–15 (discussing the possibility that in auditing, the large firms appear to have used the parallel strategy of going along with clients on contested auditing matters in order to keep their non-auditing business).



so we may expect the emergence of new, specialized audit firms; call them the “Little Four.”

There would be two benefits from this realignment of the profession. At the Little Four and other firms concentrating on auditing, auditors would not just be handling a relatively unprofitable side-business. They would be leaders able to set the professional tone. At least some firms could be expected to emphasize the old ethos of independence and integrity. In such an atmosphere, senior auditors could maintain their ethics, junior auditors could develop an ethics-first outlook, and firms could compete for clients based on reputation and audit quality.

Additionally, under current law, the Big Four can still “bundle” the audit with allowed and approved non-auditing services and offer the whole package at an attractive price by doing the audit at low cost. This makes it hard for smaller firms to compete. A client corporation is likely to keep all of its auditing and accounting business with one firm if it receives a lower cost audit as part of the package. If accounting firms could not offer auditing at loss-leader prices, however, corporations would have no reason not to diversify the rest of their non-audit service purchases as long as they had to find a new auditor anyway. They could bid out work to many different accounting firms, creating more opportunity for the Little Four and others.<sup>185</sup>

This discussion suggests that complete segregation of audit and non-audit services could help create competition in the market for quality auditing. But if such choice became available, would corporations seek it out? One issue is whether corporations will be willing to pay the extra cost of quality. This will depend on whether they think it will produce a competitive advantage.<sup>186</sup>

A knottier issue is whether the quality of audited financial statements can be transparent enough for the market to operate, so that issuers could truly compete in the area of quality of financial disclosure. This is the well-known “lemons” problem.<sup>187</sup> In order for buyers to reward high quality, they have to be able to identify it. In a lemons market, however, buyers lack the information to distinguish among high-, medium-, and low-quality products or services. When sellers cannot reliably signal high quality to buyers, it is rational for buyers to assume that all products or services are of equally lower

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<sup>185</sup> See Coffee, *It's About the Gatekeepers*, *supra* note 17, at 1414–15.

<sup>186</sup> For further discussion, see *infra* Part III.B.2.c.

<sup>187</sup> George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 499–500 (1970).

quality. The standard example is an unregulated used car market, where there is no way to know which cars are lemons and which are not. This uncertainty depresses the price of good cars as well as bad.

b. Reforms in Information Standards

The lemons problem may arise in auditing because GAAP rules may not allow sufficient quality discrimination. They are so flexible that an auditor can attest that a report accords with GAAP, yet the report will not actually “present fairly in all material respects” the corporation’s true financial condition.<sup>188</sup> For this reason, many commentators see a better GAAP as the key to better auditing. Others, however, do not think there is such a thing as a better GAAP. On this view, the books of large corporations are so complex that under *any* set of rules, it will always be possible to achieve technical compliance and still give a misleading picture. If this is true, then better standards will not help. Radical change would be needed. I will next consider radical change at two ends of the spectrum.

i. A British Solution: Enforced Self-Regulation

One view of the problem with GAAP is that it is too detailed. Far from giving welcome guidance and certainty, on this view, the large number of detailed, specific directives is just what makes it possible to follow the letter of the rules while violating their spirit.

The British approach to this issue is instructive. British accounting standards (U.K. GAAP) are far less detailed than their American counterpart (U.S. GAAP). They enunciate principles more than rules, giving auditors and accountants more flexibility than their U.S. counterparts in complying with GAAP.<sup>189</sup> Proponents of the British system argue that the lack of detailed rules to “hide behind” forces the accountant and auditor to actually live up to the principle of disclosure of the company’s true economic situation.<sup>190</sup> The weakness of a principles-based system, however, is that it may give too little guidance. In the words of the British scholars Ayres and Braithwaite, the requirement of “true and fair accounts” (U.K. GAAP) is a “bland admonishment” whose “very amorphousness hinders prosecution.”<sup>191</sup> The cure, in their view, is “enforced self-

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<sup>188</sup> See discussion *supra* Part II.B.

<sup>189</sup> ARNOLD ET AL., *supra* note 12, at 269–74.

<sup>190</sup> *Id.*

<sup>191</sup> IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 109 (1992).

regulation,” and they see corporate accounting as an ideal candidate for this approach.<sup>192</sup>

In enforced self-regulation, each regulated entity devises its own plan for meeting the regulatory objective, sometimes in consultation with stakeholders. For example, a public corporation’s stakeholders would include employees and community members along with investors, managers, and directors. Once in place, the plan is the “law” for the entity, and violations can be penalized. Tailored self-regulatory standards are easily enforced because they contain clear guidelines that the corporation has already agreed are applicable and feasible. “Creative compliance” is unlikely because the company selects and discloses its own set of rules to vindicate the regulatory principles. Thus, following these rules achieves, rather than frustrates, the principle of financial transparency.<sup>193</sup> Companies have an incentive to follow their plans because it is easy to tell if they are not following them. And, they have an incentive to commit themselves to a high level of quality in the plan because the plans are disclosed to the public.

Any advantages of enforced self-regulation, however, are overwhelmed by the problem of comparability. The hallmark of enforced self-regulation is that there is no single standard, but rather many roads to the regulatory goal. Each company is different. In financial disclosure, however, the regulatory goal requires that disclosed information enable investors to compare corporations. Comparison requires a common measure. If enforced self-regulation were used, investors would need to analyze and digest company plans and then translate the information into some comparable form. Investors or their intermediaries would simply end up reinventing general standards, with the difference that there would be no regulatory enforcement to back them up.

#### ii. Raw Information Disclosure

An opposite approach to allowing self-tailored analysis of corporate financial information is to forego the analysis altogether. This reform is based on the observation that at its root, the problem of creative compliance with the GAAP rules is that accountants and auditors analyze information in a way that turns out to be misleading. Self-regulation tries to improve the analysis by making it more individualized, so that companies cannot get around the rules. Alternatively, instead of telling companies to disclose audited

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<sup>192</sup> *Id.* at 106–09.

<sup>193</sup> *Id.*

financial *reports*, Congress could require them to disclose raw disaggregated data, such as daily revenue, materials expenditure, lease payments, etc. Investors and their intermediaries, armed with computer capacity, would do their own interpreting. Some companies might still offer analyzed information, as they do now, knowing that others would be reviewing it and comparing it with the underlying data.<sup>194</sup> Other companies may skip the expense of their own analysis and let the numbers speak for themselves.

Supporters of simplified disclosure rightly link it to continuous disclosure, as has Congress.<sup>195</sup> Through Sarbanes-Oxley, Congress authorized the SEC to require corporations to disclose material changes in operations or financial condition “on a rapid and current basis” and “in plain English.”<sup>196</sup> This makes sense. Stocks now trade virtually instantaneously and financial news is reported around the clock. It is somewhat anachronistic for the SEC’s disclosure regime to follow the schedule, developed in the 1930s, of annual and quarterly reports with fifteen-day supplemental filings for a few material events.<sup>197</sup> The posting of these filings on the internet through the SEC’s EDGAR system<sup>198</sup> and the accelerated deadlines for some large corporations to file their quarterly and annual reports<sup>199</sup> does not change the fact that the information is still compiled only at these relatively long intervals. Even the best information represents only a snapshot, not a moving picture.

The persistence of quarterly reports in a world of near-constant financial news reporting is not just quaint but dangerous. For instance, it enables corporations to engage in “earnings management,”<sup>200</sup> the practice of manipulating accounting to show quarterly earnings that meet publicized projections, even if that means reporting income and expenses in the wrong quarter. Corporations also may release overoptimistic *pro forma* earnings to the press, enjoy the resulting rise in share prices, and then correct the information with little fanfare in official filings weeks later.<sup>201</sup>

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<sup>194</sup> Chan, *supra* note 179, at 382–84.

<sup>195</sup> Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753, 770–71 (1997); Prohs, *supra* note 6, at 481.

<sup>196</sup> Sarbanes-Oxley Act of 2002 § 409, 15 U.S.C. § 78m(l) (Supp. II 2002).

<sup>197</sup> 15 U.S.C. § 78m.

<sup>198</sup> See U.S. Securities and Exchange Commission, <http://www.sec.gov/edgar.shtml>.

<sup>199</sup> See Wally Suphap, *Getting It Right Versus Getting It Quick: The Quality–Timeliness Tradeoff in Corporate Disclosure*, 2003 COLUM. BUS. L. REV. 661, 688 & n.97.

<sup>200</sup> Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 83, at 17.

<sup>201</sup> LEVITT, *supra*, note 85, at 157–60.

Sarbanes-Oxley tries to discourage this by requiring executives to disgorge bonuses and profits they earn through manipulating share prices.<sup>202</sup> With continuous information disclosure, these deceptive practices would be impossible because they depend on the lag time between the unofficial projections, which can be made with few legal consequences, and the official regulatory filings.

Though this reform proposal is directed at the nature of the information disclosed, we are interested in it here because of its effect on the structure of the relationship between auditor and client, and therefore, on the auditor's incentives. If companies disclose raw financial information, the job now done by auditors would be split in two. Corporations would hire other auditors to design and monitor their information disclosure systems. Then, investors or other entities would hire auditors to review and analyze the disclosed raw information.

The auditors engaged by the corporation would concentrate on issues such as designing and monitoring information systems and internal controls. They would not be reviewing the client's analysis of the financial information, with its many accounting judgment calls and numbers that rest on future projections (e.g., the value of leases, intellectual property, options, etc.). There would be no such analysis and no such predictions. Continuous disclosure gives companies reason to work with these auditors to design the best information-disclosure systems they can. First, with disclosure made on a continuous basis, corporations will face additional exposure to liability for material misstatements or omissions and presumably will turn to their auditors to help minimize it.<sup>203</sup> Second, good information disclosure should create a competitive advantage for the company that makes it. When investors bear the cost of information analysis, they will presumably reward corporations that disclose reliable information in an easy-to-use form. Thus, the auditors engaged by the corporation would find it easier to do their job in a way that protects the public interest. Their clients would have reason to demand better disclosure, and their jobs would involve less exercise of judgment and the attendant opportunity to shade judgments in a client's favor.

The other half of the current auditor's job is reviewing the client's analysis of financial information according to GAAP. The corporation's auditor would not conduct this review because the information released by the client would not be analyzed. However,

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<sup>202</sup> 15 U.S.C. § 7243.

<sup>203</sup> Prohs, *supra* note 6, at 495.

someone will still need to digest the raw numbers in order to make them useful as a basis for investment decisions. This will create a second body of “analysis auditors” to serve investors. At first blush, this seems to promise a good alignment of incentives; as in detective auditing, the auditor will be working for the information user.

The problem, however, is that investors come in a variety of shapes and sizes. Institutional investors will be able to hire high-quality auditors who will report to them directly and have incentives to read the numbers skeptically and carefully.<sup>204</sup> These auditors should be able to do a good job. They will be dealing with fresh information that they can more easily evaluate and analyze in whatever way best serves the client-investor’s information needs.<sup>205</sup>

Other investors, however, will not be able to have full-time auditors on their payrolls. Instead, they will need to obtain financial analysis elsewhere. Presumably, a body of “consulting auditors” will market their independent services. Their incentive to do a good audit of the raw data will depend on how valuable quality is in marketing their services. There is a potential lemons problem here. If auditing quality is not transparent to consumers (and it may well not be), then these consultants could end up competing along other lines. The role of these independent consulting auditors is analogous to the role played by securities analysts now. Their many failures to give impartial advice<sup>206</sup> suggest that while this proposal can result in good in-house “private watchdogs” for some institutional investors, it will not necessarily ensure that “public watchdog” auditing is available generally. And, viewed at a macro level, the sheer number of “investor-audits” will surely entail duplication of efforts and a waste of resources.<sup>207</sup> These considerations suggest that investors are not necessarily a better principal for the auditor than the government. We therefore return to considering whether the current structure, in which auditors work for audited corporations, can be preserved but reformed.

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<sup>204</sup> Chan, *supra* note 179, at 370–72.

<sup>205</sup> Standard & Poor’s has already promoted a proprietary method of analysing information that it claims gives a fairer portrayal than GAAP of, for instance, pension commitments and derivatives. *Standard & Poor’s CVC Assists Accenture to Calculate Company’s S&P Core Earnings: Standardized Earnings Calculation Allows Investors to Make Consistent Comparisons Across Companies/Industries*, PR NEWSWIRE, Jan. 13, 2003, <http://www.companyreports.com/cgi-bin/stories.pl?ACCT=105&STORY=/www/story/01-13-2003/0001870969>.

<sup>206</sup> See Coffee, *It’s About the Gatekeepers*, *supra* note 17, at 1404–05.

<sup>207</sup> See Cunningham, *Choosing Gatekeepers*, *supra* note 147.

c. The Elusive Market for Good Disclosure

I will assume for purposes of this discussion that corporations will seek out and buy better auditing only if it gives them a competitive advantage with their own customers and investors.<sup>208</sup> Such competition is not obvious right now; there are no corporate full-page *Wall Street Journal* ads promising “We Will Not Try to Fool the Auditors,” nor does “Fair Financial Disclosure” appear on consumer product labels along with “Cruelty-free” (cosmetics) and “Fair Trade” (coffee and cocoa). Competition on the axis of financial disclosure quality would require auditors to compete for customers, that is, investors who care about it and will use it as a reason to invest. Who are these investor-customers?

Some investors might buy shares in a company just because it offers better financial disclosure. Ethical investment funds are an obvious possibility. However, these funds generally seek a variety of characteristics in companies they own, such as good labor and environmental practices. It might be difficult for issuers to gain a significant advantage just by offering fair financial disclosure. Additionally, these funds do not represent a huge segment of the market.

The other possible customers of financial disclosure quality are investors who care about an issuer’s long-term success. In the short run, good auditing may well hurt share prices by disclosing information about a company’s failure and limitations. However, it is a benefit in the long run. Misleading disclosure rarely does more than buy time, and there are substantial reputational and economic costs when the truth finally emerges.<sup>209</sup> The problem is that investors generally seek financial gain based on the long-term prospect of an entire portfolio of diversified investments, not just a *particular* company. For any particular company, good financial disclosure would be just one of many indicia of future success. It could not make up for a bad product, for instance. Nevertheless, good financial disclosure could well become one among many reasons for long-term investors to pick X Company’s shares over Y Company’s, and that could provide the needed competitive advantage.

Note however, that this competition can only take place if the reforms discussed above have already been made and (a) auditors compete for business on the basis of quality and (b) GAAP is

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<sup>208</sup> After shares are initially offered to the public, of course, a corporation gains no capital directly from sales of shares. This discussion assumes, however, that high share prices are generally a benefit to public corporations.

<sup>209</sup> Chan, *supra* note 179, at 353.

reformed so that higher (and lower) quality financial disclosure auditing is more obvious to the market. Neither is the case now.

The SEC has tried to create investor demand for quality via regulation of mutual funds. Mutual funds invest the savings of some ninety-three million people<sup>210</sup> and have a long-term outlook. It seemed as if they might have had an incentive to become involved in the governance of the corporations they invest in, in order to make those corporations improve their financial disclosure. In 2002, the Department of Labor issued an interpretation of federal pension law stating that one of the fiduciary duties of fund managers is to vote proxies on shares that the plan holds where the vote concerns an issue “that may affect the value of the plan’s investment.”<sup>211</sup> In order to encourage funds to participate in corporate affairs, the SEC followed with a rule that funds must publicize their proxy votes:<sup>212</sup> “As major shareholders, mutual funds may play a vital role in monitoring the stewardship of the companies in which they invest.”<sup>213</sup>

Mutual funds, so far, do not seem to want to be surrogate regulators of corporate behavior. The largest U.S. mutual funds strongly (but unsuccessfully) opposed the SEC voting disclosure rule. They feared it would invite lobbying from special interest groups, thereby distracting the funds from getting their investors the best return on their savings.<sup>214</sup> This opposition is not surprising. Mutual funds historically have avoided involvement in corporate affairs except in rare instances, for example, if a fund ends up holding so many shares in a particular corporation that selling them all at once would depress the price.<sup>215</sup> A fund might have to get involved in corporate governance if an investment policy requires it to hold shares in set proportions (such as an index fund). In such a situation, it could not sell poor performers and should therefore try

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<sup>210</sup> Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 n.9 (Feb. 7, 2003) (proposing regulations subsequently codified at 17 C.F.R. pts. 239, 249, 270 & 274).

<sup>211</sup> 29 C.F.R. § 2509.94-2(1) (2005).

<sup>212</sup> 17 C.F.R. §§ 239, 249, 270, 274 (2005).

<sup>213</sup> Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 n.9.

<sup>214</sup> John J. Brennan & Edward C. Johnson, *No Disclosure: The Feeling Is Mutual*, WALL ST. J., Jan. 14, 2003, at A14; Robert D. Hershey, *Signs Are Unclear on the S.E.C.’s Path*, N.Y. TIMES, Apr. 6, 2003, at C18.

<sup>215</sup> Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1435–36 (2002).



to improve them internally.<sup>216</sup> Otherwise, most funds have pursued a strategy of exit, not voice, following the “Wall Street Rule”: If investors don’t like what management is doing, they should sell their shares and take their money somewhere else.<sup>217</sup>

Some mutual funds did take an interest in long-term corporate welfare after the recent scandals. Some voted their shares to oppose executive stock options,<sup>218</sup> and several announced that they would take a more activist stance and impose stricter guidelines regarding corporate governance.<sup>219</sup> Nevertheless, the general approach of mutual funds toward long-term investing remains unclear. Unless funds could be counted on to reward good long-term corporate behavior, it is hard to see how they could be the catalyst for competition among public corporations in the arena of auditing and financial disclosure quality.

*C. The New Watchdog: Financial Statement Insurers*

Is there any private entity with an incentive to insist on the bold detective auditing that will then incidentally serve the public’s need for corporate transparency? So far, the outlook is not bright. The big accounting firms, who dominate auditing, do not currently compete with each other to offer high-quality work. Though regulation could nudge them in that direction, the GAAP standards would have to be reformed so that financial statement quality is more obvious. And, even if audit quality were more transparent, we have not identified a strong reason for corporations to pay extra for it. Corporations could disclose raw data, leaving investors to hire their own auditors to analyze it. Large investors who do hire auditors might approach the status of medieval lords with their own detective auditors combing the financial data for problems. But small investors would need to buy such auditing services from consultants, who might be able to succeed in the business without actually providing the needed watchdog-quality auditing.

In short, we are still seeking a principal for the auditor with both its own, direct interest in good detective work and the power to see that it is delivered.

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<sup>216</sup> Securities and Exchange Commission, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 n.13.

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

### 1. The Mechanics of FSI

An intriguing suggestion is that insurance companies could be the proper principals for auditors. The proposal is Financial Statement Insurance (FSI) for public companies.<sup>220</sup> A Model Financial Statement Insurance Act, patterned on the Trust Indenture Act of 1939, has been drafted by Professor Lawrence Cunningham<sup>221</sup> (and described in detail by Professor Joshua Ronen<sup>222</sup>). With FSI, companies would have the option to insure themselves against claims that their financial statements are misleading. FSI insurers would hire auditors to review the quality of the corporation's accounting and estimate the risk that it will mislead investors. Insurers would offer companies coverage on the basis of an expert risk assessor's report. In Ronen's proposal, shareholders would vote whether to accept the maximum insurance offered, an amount suggested by management, or no insurance at all. The key is that the FSI insurer, and not the corporation, would commission an audit of the financial statements. Based on the audit, FSI will be issued (or declined if the insurer found the risk unacceptable), and the premium price determined.<sup>223</sup>

Crucially, Ronen proposes that the policy coverage amount and premium cost of a corporation's FSI policy be made public. The amount of insurance will notify investors of what they might hope to recover in fraud litigation. Though plaintiff investors may seek more, courts could limit damages on the theory that what investors paid for the shares already reflected the limited insurance coverage.<sup>224</sup> More importantly, the disclosure of the premium amount would provide information about the quality of the financial information, much as political polls are reported together with the margin of error so that readers can assess their reliability. High insurance at a low premium would tell investors that the financial statements are reliable. Low

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<sup>220</sup> See Cunningham, *Choosing Gatekeepers*, *supra* note 147; Ronen, *supra* note 5. For a more formal economic description of the FSI model, see ALEX DANTON ET AL., FINANCIAL STATEMENTS INSURANCE (2003), <http://pages.stern.nyu.edu/~jronen/articles/Academic%20FSI%20Paper.pdf> (last visited Feb. 28, 2005); see also David B. Kahn & Gary S. Lawson, *Who's the Boss?: Controlling Auditor Incentives Through Random Selection*, 53 EMORY L.J. 391, 424-30 (2004) (arguing that FSI will not be workable because of the difficulty of isolating bad financial disclosure as a cause of claimed damages to investors).

<sup>221</sup> Lawrence A. Cunningham, *A Model Financial Statement Insurance Act*, 11 CONN. INS. L.J. 69 (2004); see Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (2000).

<sup>222</sup> Ronen, *supra* note 5.

<sup>223</sup> Ronen, *supra* note 5, at 50-51.

<sup>224</sup> *Id.* at 58.

coverage at a high premium would give the opposite message. Investors would then have valuable information—what might be called “information about the information”—to use in deciding whether to buy a particular company’s shares.

The FSI plan also contemplates expedited evaluation of claims. A fiduciary organization selected jointly by the insurer and the insured corporation would do the initial review. Then an independent expert answering to the organization and the insurer would review the claim. With the expert’s approval, the claim would be paid expeditiously.<sup>225</sup> If the claim were denied at any stage, the investor could sue the corporation, as it can do now.

FSI, according to Professor Ronen, would also allow GAAP to become more principle based. Properly motivated auditors and corporations would no longer need the guidance that complex rules are supposed to provide.<sup>226</sup> Nor would comparability be a reason to keep the detailed GAAP rules. With FSI, the financial reports would provide a rounded narrative and investors could compare corporations by looking at the policy limits/premium disclosure.

## 2. Should FSI Be Mandatory?

A threshold question is whether FSI should be mandatory. So far, discussion has seemed to assume that it should not. Professor Ronen proposes that after an initial “jumpstart” period in which FSI is mandatory in order to develop the insurance market, individual corporations should be able to decide whether or not they want it.<sup>227</sup> Professor Lawrence Cunningham would not even have an initial period of mandatory FSI, but would simply offer corporations the choice of buying FSI or using traditional financial statement auditing.<sup>228</sup> This, he says, would offer “more effective self-tailoring of the financial reporting and assurance process.”<sup>229</sup>

The argument that FSI should be voluntary to allow corporations to tailor their own financial disclosure proves too much. By this reasoning, why not allow corporations to disclose unaudited financial statements, statements audited by auditors meeting only some or none of the Sarbanes-Oxley independence rules, or statements in

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<sup>225</sup> *Id.* at 51.

<sup>226</sup> *Id.* at 60–67.

<sup>227</sup> *Id.* at 68; cf. Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 7 (2002) (“[I]t would take only a small tweak to [Ronen’s proposed] system to imagine minimum coverage requirements based on market capitalization or other factors.”).

<sup>228</sup> Cunningham, *Choosing Gatekeepers*, *supra* note 147, at 427–32.

<sup>229</sup> *Id.* at 427.

formats<sup>230</sup> other than those allowed by the SEC? Any regulation has the effect of depriving market actors of the ability to make their own choices in the products sold or information released. The question becomes whether the good to be gained through regulation outweighs the evil of limiting choice. This Article has discussed the advantages of FSI. There is strong reason to believe that FSI cannot work unless it is mandatory because of the way in which investors are likely to react to a double regulatory scheme.

Recall that if FSI is voluntary, the SEC will need to keep regulating the auditors and monitoring the financial statements of those corporations choosing not to buy it. If we assume that corporations who reject the outside assessment of the FSI insurer and its auditor in favor of hiring their own auditors are more likely than insured corporations to produce deceptive financial statements, then residual SEC regulation of these corporations could be a problem. It could lull investors into the false belief that their financial statements are as good as, if not better than, those of insured corporations.

Share prices of the uninsured corporations could be doubly higher than warranted by economic reality. Not only would there be a greater chance that their financial statements are misleading, but the market might not sufficiently discount for the lack of insurance due to misplaced reliance on residual regulation of auditing. While sophisticated investors might understand that SEC regulation was not necessarily a mark of quality, less sophisticated investors could be misled. These corporations, in other words, could benefit by *not* buying FSI. This could trigger a race to the bottom, destroying the system and leaving FSI to be used by only a small top tier of corporations. On the other hand, mandatory minimum FSI will provide a level playing field and comparability of information. For every corporation, investors will know that the auditors work for insurers and that FSI coverage and premium information is available for comparison.

Mandatory FSI would benefit the regulatory system in two ways. First, the SEC would not need to provide residual regulation for non-insured issuers. It could get out of the business of routine auditing regulation and disclosure oversight, freeing resources for other uses, including prosecution of what should be a reduced number of deceptive financial disclosure cases. Second, if all issuers buy FSI, all of them will be able to disclose the amount of the FSI premium, which will be an independent indicator of the quality of financial

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<sup>230</sup> See, e.g., Securities and Exchange Commission Forms List, <http://www.sec.gov/about/forms/secforms.htm> (last modified Aug. 22, 2005).

statements. If FSI is optional, this information will be available for some companies but not all.

Furthermore, mandatory FSI will still afford corporations a great degree of flexibility. Shareholders can select the insurer, terms of coverage (within limits), and the amount of coverage. The law would set a legal minimum of coverage, perhaps calculated, as Professor Ronen suggests, as a multiple of the corporation's "largest negative earnings surprise" over the previous three to five years,<sup>231</sup> but companies could signal quality by buying more. Thus, by mandating FSI, the government would extricate itself from auditing regulation, while providing a "floor" of good behavior for the market and reliability for investors.

As a significant departure from current regulation, FSI will certainly require testing; for instance, it could be optional for a period of time, or it could be mandatory in selected industries or for issuers in a particular market-capitalization size range. Nevertheless, strong consideration should be given to making it mandatory to obtain its full benefits without wasteful and confusing duplicate regulation.

### 3. Elements of a Regulatory Framework

Whether FSI is mandatory or whether it is just a permitted alternative to current auditing practices, there should be federal minimum standards for FSI policies in order to see that policies adequately protect investors and that the disclosed information regarding policy size and premium really does give investors useful information about the corporation.

Regarding the content of policies, as Professor Cunningham points out, FSI is more akin to title insurance than to traditional liability insurance.<sup>232</sup> A company writing title insurance examines a property's deed and title documents and, if it is satisfied that title is good, insures that there are no defects. FSI insurers will likewise examine the financial statements and, if satisfied, issue a policy. Each is insuring the dependability of information, rather than offering protection against fortuitous events. In both cases, claims may not arise until years later. Thus, FSI policies should be occurrence based, rather than claims based.<sup>233</sup> If a policy is occurrence based, it covers damages resulting from an occurrence while it is in effect, even if a claim does not surface until later. This way, if an investor relies on

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<sup>231</sup> Ronen, *supra* note 5, at 68.

<sup>232</sup> Cunningham, *Choosing Gatekeepers*, *supra* note 147, at 444–45.

<sup>233</sup> *Id.* at 455–56.

misrepresentation while the policy is in force, the claim is covered, even if the policy is cancelled the next day. Investors could count on having an FSI policy to turn to as long as they confirmed before investing that the corporation was insured.

Insurance policies should also be required to cover claims against insured corporations that are bankrupt.<sup>234</sup> This is important even though the Sarbanes-Oxley Act made debts for judgments and settlements connected with securities law violations non-dischargeable in bankruptcy.<sup>235</sup> Non-dischargeability only preserves a debt—it does nothing to make funds available to pay it. With insolvent corporations unable to pay fraud judgments, investors naturally look to other defendants; but in 1995, Congress severely limited the doctrine of joint and several liability for securities fraud. A corporation that commits securities fraud often does so on its way into bankruptcy, but may be aided by a number of parties that survive and are solvent such as lawyers, securities analysts, and auditors. These solvent parties, however, are little comfort to injured investors, because they, like the disclosing corporation itself, can be held liable only for their proportionate share of the losses.<sup>236</sup> In short, even if investors are awarded full damages in a fraud proceeding, they are often unable to collect. FSI could remedy this.

Insurance coverage that survives the demise of the insured corporation will not only protect investors, but should also lead insurers to take steps to reduce the risk of catastrophic loss. For instance, in some cases, insurers could require that policies be backed by executives' personal guarantees to prevent them from looting a corporation, keeping the proceeds, and leaving the insurer to pay off deceived investors.<sup>237</sup> Insurers may also insist that

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<sup>234</sup> Obviously, insurers should be safeguarded against a deluge of ill-founded claims that might be filed against failing companies even by investors who were not actually deceived. One possibility might be to recognize the FSI policy as an asset of the estate of a company in bankruptcy for the limited purpose of satisfying claims by defrauded consumers and to direct the bankruptcy trustee to scrutinize and, if warranted, to deny claims filed within a stated period before the bankruptcy filing, e.g., six to nine months, much like the trustee's current power to set aside preferential transfers. 11 U.S.C. § 547 (2000). In Chapter 11 filings, where the debtor-in-possession usually serves as the trustee of its own bankruptcy estate, 11 U.S.C. § 1107(a), it might be advisable for the court to appoint a disinterested examiner to investigate claims. See 11 U.S.C. §§ 1104(d), 1106(a)(3) (stating that an examiner may "investigate the . . . liabilities . . . of the debtor").

<sup>235</sup> Sarbanes-Oxley Act of 2002 § 803, 11 U.S.C. § 523(a)(19) (Supp. II 2002).

<sup>236</sup> Private Securities Litigation Reform Act of 1995 § 201, 15 U.S.C. § 78u-4(f) (2000); see also *Enron Hearings*, *supra* note 64, at 5–6 & n.7.

<sup>237</sup> These guarantees will buttress the Sarbanes-Oxley provision that executives repay bonuses after a major restatement. Sarbanes-Oxley Act § 304, 15 U.S.C. § 7243.

corporations communicate better with stock-holding employees. Many of the small investors hurt in the Enron collapse were Enron employees who owned company stock in their retirement accounts, had not been encouraged to diversify, and were prevented from selling shares by a freeze just at the time share prices were plummeting.<sup>238</sup>

Furthermore, the FSI scheme may need to regulate how insurers set FSI premiums. A key aspect of FSI is that disclosed premium costs and policy limits give investors information about the quality of corporations' financial statements. This assumes that insurers will underwrite carefully, so that the premium a company pays for FSI actually represents the risk that *its* financial statements might be misleading. One worry is that to compete for business, insurers will set premiums too low.<sup>239</sup> This is hardly unique to FSI but occurs in any insurance market and is met by countervailing economic pressure to correctly assess premiums so that enough money is taken in to cover the risk of having to pay claims. State insurance laws may also regulate premiums to minimize the risk of insurers becoming insolvent.<sup>240</sup> And, insurers should find it easier to calculate FSI premiums than liability insurance premiums. As with title insurance, the bulk of the cost is in investigation, rather than in reserves for paying claims (as with liability policies). Once the insurer has audited the financial statements, it should have an excellent idea of the risk.

Another worry is that corporations might buy too much insurance if they believe that this shows particular confidence in the quality of their books. As Professor Cunningham suggests, this can be resolved by linking coverage to a metric such as the company's market capitalization.<sup>241</sup> Corporations might also try to manipulate to their advantage the premium/coverage figures through coverage choices that affect premium price, such as whether insurance is primary or secondary and whether it includes providing a defense to suit or only indemnification of liability. It may be wise to prohibit some of these choices through regulation; in any event, all of these choices made by an issuer should be disclosed, perhaps in a standard form chart, so that investors can make comparisons.<sup>242</sup>

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<sup>238</sup> FOX, *supra* note 1, at 289.

<sup>239</sup> Cf. Chan, *supra* note 179, at 370–71 (stating that insurance companies have incentive to earn premiums from companies despite the many risks involved).

<sup>240</sup> See Cunningham, *Choosing Gatekeepers*, *supra* note 147, at 468–73.

<sup>241</sup> *Id.* at 458–59.

<sup>242</sup> *Id.* at 467 n.13.

A related and more serious objection is that insurers might aggregate risk by charging companies that are known to present a high risk for issuing misleading financial information the same premium as those known to present low risks. If this were to happen, premium cost will obviously be less useful information. There are both market and regulatory checks available to control this sort of pooling. The market check is that insurers will want an accurate risk assessment so that the premium is set at a level that covers expected claims. Although for many kinds of insurance, insurers classify applicants as high-, medium-, or low-risk, and then use appropriate form contracts, this is generally not done for Directors & Officers and entity insurance. There, policies are individually tailored to the company's particular risks.<sup>243</sup> Since FSI involves issues of similar complexity, there is no reason not to expect insurers to tailor FSI policies similarly. They will have the information to do it; in Ronen's proposal, insurers will do a preliminary audit before even offering an FSI policy.<sup>244</sup>

Insurers might pool the risks of smaller companies in particular industries, on the theory that the risk assessment can be made with rough accuracy, and thus avoid the expense of a specific inquiry. This could benefit small companies by lowering their insurance costs, though it concededly would produce FSI premiums that did not precisely reflect individuated risk. Another danger might be that FSI insurers would pool FSI risk with risks on, for instance, life insurance or accident policies.

These pooling problems do not seem insurmountable but they should not be ignored. One solution would be for the SEC to prohibit insurers from pooling FSI risks with non-FSI risks. Proof of this could be in the form of a state regulator's certification that the FSI insurer would present to the SEC. The SEC would determine which insurance products are "Qualified FSI." The SEC could also provide a procedure allowing insurance companies to show the need for risk pooling for companies below a particular size. If a risk pool were approved, the disclosed premium amount would also bear a notation indicating that the insurer had used pooled risk in calculating the individual FSI premiums and perhaps referring the investor to the insurer's application and SEC decision (which could be posted on the SEC's website).

In short, FSI is a good market solution to the problem of misleading financial disclosure. However, there must be a regulatory

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<sup>243</sup> *Id.* at 457.

<sup>244</sup> *See* Ronen, *supra* note 5, at 50–51.



framework to ensure that all public companies use it, that coverage survives the demise of the insured corporation, and that premiums correctly reflect risk.

#### 4. FSI Returns Auditors to the Role of Detective

The overwhelming advantage of FSI is that auditors will finally be free to play one role only, that of detective. Because the FSI insurer wants to minimize its risk, it will insist on a thorough, impartial audit, including verification of assets and revenue, rather than just sample testing of records. Auditors will comply to please the insurer, who can offer repeat business, if not an in-house position.

Mandatory FSI will also demonstrate the traits of a healthy disclosure system. It will create several strong intermediaries for investors. The FSI insurer is obviously such an intermediary. The fiduciary claims-handling organization is another; it will make investors better able to recover damages if they have been deceived. FSI also provides more useful information. Corporations will produce better financial statements to begin with and auditors will audit them more carefully. Crucially, the policy size and cost will indicate the insurer's assessment of the quality of the financial statements, a valuable piece of additional information. Finally, FSI gives corporations incentives to improve disclosure voluntarily in order to qualify for high coverage at a low premium. The savings may not represent a great deal of money to the corporation, though they could matter to the division that prepares the financial statements. More importantly, the low premium will signal to investors that the company's statements are accurate.

FSI could be accommodated with less change in current practices than might be expected. First, FSI will work within existing liability rules because investors will be able to compare FSI premiums and policy amounts at any level (i.e., if liability rules favor corporations, all rates will be low; if they favor investors, all will be high). It can be objected that the existence of insurance will encourage claims, some of which will be false or exaggerated. The expedited claims process that Ronen proposes<sup>245</sup> should be able to deal with these claims; and, as noted, the PSLRA already sets a high bar for pleading a securities fraud case.<sup>246</sup> Second, there would be less need for the sort of changes in the accounting profession discussed above. Insurers could simply engage auditors from the

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<sup>245</sup> *Id.* at 51.

<sup>246</sup> *See supra* note 76 and accompanying text.

existing Big Four. Because of the insurers' need for a good audit, they may well refuse to hire auditors whose firms do non-audit work for the audited corporation. Very likely, insurers would hire in-house accountants to make a career of auditing. Third, there would be no need to change GAAP because auditors will have no incentive to manipulate the rules. As Professor Ronen states, FSI could make it easier to reform GAAP to focus on principles, not detail. Finally, the SEC will not need to get into the business of regulating insurance companies, but can instead cooperate with state insurance regulators.<sup>247</sup>

With this proposal, we have come full circle. Like the medieval lord, the insurer will be a principal with a self-interested reason to demand candor from the auditor. FSI resolves the confusion of auditors' roles inherent in securities disclosure auditing since 1933. Auditors can return to their first job of being good detectives, finding and reporting defects in financial statements.

#### CONCLUSION

There is something disturbing about corporations hiring their own auditors. As a federal judge commented in introducing an SEC roundtable on auditing reform, it is as if slaughterhouses hired their own meat inspectors.<sup>248</sup> The intuition that something is wrong is confirmed when we analyze the law to see what role it expects the auditor to play.

Historically, medieval auditors were detectives whose job was to scrutinize the accounts of their clients' agents in depth. Later, auditors did certification auditing, in which their clients engaged them to review and approve information to be disclosed to others. In auditing for securities financial disclosure, the law calls on the auditor to play the role of detective. The auditor, however, is still hired by the audited corporation, which has reason to prefer merely certification auditing. Even as reformed by Sarbanes-Oxley, federal

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<sup>247</sup> Cunningham, *Choosing Gatekeepers*, *supra* note 147, at 468–73 (noting that federal securities laws already rely on state corporation law, and that despite the strong protection of state insurance regulation from federal involvement, the federal government does have a hand in insurance regulation via its offering of reinsurance in extraordinary situations including nuclear reactors, terrorism, and floods). It has been suggested that insurance regulation should be federalized, given the scope and complexity of the modern insurance industry. The importance that FSI insurance be subject to uniform, high-quality regulation could lend support to those who favor that insurance regulation be federalized rather than left to the states.

<sup>248</sup> SEC. & EXCH COMM'N, *ROUNDTABLE DISCUSSION ON FINANCIAL DISCLOSURE AND AUDITOR OVERSIGHT* (Mar. 6, 2002), [www.sec.gov/spotlight/roundtables/accountround030602.htm](http://www.sec.gov/spotlight/roundtables/accountround030602.htm).

securities law reflects this divide. Some rules try to ensure good detective work (e.g., by having the auditor report to directors, not management), while others try to ensure honest certification (e.g., by limiting business relations between auditor and audit client). But all leave the auditor in the difficult position of having a legal duty—to serve as a “watchdog for the public”—that is, at the very least, in tension with the interests of his or her client.

Regulatory reforms, including the Sarbanes-Oxley Act, have never separated the auditor’s two roles. To succeed, however, reform must give auditors clear direction. If auditors continue to be hired by the audited corporation and to play the certification role, they must be fully independent of the client and be able to assess information quality against clear standards. If they are to be detectives, they must have an appropriate principal, namely, someone who wants a candid audit report. In this Article I have tested a number of reform proposals against these criteria.

Of four proposals to improve certification auditing, the one best able to stop auditor corruption and encourage competition for quality auditing is probably real-time disclosure of simplified information. This is promising, but has the potential to recreate the current problem if investors come to rely on financial information analysts who may have their own incentives to be sloppy or less than candid. As for detective auditing, the key is that the auditor report to someone who, unlike the audited corporation, has an interest of its own in ensuring aggressive auditing. One proposal is that auditors work for the government, but political concerns over federalism and government interference in business decisions, as well as the likelihood of undependable funding seem to rule out that option.

The best reform proposal is that corporations be required to insure their financial statements against liability for misleading investors. Insurers would hire auditors to ensure that the statements were not misleading. Because insurers have a financial interest in good auditing in order to avoid paying claims, they will want the auditor to be a good detective. Thus, FSI would fulfill the original vision of securities law as harnessing private incentives to serve the public good. It ends the certification/detective confusion that has plagued public auditing for seventy years. It finally gives auditors a client who wants them to be the public’s watchdog.