

4-1-2004

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Recommended Citation

David F. Birke, *The Toothless Watchdog: Corporate Fraud and the Independent Audit - How Can the Public's Confidence Be Restored?*, 58 U. Miami L. Rev. 891 (2004)

Available at: <https://repository.law.miami.edu/umlr/vol58/iss3/5>

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COMMENTS

The Toothless Watchdog: Corporate Fraud and the Independent Audit – How Can the Public’s Confidence Be Restored?

I. INTRODUCTION

“Th[e] ‘public watchdog’ function [of the Certified Public Accountant in performing independent audits] demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.”¹ This statement by Chief Justice Burger, writing for the United States Supreme Court, illustrates the public’s perception and expectations of the independent audit.² However, in the wake of recent corporate mega-scandals,³ public confidence in the attest function,⁴ particularly the independence of auditors, has been shaken.⁵ Lawmakers have been quick to criticize the accounting profession, suggesting that the auditors of the companies involved in these scandals were either complacent or complicit. In July 2002, Congress, in a rush to prevent further fraud and restore confidence in the financial markets, passed the Sarbanes-Oxley Act of 2002 (the “Act”).⁶

As a former auditor at a Big Five,⁷ now Big Four, accounting firm,

1. *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

2. Dan Bilefsky, *Dutch ‘Pitbull’ Was Challenging Accountants Long Before Enron*, WALL ST. J., Sept. 18, 2002.

3. Although the bankruptcy of Enron has captured the public’s attention, there have been others (*e.g.*, Sunbeam, WorldCom, Adelphia, Parmalat).

4. An attestation service is defined as “an engagement in which a practitioner is engaged to issue, or does issue, a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.” Statement on Standards for Attestation Engagements, No. 1 at § 100.1.

5. Cassell Bryan-Low, *Deloitte Yearly Revenue Rose 21% Even with Consulting Unit Issues*, WALL ST. J., Oct. 1, 2003.

6. Pub. L. No. 107-204, 116 Stat. 745 (2002).

7. The Big Five referred to the five largest accounting firms: PricewaterhouseCoopers, Andersen (formerly Arthur Andersen prior to the somewhat hostile spinoff of its major consulting arm, Anderson Consulting), Deloitte & Touche, KPMG Peat Marwick, and Ernst & Young. In June 2002, Andersen was convicted by a jury of obstruction of justice and sentenced by Judge Melinda Harmon, United States District Court for the Southern District of Texas, to five years probation and a \$500,000 fine. *See Anderson Sentenced to 5 Years Probation*, WALL ST. J., Oct. 17, 2002, available at 2002 WL-WSJ 3409072. As of the date of this Comment, Andersen had surrendered most of its state licenses to practice accounting. Consequently, partners and

I submit that current efforts to reform the accounting profession, though necessary, miss the mark. Congressional efforts aimed at improving auditor independence focus on providing the following remedies: curbing the amount and type of consulting services accounting firms can provide to audit clients, restricting client employment of former outside audit personnel, and requiring audit partner rotation. Although some of these reforms are necessary and would improve auditor independence, others are costly and fail to address significant factors underlying the diminution of audit quality. By addressing conflicts of interest through increasing already significant audit client employment restrictions, Congress has failed to recognize that longstanding institutional relationships between accounting firms and their clients greatly impact public perception of auditor independence. Further, although additional restrictions on non-audit fees may improve auditor independence, they do not improve audit quality because they do not change the relationship between audit fees and audit quality. To fill these regulatory gaps, mandatory rotation of audit firms and a change in audit fee structure are necessary.

This Comment discusses some of the current legislative efforts at regaining public confidence in the financial markets through regulation of the independent audit. Further, it suggests additional measures to address the gaps left by these legislative efforts. Part II provides a brief history of the public accounting profession, its role with respect to financial markets, and the structure of its regulatory environment. Part III discusses incentives to commit corporate fraud or engage in overly aggressive accounting practices. Part IV describes conflicts of interest inherent in the triangular relationship among the auditor, the company under audit, and the public. Part V discusses current efforts to deal with corporate fraud and accounting irregularities through reformation of the accounting profession, focusing primarily on the Act and whether it will accomplish its drafters' objectives. Part VI argues for mandatory rotation of audit firms and a change in audit fee structure.

II. THE PUBLIC ACCOUNTING PROFESSION AND ITS RELATIONSHIP TO THE CAPITAL MARKETS

A. *A Brief History of Modern Public Accounting*

The public accounting profession's genesis was in large part a reaction to nineteenth century corporate abuses of the public's trust.⁸ The

associates have flocked to other accounting and consulting firms, which are eager to sign up former Andersen clients.

8. See Jordan H. Liebman & Anne S. Kelly, *Accountant's Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L.J. 345,

need to channel capital into credit markets in the 1900s required regaining public trust in bankers and securities professionals by subjecting internal corporate affairs to greater public exposure.⁹ Although this movement was furthered by the leaders of the New York Stock Exchange,¹⁰ “the essential principles of classical economics . . . remained dominant in financial circles, so that the option of direct federal regulation to control corruption and fraud was resisted.”¹¹ Because direct federal intervention in corporate affairs would have subjected managerial decisions to *ex ante* scrutiny, such intervention would have run contrary to unfettered competition, a fundamental tenet of classical economics. Nevertheless, to provide increased corporate transparency, the public turned to the accounting profession.

Because there was little demand from the government for audited financial statements of privately held corporations, accountants focused on non-attest services such as tax consulting, budgeting, and internal costing systems.¹² The derivation of significant fees from non-attest functions and the lack of comparable audit fees resulted in a congruence of corporate and public accountants’ interests and strengthened the accountants’ view of themselves as business advisors rather than watchdogs.¹³ Consequently, there was little debate about accountants’ responsibility to parties other than their corporate clients.¹⁴ Further, early judicial decisions seemed to reinforce the belief that accountants had little responsibility to the public.¹⁵

Until the crash of 1929, investors and creditors seemed reasonably satisfied with corporate disclosures of financial information certified by accounting firms.¹⁶ However, because the accountant-client relationship structure had become so entrenched, reformers pushed for government regulation requiring auditors to provide the public with complete disclo-

353-54 (1992) (citing GARY J. PREVITS & BARBARA D. MERINO, *A HISTORY OF ACCOUNTING IN AMERICA* 129 (1979)).

9. *Id.* at 354.

10. *Id.*

11. *Id.*

12. *Id.*

13. *See id.* at 355. Reduced to a simple proposition, corporate interests are to maximize shareholder wealth, generally through profit generation. Because non-attest fees often can be linked to the efficacy of the accountant’s advisory services, accountants providing non-attest services may have a direct interest in the profitability of their clients.

14. *See* Rebecca L. Sczepanski, *Stockler v. Rose: Michigan’s Role in the “Play” of Third Party Liability for Negligent Accounting*, 42 WAYNE L. REV. 195, 197 (1995).

15. *See, e.g.,* *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931) (holding that if there has been neither reckless misstatement nor insincere profession, but only honest blunder, negligence will not lie).

16. LIEBMAN & KELLY, *supra* note 8, at 356.

sure of their corporate clients' financial positions.¹⁷ Thus, with the enactment of the Securities Act of 1933,¹⁸ issuers seeking to offer securities to the public had to register such offerings with the Securities and Exchange Commission ("SEC") and were required to file comprehensive financial statements certified by independent accountants.¹⁹

In the half-century following the crash, the entrepreneurial role of the accountant continued relatively unchallenged. It was not until the late 1970s, when massive investment funds were acquiring larger portions of American corporate equity, that the need for more reliable financial information became evident.²⁰ Because corporate equity continued to be spread over a greater number of investors, the relationship between stockholders and corporate managers was becoming more impersonal. Thus, rather than each investor verifying corporate information, efficiency demanded that one disinterested party perform the task. Recognizing this need, the American Institute of Certified Public Accountants ("AICPA") stated in its Professional Standards that it supports the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown and as government reliance on accounting information increases.²¹ Also, in 1984 Chief Justice Burger conveyed the Supreme Court's view of the public accountant's role when he assigned the term "public watchdog" to the profession.²²

The role of the public accountant as a watchdog seemed to pervade the public's perception through the 1980s.²³ Claims against public accountants, alleging either negligence or fraud, were rife throughout the 1990s,²⁴ and it is clear that public perception has changed little, if at all,

17. *Id.* at 357. "Some studies have advanced the theory that full disclosure would not have prevented the crash because it has never been established that investors prior to 1929 actually received inadequate information." *Id.* at n.55.

18. 15 U.S.C. §§ 77a-77bbb (2000).

19. *See id.* at § 77s(a). Comparable disclosure requirements may also be found in the Securities Exchange Act of 1934, see 15 U.S.C. § 78m(b) (2000), the Public Utility Holding Company Act of 1935, see *id.* at § 79n, and the Investment Company Act of 1940, see *id.* at § 80a-37(a).

20. LIEBMAN & KELLY, *supra* note 8, at 360.

21. *Id.* at 361 (citing AICPA Professional Standards, Code of Professional Ethics ET § 51.04 (Am. Inst. of Certified Pub. Accountants (CCH) 1984)).

22. *See United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

23. *See, e.g.*, Robert Chatov, *The Possible New Shape of Accounting in the United States*, 4 J. ACCT. & PUB. POL'Y 161 (1985). Referring to foreign bribes by American businesses, Chatov wrote: "The fact remained that outside auditors had failed to uncover the criminal activity rife among many of the largest U.S. corporations. Today, the events under scrutiny . . . have been termed audit failures involving major business firms and banks." *Id.* at 163.

24. *See, e.g.*, *Reves v. Ernst & Young*, 507 U.S. 170 (1993); *Endo v. Arthur Andersen & Co.*, S.C., 163 F.3d 463 (7th Cir. 1999); *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998); *Rodney v. KPMG Peat Marwick*, 143 F.3d 1140 (8th Cir. 1998).

since then.²⁵

B. *The Scope of the Independent Audit and Its Role in the Capital Markets*

Accountants play many roles in society. Perhaps the most significant is that of the auditor.²⁶ Much like investment bankers and securities lawyers, auditors function as gatekeepers to financial markets. Because “[o]ver time, individuals and institutions acquire reputation based on their behavior,”²⁷ entities acquire what is commonly known as “reputational capital.” By leveraging their reputational capital, accounting firms use trust to reduce their clients’ costs of capital transactions.²⁸ This is accomplished by giving assurance to capital markets, more efficiently than their clients, that issuers of financial statements conform to certain generally accepted standards.²⁹ Such efficiency is gained by allowing investors to rely on the work of one party, the auditor, whose interests are purportedly consistent with those of the investors, as opposed to issuers opening their books to each investor.

Generally, the public’s expectations of an independent audit are only tangentially related to audit efficacy. Although the limitations of an audit are well known to auditors, such is often not the case for users of audited financial information. Frequently, the public mistakenly assumes that auditors are “responsible for identifying and disclosing all instances of fraudulent financial reporting and illegal activities.”³⁰ Those who are not immersed in company finances often liken the role of an independent auditor to that of an Internal Revenue Service auditor. Even those who are so immersed may be confused as to the scope and purpose of an audit. As a former auditor, I am constantly reminded of

25. See Bryan-Low, *supra* note 5.

26. Norman S. Johnson & Ross A. Albert, “Deja Vu All Over Again”: *The Securities and Exchange Commission Once More Attempts to Regulate the Accounting Profession Through Rule 102(e) of Its Rules of Practice*, 1999 UTAH L. REV. 553, 556.

27. Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 494 (2001).

28. See *id.*

29. The standards used by auditors of publicly held entities are Generally Accepted Accounting Principles (“GAAP”). However, other bases of accounting exist and may be requested in other engagements. For instance, financial reports may be generated using the cash basis of accounting. Such a basis does not seek to match revenues with the costs incurred to produce those revenues, but rather reports costs as they are actually paid. Cash basis often is required by the Internal Revenue Service for income tax purposes. See *infra* for a more detailed discussion of GAAP.

30. Andrew W. Reiss, Note, *Powered by More Than GAAS: Section 10A of the Private Securities Litigation Reform Act Takes the Accounting Profession for a New Ride*, 25 HOFSTRA L. REV. 1261, 1273 1070 PLI/CORP 705, 718-19 (1997). “This misconception is commonly referred to as the ‘expectation gap.’” *Id.* at 1273 n.45.

the lengthy discourse required to explain the role of the independent auditor to clients.

To understand the gap between public expectations and those of the auditor (the "expectation gap"), it is important to understand the purpose of a financial statement audit from the perspective of the profession and the tools used by the auditor to complete the task. Such an understanding is necessary if the expectation gap is to be bridged. Bridging the gap better positions the public to decide what further assurance, if any, it needs for investment decisions and whether the benefit of additional assurance exceeds the cost. That said, "[t]he objective of an audit of financial statements by the independent auditor is the expression of an opinion of the fairness with which [the financial statements] present in all material respects, financial position, results of operations, and . . . cash flows in conformity with generally accepted accounting principles."³¹ The objective is accomplished primarily by evaluating accounting records and other relevant information.

Two concepts in particular contribute significantly to the expectation gap: "materiality" and "reasonable assurance."³² Though relatively routine to the auditor, the word "material" denotes a pecuniary concept foreign to the general public. "The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements . . . while others are not."³³ Put differently, materiality means "the magnitude of an omission or misstatement of accounting information that, in light of the surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."³⁴

The cause of a misstatement is also a factor in the determination of materiality. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable chance that the payment could lead to a material contingent liability.³⁵ Even though the profession provides general guidelines, materiality is determined by the auditor's professional judgment based on his or her experience as well as various other factors.³⁶

31. AICPA PROFESSIONAL STANDARDS, STATEMENTS ON AUDITING STANDARDS NO. 1, AU § 110.01 (American Inst. of Certified Pub. Accountants 2001) [Hereinafter SAS].

32. The contribution of reasonable assurance to the expectation gap is particularly apparent in the area of the auditors' responsibility to detect their clients' illegal acts. See Reiss, *supra* note 30, at 1276.

33. SAS No. 47, *supra* note 31, at AU § 312.03.

34. *Id.* at AU § 312.10.

35. *Id.* at AU § 312.11.

36. See *id.* at AU § 312.09-25. Determination of materiality requires consideration of both quantitative and qualitative factors. Materiality is first assessed in the planning stage of the audit

Materiality must be applied contextually and therefore varies from entity to entity. Because those unfamiliar with the concept of materiality tend to relate the value of a potential misstatement to their own financial worth, rather than to the worth of the entity under audit, auditors have come to anticipate the incredulity of a layperson who has just been told that one million dollars is immaterial to the financial statements of a company whose balance sheet shows net assets in excess of one billion dollars.

The auditor must plan and perform the audit to obtain *reasonable assurance* about whether its client's financial statements are free of material misstatement, whether caused by error or fraud.³⁷ Because of the nature of audit evidence and the characteristics of fraud, an audit can provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements.³⁸ One of the primary tools used by the auditor to achieve reasonable assurance is sampling. Sampling is the process by which a population of accounting information, such as all accounts receivable on the last day of the entity's year, is tested through evaluation of a sample of that population.³⁹ Sampling can be either statistical or non-statistical, both of which require the auditor's professional judgment. Because less than 100 percent of the population is tested, it is possible that a material misstatement may not be detected. Further, given the nature of fraud, even if underlying financial records of an entire population are tested, an intentional misstatement (i.e., fraud) may be difficult to uncover.⁴⁰

Given the use of ambiguous terms such as "fairness," in all "material respects," and "reasonable" in the standard audit opinion,⁴¹ congres-

and is generally calculated as a percentage of net income or loss, total assets, net assets or revenue depending on the characteristics of the industry and individual entity. Other factors include, but are not limited to, internal control structure, complexity of business transactions, integrity of management and ability of accounting staff. *See id.*

37. SAS No. 1, *supra* note 31, at AU § 110.02. A material misstatement can be either intentional or unintentional. An intentional misstatement can be fraudulent.

38. *Id.*

39. For example, when testing revenue recognition of a software company that sells licenses bundled with support services, the auditor will likely perform the following: 1) obtain the numbers of the first and last invoices generated during the reporting period; 2) input those numbers into a computer program to generate a random sample based on the size of the population and the level of confidence desired by the auditor; 3) pull the selected invoices; and 4) review the invoices and trace the transactions back through the accounting records to ensure proper recognition of revenue.

40. Fraud can involve multiple parties in complicity to misappropriate assets or misrepresent financial information. Also, underlying third party data or company records used as audit evidence can be falsified. Though complicity is less common, it is much more difficult to detect.

41. Following is an example of a standard unqualified or "clean" audit report covering a single year:

Independent Auditor's Report

sional and public frustration with and confusion about the independent audit are easily understood.⁴² In fact, it is these very terms that may provide the fodder for claims against accounting firms in shareholder derivative suits and direct actions. Because the cost of complete assurance would be prohibitive, it is unlikely that capital markets would ever demand such assurance of auditors. Until they do, auditors must qualify their opinions with such malleable language.

Despite concerted efforts by the profession, auditors have been constantly reminded that they have failed to close the expectation gap. Because the current post-Enron atmosphere demands more from capital market gatekeepers, I believe that now is the time for the accounting profession to join with lawmakers in an effort to close the expectation gap and help restore confidence in the independence of public accountants.⁴³

C. *Self-Regulation: GAAP, GAAS, and the Audit*

Also important to understanding the accounting profession is an awareness of its regulatory structure and environment. The accounting profession is largely self-regulated. Self-regulation of the accounting industry can be traced to just after the establishment of the SEC by the Securities Exchange Act of 1934.⁴⁴ "The SEC was given statutory

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of *material misstatement*. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above *present fairly, in all material respects*, the financial position of X Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

SAS No. 58, *supra* note 31, at AU § 508.08 (emphasis added).

42. Reiss, *supra* note 30, at 1287.

43. Cf. Jordan H. Liebman & Anne S. Kelly, *Accountant's Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L.J. 345 (1992). Liebman & Kelly suggest that because the well-established accounting profession would be fervently opposed, radical structural change in the accountant-client relationship is unlikely. *Id.* at 366.

44. 15 U.S.C. § 78j-1 (2000).

authority to set accounting standards [for companies subject to the Securities Exchange Act] and oversight over the activities of [their] auditors.”⁴⁵ Since then, the SEC has looked largely to the profession to establish both accounting and auditing standards.

In recognition of the profession’s expertise, the SEC historically has relied on private-sector standard-setting bodies to lead efforts in establishing accounting principles and reporting standards.⁴⁶ The first notable initiative was between 1938 and 1959 when the AICPA’s Committee on Accounting Procedure (“CAP”) issued fifty-one authoritative pronouncements called Accounting Research Bulletins (“ARBs”).⁴⁷ ARBs formed the basis for what is now known as GAAP.⁴⁸ The CAP was replaced by the Accounting Principles Board in 1959, another part-time body that issued thirty-one new standards in its fourteen-year existence.⁴⁹

Due to both the increasingly complex business environment and the public’s call for a more independent body, the profession decided that a new full-time entity was required. As a result, in 1972 primary responsibility for setting accounting standards was transferred to the Financial Accounting Standards Board (“FASB”), a body independent of the AICPA.⁵⁰ The FASB promulgates standards on topics ranging from broad accounting concepts to more specific disclosure requirements. These standards are recognized by the SEC as authoritative and generally are required by other users of financial statements.⁵¹

Through the AICPA and its predecessor, the accounting profession also has promulgated audit standards known as Statements on Auditing Standards (“SAS”).⁵² SAS help to ensure uniformity in audits as well as

45. American Institute of Certified Public Accountants, *A Brief History of Self-Regulation* (Feb. 20, 2002), at <http://www.aicpa.org/info/regulation02.htm>. See also Securities & Exchange Commission, *SEC Policy Statement: Establishment and Improvement of Standards Related to Auditor Independence* (July 17, 2001), available at <http://www.sec.gov/rules/policy/33-7993.htm>.

46. American Institute of Certified Public Accountants, *supra* note 45.

47. *Id.*

48. See *supra* text accompanying note 29.

49. See AICPA, *supra* note 45.

50. The FASB operates under the auspices of the Financial Accounting Foundation (“FAF”), which consists of sixteen trustees, twelve of whom are elected by representatives of FAF’s sponsoring organizations — the AICPA, the American Accounting Association; the Financial Executive Institute; the Securities Industry Association; the National Association of State Auditors, Controllers and Treasurers; the Institute of Management Accountants; and the Government Finance Officers Association. The other four at-large members are appointed by the FAF itself. The FAF, in turn, appoints the members of the FASB and its advisory council.

Id.

51. Even companies that are not required to file registrations with or report to the SEC often are required by lenders or shareholders to comply with GAAP.

52. The American Institute of Accountants, the AICPA’s predecessor, originally promulgated ten broad auditing standards known as Generally Accepted Auditing Standards (“GAAS”) which

a minimum level of quality by providing broad audit objectives as well as defined procedures for their performance.

Peer review has been an essential ingredient of quality control with respect to the audit.⁵³ Though large firms have engaged in peer review since the early 1960s as a means to enhance audit quality, the AICPA made the process compulsory in 1989 for all firms that audited publicly held companies.⁵⁴ Peer review is administered by the AICPA's SEC Practice Section ("SECPS"), which requires all members who audit publicly held companies to work for a firm that belongs to SECPS.⁵⁵ A peer review program is also in place for firms that audit non-SEC registrants. This program is administered by state CPA organizations and overseen by the AICPA.⁵⁶

Auditor independence is an element indispensable to the efficacy of the independent audit. Although the AICPA also promulgates rules regarding auditor independence through its Code of Professional Conduct,⁵⁷ the SEC was given statutory authority to define accounting, technical, and trade terms used in the acts governing issuers required to

were later adopted by the AICPA. Interpretations of GAAS are set out in the SAS. *See* Reiss, *supra* note 30, at 1275 n.61. The Audit Standards Executive Committee was initially charged with the responsibility of GAAS.

In 1978, the Auditing Standards Board (ASB) was formed as the SEC's successor. The ASB is now the entity within the AICPA that sets the ground rules for how an auditor determines whether the information reported in a financial statement is reasonable and whether it conforms with . . . (GAAP). It has 15 members, and as a senior technical committee it is authorized to make public statements without clearance from the AICPA Council or Board of Directors. As a practical matter, before promulgating auditing standards, the ASB carefully considers the views of the SEC's Chief Accountant, as well as the views of many others invited to comment on the proposals.

A Brief History of Self-Regulation, supra note 45.

Throughout this Comment, GAAS will refer to both the original ten pronouncements as well as its interpretations.

53. Peer review is the process by which an accounting firm is, in essence, audited by another accounting firm of comparable size. The purpose of peer review is to ensure that the audits of the firm under review comply with both GAAP and GAAS. *See A Brief History of Self-Regulation, supra* note 45. While I believe that peer review plays an essential role, experience tells me that this should not be the mainstay of quality control. Because of the severe consequences of failing a peer review, firms practice what seems to be professional courtesy. This is meant merely to suggest that prior to a peer review, while the firm under review does not "know" what engagements will be selected, the firm's management generally has a pretty good idea. Essentially, peer review is akin to asking the fox to guard the henhouse.

54. *See A Brief History of Self-Regulation, supra* note 45.

55. *Id.*

56. *Id.*

57. *See* AICPA PROFESSIONAL STANDARDS, CODE OF PROFESSIONAL CONDUCT, ET § 101 (American Inst. of Certified Pub. Accountants 2002).

register offerings or file reports with the SEC.⁵⁸ Pursuant to its authority, the SEC maintained its own auditor independence standards for approximately 60 years. In 1997, however, the SEC decided to look largely to a private sector body known as the Independence Standards Board ("ISB") to establish independence standards.⁵⁹ The ISB is composed equally of members from the accounting profession and the public.⁶⁰ In 1999, the ISB faced significant issues regarding its efforts to address auditor independence and asked the SEC to assume the project.⁶¹ Subsequently, the SEC amended section II of Financial Reporting Release No. 50 to state that it would no longer look to the ISB to establish independence standards, nor would it consider the ISB pronouncements authoritative.⁶²

The above amendment was promulgated approximately six months before the Enron debacle, the first of the corporate mega-scandals. Since then, as discussed in Part V, Congress, through the Act, has directed the SEC to adopt, *inter alia*, more stringent rules regarding auditor independence.⁶³ Although the new requirements address some valid concerns, many are unworkable and fail to address the most significant independence and audit quality issues.

III. INCENTIVES TO COMMIT CORPORATE FRAUD OR ENGAGE IN AGGRESSIVE ACCOUNTING PRACTICES

Because the only boundaries limiting the definition of fraud are those that limit human knavery, no invariable rule may be prescribed to such a definition.⁶⁴ A common definition, however, is "the intentional use of deceit, a trick or some dishonest means to deprive another of his

58. 15 U.S.C. § 77s(a) (2000); 15 U.S.C. § 78c(b) (2000); 15 U.S.C. § 79t(a) (2000); 15 U.S.C. § 80a-37(a) (2000).

59. SEC Policy Statement: Establishment and Improvement of Standards Related to Auditor Independence, available at <http://www.sec.gov/rules/policy/33-7993.htm>.

In FRR 50, issued February 18, 1998, the Commission announced its endorsement of the ISB. In doing so, however, the Commission stated that it was not abdicating its authority to modify or supplement ISB standards or . . . to take such other action as it may deem appropriate. . . . Because of the experimental nature of the ISB, the Commission also stated in FRR 50 that it would review the operations of the ISB as necessary or appropriate and evaluate, within five years, whether the framework of the ISB was serving the public interest and protecting investors.

Id.

60. *Id.*

61. *Id.*

62. *Id.*

63. 68 Fed.Reg. 6006, 6006 (Feb. 5, 2003).

64. Geni M. Giannotti & Jason W. Winters, *Fraud and the Troubled Company*, AM. BANK. INST. J., June 1993, at 16.

... money, property or a legal right.”⁶⁵ In the capital markets, fraud often takes the form of a “sham transaction” or intentional misrepresentation of the financial information related to an otherwise legitimate transaction. Without the requisite intent to deceive, however, “aggressive” accounting practices do not fall within the boundaries of any legal definition of fraud.⁶⁶ While fraud must be distinguished from “aggressive” accounting practices, the two share common geneses. Consequently, unless otherwise stated, fraudulent intent will be assumed when referring to accounting practices in the ensuing discussion.

Corporate fraud can occur at any time during a company’s existence.⁶⁷ Though its form may vary,⁶⁸ its causes are relatively similar. Generally, fraud is commenced in response to financial trouble⁶⁹ or greed. This section will briefly discuss the factors contributing both to financial trouble and greed, as well as the contribution of GAAP to misrepresentation of financial information.

It is generally believed that most people who engage in fraudulent financial reporting once were honest people who, for one reason or another, eventually succumbed to personal or corporate pressure.⁷⁰ Although pressure on corporate management to report positive financial information has always been severe, the boom of the 1990s illuminated this point in the extreme. Rare was the investor who did not believe that his or her investment should yield double-digit returns. Such beliefs were demonstrated by the punishment visited on companies for failing to meet quarterly earnings or revenue projections, regardless of the reason.⁷¹ Thus, it is not difficult to imagine the substantial pressure to use fraudulent, not to mention aggressive, accounting practices to inflate a company’s financial position.⁷²

65. See <http://dictionary.law.com>.

66. It is helpful to understand that GAAP is necessarily fraught with rules that require management to estimate values or rates. Consequently, reasonable people may disagree on the proper estimate for a given transaction or account balance. Intent to deceive must be distinguished from intent to adopt a particular position on the accounting treatment of a particular transaction. Merely taking a position that others may disagree with does not require intent to deceive. Inevitably, the measure of a particular position becomes the judgment of a reasonable disinterested auditor. Thus, to fall within the definition of fraud, accounting treatment must be beyond the range of reasonableness.

67. Giannotti & Winters, *supra* note 64, at 16.

68. Examples of fraudulent activity include embezzlement, forgery, expense padding, and financial misrepresentation. *Id.*

69. Financial trouble, as discussed *infra*, may be no more than the fear of the market’s negative reaction to financial information.

70. Giannotti & Winters, *supra* note 64, at 16.

71. Because many high-tech startups were reporting heavy losses in the 1990s, business valuations were often driven by the promise of revenue.

72. I recall the efforts of a client to vehemently argue for the recognition of approximately \$25,000 in revenue in the current quarter by questionable characterization of the transaction to

Also a cause of much fraud is the personal greed of those best in a position to profit from such fraud. The ability to profit from fraudulent financial reporting is often a result of the tying of executive compensation to the company's financial performance via stock-based incentives.⁷³ For example, because of the recognition that managers' and shareholders' incentives must be aligned to solve problems of different perspectives, stock options have become an increasingly important form of executive compensation.⁷⁴

Because options have value to the grantee only if the grantee is "in the money," meaning the stock price is above the exercise price at the time of exercise, swings in stock price can mean almost instant wealth for the executive who holds large amounts of options that are exercisable in the near future.⁷⁵ "More formally, the Black-Scholes option pricing model⁷⁶ instructs us that the value of the executive's stock option will be increasing both in value of the underlying security and the variance (since stock options are issued 'at the money')."⁷⁷ Consequently, managers have incentives not only to commit fraud to increase stock price but also to engage in risky ventures that increase stock price volatility.⁷⁸ Although stock-based incentives align managers' interests with those of shareholders', they are not without their costs.

avoid the clear language of an SEC Staff Accounting Bulletin. While the amount was immaterial to the company's quarterly loss, it was approximately 25% of quarterly revenue. It was only after heated debate that the disagreement was resolved and the revenue properly recognized in the succeeding quarter. This example is not intended to disparage the company or the integrity of its executives, but merely to illustrate the pressure to meet analysts' and, therefore, the market's expectations.

73. See generally Jeffery N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation*, *Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002).

74. *Id.* at 1245. Stock options are a preferred vehicle primarily because of their "mismatch between accounting and tax consequences: the grant of stock options is not booked as an 'expense' that reduces accounting earnings, yet, when exercised, options produce a tax deduction for the firm equal to the difference between the market value of the stock and the exercise price of the option." *Id.* Issuances of stock options often are not recorded in the income statement as compensation expense during the period. Although Statement of Financial Accounting Standards ("SFAS") No. 123 requires income statement recognition of the fair value of employee options granted, it also allows companies to continue to use Accounting Principles Board ("APB") Opinion No. 25 and instead make *pro forma* disclosures in the notes to the financial statements detailing the fair value of the options granted. Because use of SFAS No. 123 would drag down earnings, most companies have chosen to report under APB No. 25 and merely make *pro forma* disclosures, which are buried in the notes to the financial statements, in the hopes that investors will pay little attention.

75. *Id.* at 1246.

76. The Black-Scholes option-pricing model is widely recognized by the accounting profession as the primary means by which to value stock options. It calculates the theoretical value of the option by using inputs such as the exercise price, an assumed interest rate, the underlying stock's volatility and the expiration date of the option.

77. Gordon, *supra* note 73, at 1246-47.

78. See *id.*

Though not nearly as significant as the aforementioned incentives, the contribution of GAAP to financial misrepresentation is worthy of brief mention. As any former or practicing auditor can attest, GAAP can create a labyrinth of complex rules that only an experienced auditor could hope to understand.⁷⁹ Without experienced accounting personnel, management has very little chance of complying with GAAP when engaged in complex transactions.

Further, many accounting standards require significant managerial estimates. Consequently, when companies engage in transactions for which they lack the operating history to accurately estimate results, those results might well fall outside a reasonable range of values. If the estimate, while made in good faith, is significant and inaccurate enough, the impact on stock price could be disastrous because of the unforgiving market.⁸⁰

For the less honorable, accounting estimates can be a playground for earnings mismanagement. One common technique, of which the SEC has taken note, is the use of "cookie jar reserves" to manipulate earnings.⁸¹ Companies can overestimate liabilities or contra-asset accounts⁸² in "good years" and then reach in and take the overestimated amounts back into income in "bad years." Another technique is the "big bath."⁸³ The term denotes the practice of including charges arguably unrelated to the specific costs incurred when management decides to restructure the company's operations.⁸⁴ This practice is defended by management under the rubric of conservatism, a fundamental precept of financial accounting. The force driving this practice is the belief that the market will forgive a one-time charge.⁸⁵

79. I am not aware of any "Big Five," now "Big Four," accounting firm that does not have a significant full time staff of experienced partners or managers whose job is not to deal with clients, but to serve as technical support to those who work "in the field." These groups not only provide support, but often serve as liaisons for the firm between the FASB, SEC and other regulatory bodies.

80. "I recently read of one major U.S. company that failed to meet its so-called 'numbers' by one penny and lost more than six percent of its stock value in one day." Arthur Levitt, Former Chairman Securities Exchange Commission, *The Numbers Game*, Remarks at the NYU Center of Law and Business (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

81. See *id.*

82. A contra asset account is an account that reduces the value of its corresponding asset account. For example, Allowance for Doubtful Accounts is used to reduce the value of accounts receivable by the amount management believes to be uncollectible.

83. Levitt, *supra* note 80.

84. *Id.*

85. *Id.* Because of the nature of estimates, it is extremely difficult to suggest, not to mention prove, any malfeasance with respect to such estimates. Further, conservatism, one of the fundamental precepts of accounting, appears to be at odds, in this situation, with the goal of the fair presentation of financial statements.

The purpose of this last section is not to suggest that GAAP is ineffective overall, or to argue for another basis of accounting.⁸⁶ This section is meant merely to illuminate some of the tensions created by accounting standards and how companies can “play by the rules” while manipulating financial reporting outcomes. Although GAAP may have its problems, many would argue it is the best we have.⁸⁷

IV. INHERENT CONFLICTS

A. *Who Is the Client?*

Because the independent auditor renders an opinion on reports issued to the public that represent a corporation’s financial status, he assumes a public responsibility that transcends the client relationship.⁸⁸ “[The auditor] . . . owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public.”⁸⁹ Chief Justice Burger’s statement underscores not only the Court’s but also the public’s view of the triangular relationship among the auditor, the company, and the public.⁹⁰ Most managers and directors appreciate that the auditor’s primary responsibility is to the public. Nevertheless, sometimes it seems that managers believe auditors should align with management rather than the public when accounting treatment must be applied in an area in which reasonable minds differ.

As a predicate to analyzing the complex issues created by this triangle, it is helpful first to understand the nature of the relationships. Although accounting firms perform many functions, generally auditors are engaged by their corporate clients to opine on the accuracy of the entity’s financial statements. The engagement usually results from statutory, regulatory, or contractual requirements imposed on the entity.⁹¹

86. GAAP is based on the accrual method of accounting. As discussed *supra*, other methods of accounting exist.

87. I believe that significant benefit could be gained by making accounting standards much less complex, though such a discussion is beyond the scope of this Comment. It is my experience that few in the investing public actually understand what they are reading in the financial statements and footnotes to the financial statements. Further, financial analysts often will essentially “rewrite” financial statements by “carving out” certain charges. For example, non-cash deferred compensation charges for employee stock options issued below fair value are often pulled out of earnings per share.

88. *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

89. *Id.* at 818.

90. While auditors do not function as advocates, the relationship may be compared fairly to that of the lawyer and his corporate client. For a discussion of the triangular relationship among lawyers, corporations, and the public, see Geoffrey C. Hazard Jr., “*Triangular Lawyer Relationships*”: An Exploratory Analysis, 1 GEO. J. LEGAL ETHICS 15 (1987).

91. Rarely does an entity engage an auditor to ensure its compliance with GAAP absent a third party requirement. As discussed *supra*, the Securities Act of 1933 requires an audit of the financial statements of an issuer seeking to register offerings of securities under that act. Further,

Consequently, the auditor's work product, its opinion, is primarily used by third parties.

Although auditors and their clients understand the nature of the engagement well, clients nevertheless appear to expect, and the AICPA guidelines require,⁹² a certain level of loyalty. The loyalty starts with the duty not to disclose confidential client information.⁹³ However, as the relationship grows over the years, the expectation grows as well. More particularly, over the long-term, clients begin to expect a certain amount of flexibility from the auditor. Because of the subjectivity of accounting estimates, this flexibility primarily appears in estimates. For example, if management takes a position on a given estimate that the auditor does not believe to be the best available choice, the auditor may nevertheless acquiesce because the estimate arguably falls within the bounds of reason.⁹⁴ The judicial analogue for this standard of review would be "abuse of discretion." The necessary implication of such a standard is that decisions are being made not on the basis of what the auditor believes to be the best choice, but rather on the basis of whether the client's choice is "reasonable" under the circumstances. Or, for the more cynical, "Can we defend this practice if we are hauled into court?" Because the line between intentional misstatements and aggressive accounting is so tenuous, aggressive accounting practices are easily justified, maybe appropriately, in the minds of management and auditors.⁹⁵

publicly traded companies are statutorily required to be audited annually and reviewed quarterly. Most private lenders or equity financiers also condition the advancement of capital on a "clean" audit opinion.

92. See AICPA PROFESSIONAL STANDARDS, CODE OF PROFESSIONAL CONDUCT, ET § 301 (American Inst. of Certified Pub. Accountants 2002) (discussing confidential client information).

93. *Id.* Although beyond the scope of this Comment, it is worth mentioning that this duty appears on its face to conflict with the purpose of the Securities Acts as well as the nature of an audit itself. However, during the course of an audit, auditors are privy to many types of proprietary information, including methodologies, customer lists, and management's strategic plans. As a result, disclosure of certain confidential information has broad implications regarding the client's viability. For example, management may solicit the advice of its auditors about the consequences of a particular transaction. Often such a transaction could have a significant impact on the financial position of the company. If management had not yet decided on a course of action, and this information was made public, the market might react violently to a mere contingency.

94. Because auditors, like other gatekeepers, are rational actors, they are driven by the perceived level of risk associated with a given course of action. They may acquiesce to the client's request for "flexibility" because they perceive the risk associated with such acquiescence as less than the cost of a strained client relationship. See generally Partnoy, *supra* note 27, at 494.

95. This statement merely reflects the auditor's struggle to reconcile the client's position with the auditor's best judgment. Because there is often no "right" answer with respect to an estimate, any position within certain bounds can be justified even though it may not be the "best answer." Plausible arguments may be made on either side of the fence: The estimate is too conservative and the company is creating a "cookie jar reserve" or the estimate is too aggressive and the value is not realizable.

From the above discussion, it is not necessary to infer that an auditor's acquiescence to a management position is grounded in anything other than the desire to "play by the rules" while accommodating its client. It does, however, demonstrate the inherent conflicts in the relationship among the auditor, the client, and the public. Though these conflicts are reconcilable, they may be undermining the auditor's reputation, and thus his viability as a gatekeeper for the capital markets.

B. *Audit Status and Fee Incentives*

This section explains corporate managers' perception of the audit as well as the nature and reasons behind the shift in audit methodology and audit fee structures. Further, this section suggests that changes in fee structure have affected audit quality.

Clients often perceive an audit as having little benefit outside of satisfying an externally imposed requirement.⁹⁶ It is just another cost the company and its employees must bear. Any auditor can attest to the all too familiar look of disdain on the client's face when the auditor arrives with laptops and supply kits in hand. This means only one thing to the client's accounting staff — more work. To the entity's upper management, it means explanations of past transactions that often require complex schedules and voluminous reports to support. As a result, managers often feel as though their judgment, and sometimes their integrity, is being questioned. Because this sentiment represents the opinion of many if not most clients, it is fair to say that the audit is viewed largely as a commodity.⁹⁷

Though managers of both large and small entities subscribe to the audit commodity view, large entities may have significant justification.⁹⁸ Most reporting companies⁹⁹ have highly competent financial and accounting personnel who are able to perform all but the most important function of an auditor — the opinion of an independent third party. In

96. See Bryant G. Garth & Carole Silver, *The MDP Challenge in the Context of Globalization*, 52 CASE W. RES. L. REV. 903, 919 (2002).

97. See *id.*

98. Many smaller companies do not employ personnel with the requisite expertise to account for business transactions in accordance with GAAP. Also, such personnel often do not have the skills to evaluate and structure their employer's business processes to ensure, *inter alia*, adequate financial reporting or control of assets.

99. Reporting companies are those companies subject to the Securities Exchange Act of 1934.

Three categories of companies are subject to the '34 Act's continuous disclosure requirements: 1) companies that have a class of securities listed on a national exchange (Section 12(b)), 2) companies that have assets in excess of \$10 million and that have a class of equity securities held by at least 500 persons (Section 12(g) and Rule 12g-1), and 3) companies that have filed a '33 Act registration statement that has become effective (Section 15(d)).

JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIAL* 8 (3d ed. 2001).

fact, it would be safe to say that there are few chief accounting and financial personnel in reporting companies who do not have significant Big Five experience.¹⁰⁰

Because of the audit's commodity status among corporate management, "and the rise in importance of the Chief Financial Officer (in many cases a former partner of the Big Five), . . . there is intense competition over fees."¹⁰¹ Such fierce competition, coupled with management's view of auditor interchangeability, has forced accounting firms to bid for audit clients on a fixed-fee basis rather than an hourly basis as was common in the 1960s and 1970s.¹⁰² Previously, junior auditors often were billed at four times their cost.¹⁰³ Now, it is typical for the billing ratio to fall below two, or even one, when the accounting firm is faced with a competitive bid.¹⁰⁴ This type of fee arrangement has considerable implications with respect to audit profitability, therefore increasing the potential for diminution of audit quality.¹⁰⁵ Accounting firms have done little to change this view, and in fact may have aided in perpetuating the audit's commodity status by submitting low-ball bids for new or continuing audit engagements.

Often times, accounting firms will employ the audit in a "loss leader" strategy.¹⁰⁶ The loss leader strategy works by pricing the engagement below the accounting firm's cost to perform the audit in order to create a relationship with the client. This strategy can be used both with large and small clients. During the late 1990s, the strategy was used extensively when bidding for startup companies. The hope was that the client would go public, and the firm then would be able to charge full fees for the initial public offering. The strategy is also an effective way to gain access to a client that later would use the firm's extensive consulting practice — at full fees, of course. The problem is that by low-balling bids for audit engagements, the accounting firm

100. The Big Five strive to place outgoing personnel in the employ of their clients. This practice primarily serves to retain clients. However, the practice also has the ancillary benefit of making an audit more efficient. Lately, this practice has been the subject of much government scrutiny. See generally Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release Nos. 33-8183, 34-47265, 35-27642 (Feb. 5, 2003).

101. Garth & Silver, *supra* note 96, at 919.

102. *Id.* Though fee structures vary, the fixed fee is now the most prevalent arrangement with larger companies. It is often contingent on complete cooperation of the client, meaning that the accounting staff has the necessary audit evidence prepared before the auditors arrive in the field. In return, large clients often require the audit partner, manager, and senior to have experience in their particular industry.

103. Max H. Bazerman, *The Impossibility of Auditor Independence*, SLOAN MGT. REV., Sept. 22, 1997, at 89.

104. *Id.*

105. See Garth & Silver, *supra* note 96, at 919-20.

106. See 65 Fed. Reg. 76008, 76015-6 (2003).

sends a message, to the client and the firm's employees, that its audit services are fungible.¹⁰⁷

Before discussing the consequences of the fixed-fee arrangement, it is instructive to briefly examine the organizational structure of an accounting firm as well as audit procedures. Accounting firms, much like law firms, generally are organized under applicable law as either partnerships or limited liability companies. Also like law firms, but perhaps even more so, accounting firms' organizational charts bear strong resemblance to a pyramid. This structure allows firms to leverage their junior employees by using them to perform a large portion of the work.¹⁰⁸ For example, typical staffing for an audit of a mid-sized public client might include a partner, manager, senior, and two to four staff.¹⁰⁹

Fixed-fee arrangements, in conjunction with the increased complexity of business systems, have provided strong incentives for accounting firms to rethink the audit process as well as their general business practices.¹¹⁰ Audit procedures have changed to focus more on business processes and less on individual account balances.¹¹¹ Such changes both were necessary to respond to technological progress, and desirable to change the audit's status by providing value to the audit process.¹¹² The change in audit process also provided, subsequent to the implementation period, the ancillary benefit of increased profitability for audit engagements. Because companies' major business processes generally do not change frequently, economies could be gained by testing the business process thoroughly one year and then performing more limited testing in subsequent years, absent significant change in the business process. Further, by emphasizing control testing, work could be more evenly distributed during the year while performing the company's quarterly review.¹¹³ Therefore, accounting firms could increase effi-

107. *See id.*

108. Garth & Silver, *supra* note 96, at 918-19; *See also*, Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV., 989, 994 n.21 (2003).

109. As discussed *infra*, a concurring partner is also assigned to engagements with public clients.

110. As discussed *infra*, this may have had an impact on audit quality.

111. *See* Garth & Silver, *supra* note 96, at 920 n.51 (quoting DAVID GRAYSON ALLEN & KATHLEEN McDERMOTT, *ACCOUNTING FOR SUCCESS: A HISTORY OF PRICE WATERHOUSE IN AMERICA 1890-1990* (1993)). Deloitte & Touche was among the first to implement an almost paperless audit. During my tenure at Arthur Andersen, the firm had fully instituted a new audit process called "the Business Audit." Generally speaking, the Business Audit focused testing on risk areas by methods other than "substantive testing," such as process testing. While testing internal controls had always been included in audit programs, the Business Audit placed much greater reliance on control testing as opposed to substantiation of account balances.

112. Because there is a greater emphasis on processes, management recommendations on improving control or efficiency could be more extensive than in the past.

113. A review is of more limited scope than an audit. Consequently, the auditor does not express an opinion as to whether the quarterly financial statements are materially misstated.

ciency during historically slow times, allowing greater leverage of staff during year-end.

Though accounting theorists may disagree on whether a greater emphasis should be placed on control testing as opposed to individual account balance substantiation, none could plausibly argue that fixed fees are conducive to a more thorough audit. Because greater hours worked does not equate to greater hours billed in a fixed-fee arrangement, there is an underlying incentive to do less work, or at a minimum to have the least expensive employees perform the greatest amount of work.¹¹⁴ Though there is considerable pressure to increase engagement profitability, it is not necessary to infer that firms are performing less than GAAS audits. It is fair to infer, however, that the squeeze on audit profitability results in pressure on the auditor to perform the minimum work required to comply with GAAS, rather than to expand audit procedures beyond those required.

The significance of all this is that market forces have combined with accounting firms' responses to produce incentives that on their face conflict with the purpose of an audit. It is uncertain whether audit quality has been seriously affected by these factors. Nonetheless, one could not seriously contend that such factors are conducive to increasing audit quality. Rational economic actors will seek to maximize profit, and, certainly, accountants are rational economic actors.¹¹⁵

C. *Multi-Disciplinary Practice*

Largely as a result of the squeeze on audit fees, accounting firms began to search for other more lucrative services to provide to clients.¹¹⁶ Realizing that their audit relationships provided ample opportunity to design services clients would value, firms began recruiting MBAs and other non-accountants. The hope was to provide a broader array of services that would supplement the lower profit margins of audits.¹¹⁷

114. Garth and Silver suggest that audit staffing is more vertical than the previous pyramid shape. See Garth & Silver, *supra* note 96, at 920. Though partner and manager time may have increased due to increased complexity of business transactions and client demands, speaking anecdotally, I submit that the audit engagement's staffing structure is still heavily weighted at the bottom. For instance, when budgeting for a typical mid-sized public client, partner and manager time would be approximately ten to fifteen percent of total time spent on the client.

115. Some might argue that damage to a firm's reputational capital from misstatements will provide incentive to expand the scope of audit procedures. This argument, though appealing, lacks merit. Because auditor liability generally is determined by comparing the auditor's actions to audit standards that the accounting profession creates, the standards can be changed to accommodate decreases in audit profitability.

116. Garth & Silver, *supra* note 96, at 920.

117. *Id.* at 921. Such services include: tax consulting, enterprise resource planning, risk consulting, actuarial services, litigation support, strategic management consulting, due diligence

Eventually the firms became known as Multi-Disciplinary Partnerships ("MDPs").

MDPs have been and continue to be the subject of heated debate.¹¹⁸ The arguments are complex. In fact, entire scholarly works are devoted to the subject.¹¹⁹ The following section is intended merely to give a brief overview of the arguments regarding MDP practice as they relate to auditor independence.

The central theme of the MDP critic's argument is that fees derived from non-audit services impair auditor independence.¹²⁰ They contend that because non-audit fees generally are more lucrative, and in some situations account for more than half of total fees derived from a client, auditors are reluctant to confront clients on the appropriateness of accounting policies for fear of being replaced.¹²¹ Consequently, management can persuade the firm to buy off on overly aggressive or even inappropriate accounting treatment.

Proponents, principally accounting firms, argue that such services do not impair independence if they do not involve a financial interest in the client or the performance of certain accounting services for an audit client, both of which are prohibited by the profession.¹²² Additionally, working with management in a more cooperative capacity to evaluate and help design business processes allows the auditor not only to take a more proactive stance, but also to obtain more detailed knowledge than an audit would otherwise permit. Thus, auditors would be better able to identify and analyze risk areas.¹²³

Regardless of whether non-audit fees actually impair independence, the public believes that they do.¹²⁴ As will be discussed in the next section, much of the new legislation is aimed at reducing and monitoring the amount of non-audit fees accounting firms may derive from audit

services, outsourcing, and virtually anything else not prohibited by professional or regulatory authorities.

118. See generally Peter C. Kostant, *Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice*, 84 MINN. L. REV. 1213 (2000).

119. See generally Garth & Silver, *supra* note 96; Andrew M. Perlman, *Toward a Unified Theory of Professional Regulation*, 55 FLA. L. REV. 977 (2003).

120. See McCoy, *supra* note 108, at 991.

121. See generally Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release Nos. 33-8183, 34-47265, 35-27642 (Feb. 5, 2003).

122. AICPA PROFESSIONAL STANDARDS, CODE OF PROFESSIONAL CONDUCT, ET § 101.02-.05 (American Inst. of Certified Pub. Accountants 2003) (showing that direct or indirect investments in clients as well as performing management functions such as decision making are considered to impair independence).

123. Point in fact: Internal procedures at Andersen required the inclusion of the Computer Risk Management Group on an audit when the client had substantial computer information systems.

124. Gretchen Morgenson, *Market Watch; On Reform, It's Time to Walk the Walk*, N.Y. TIMES, Oct. 6, 2002, at C1.

clients. Although non-audit fees are generally more profitable than audit fees, I believe that substantial audit fees could easily breed the same reluctance to confront management on difficult issues. The audit's commodity status makes terminating an audit client extremely unattractive. This assertion is supported by the fact that only 348 accounting firms resigned from clients in 2002, with 59 related to independence issues or concerns about company practices.¹²⁵

PricewaterhouseCoopers's (PWC) promise to take a tougher stance with corporate clients using aggressive accounting policies is illustrative of accounting firms' reluctance to resign.¹²⁶ Recently, PWC stated that "in any case where we cannot resolve concerns about the quality of the information we are receiving or about the integrity of the management teams with whom we are working, we will resign."¹²⁷ This declaration is nothing new. Though professional standards are not specific as to when an auditor should resign, audit standards require assessment of management integrity and potential disagreement on application of accounting principles before an audit firm accepts a new client. PWC's statement merely confirms the public's perception that accounting firms have historically bent over backward to maintain the client relationship. Because the appearance of auditor independence is as important to the role of the independent audit as independence in fact, reform efforts do not go far enough to change the public's skepticism about the allegiance of audit firms.

V. LEGISLATIVE REFORMS

With the collapse of Enron and other corporate giants, Congress was forced to address public demands for greater protection from unscrupulous corporate managers. On July 30, 2002, Congress responded with the Act.¹²⁸ With respect to the independent audit, the Act has two key provisions: section 1 establishes a Public Company Accounting Oversight Board (the "PCAOB"), and section 2 addresses auditor independence.

The PCAOB is a non-governmental agency, overseen by the SEC, whose purpose is to monitor audits of companies subject to the federal securities laws.¹²⁹ The Act vests the PCAOB with substantial regulatory control over accounting firms that audit entities subject to the Securities

125. Jonathan D. Glater, *Pricewaterhouse Takes a Stand*, N.Y. TIMES, Jan. 1, 2003, at C1 (citing Auditor-Trak, a publisher of accounting industry data).

126. *Id.*

127. *Id.*

128. Pub. L. No. 107-204, 116 Stat. 745 (2002).

129. Pub. L. No. 107-204, § 101(a), 116 Stat. 745 (2002).

Exchange Act of 1934 or the Securities Act of 1933. This control is exercised by requiring public accounting firms subject to the Act to register with the PCAOB and subjecting those firms to PCAOB inspections, investigations, and disciplinary proceedings when appropriate.¹³⁰ Further, the PCAOB has the authority to establish or adopt auditing, quality control, ethics, independence, and other audit-related standards for registered firms.¹³¹

The second key provision, entitled Auditor Independence, will be the focus of this section. Section 201 appears to be the most daunting to accounting firms. It prohibits auditors from providing certain non-audit services to audit clients and requires any non-prohibited services to be preapproved by the company's audit committee.¹³² Although the prohibition of non-audit services might seem apropos in light of recent events, such measures do not completely address the independence issues. Indeed, many of the services prohibited by the Act already were prohibited by SEC rules before the Enron debacle. For example, firms could not design or implement for audit clients hardware or software systems that aggregate source data underlying the financial statements.¹³³ Consequently, with the exception of the audit committee approval requirement and the additional prohibition of certain other services, section 201 on its face appears superfluous.

Section 203 of the Act, though appearing to codify what already has been required by the profession, audit partner rotation,¹³⁴ subjects

130. *Id.* §§ 101, 102.

131. *Id.* § 101(c).

132. The following are prohibited services under section 201 of the Act:

- (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
- (2) financial information systems design and implementation;
- (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (4) actuarial services;
- (5) internal audit outsourcing services;
- (6) management functions or human resources;
- (7) broker or dealer, investment adviser, or investment banking services;
- (8) legal services and expert services unrelated to the audit; and
- (9) any other service that the Board determines, by regulation, is impermissible.

133. *See* 65 Fed. Reg. 76008, 76045 (Dec. 5, 2000).

134. *Compare* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017-18 with AICPA SEC Practice Section, Requirements of Members, available at <http://www.aicpa.org/members/div/secps/require.htm>, which provides as follows:

Assign a new audit partner to be in charge of each SEC engagement that has had another audit partner-in-charge for a period of seven consecutive years, and prohibit such incumbent partner from returning to in-charge status on the engagement for a minimum of two years except as follows:

- (1) This requirement does not apply to member firms that have less than five SEC audit clients and less than ten partners.

audit partners to PCAOB sanctions and other potential liability. Section 203 makes it unlawful for a registered public accounting firm to audit an entity subject to the Securities Acts if either the lead or reviewing audit partner has performed audit services for that entity for each of the previous five years.¹³⁵ Aside from subjecting the audit partner to liability under the Act, the only significant contributions were changing the profession's seven-year rotation requirement to a five-year requirement and broadening the rotation requirement to reviewing partners. This effort, though attractive at first glance, fails to recognize fully the nature of the firms' relationships with their clients.

The audit partner rotation requirement is intended to provide a fresh look at the engagement, while at the same time maintain engagement continuity.¹³⁶ The rotation requirement might have more merit if the partner assuming engagement responsibility after the five-year period were someone situated halfway across the world rather than someone seated in the office next door. It borders on the ridiculous to assume that the new audit partner will not have significant discussions with the outgoing partner about the audit risks of the particular client. Based on those discussions, the new partner, though he brings a different perspective, already will have his perception altered. Thus, the "fresh look" might be better termed "fresh-frozen." Further, partner rotation does nothing to address the considerable pressure management can continue to place on the audit firm.

Although section 206 is not new conceptually, it significantly extends prior SEC rules.¹³⁷ Section 206 relates to conflicts of interest and makes it unlawful for a registered public accounting firm to audit an entity subject to the Securities Acts, if certain of the entity's chief officers, or anyone serving in an equivalent position, were "employed by that registered independent public accounting firm and participated in any capacity in the audit of that [entity] during the 1-year period preceding the date of the initiation of the audit."¹³⁸

Pursuant to the authority of section 208(a) of the Act, the SEC has

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- (2) An audit partner who has been the audit partner-in-charge of an SEC audit client for seven consecutive years may continue to serve in that capacity for audits for periods ending within two years from the date the firm becomes a member, or within two years from the date the firm no longer qualifies for the exemption in (1) above, whichever is later.

135. Pub. L. No. 107-204, § 203, 116 Stat. 745 (2002).

136. See Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003).

137. See *id.* at 6007.

138. Pub. L. No. 107-204, § 206, 116 Stat. 745 (2002).

promulgated rules ("Final Rules") regarding auditor independence,¹³⁹ expanding audit client employment restrictions. Previously, under SEC rules, independence was impaired if "a former partner . . . or professional employee . . . accepts employment with a client if he or she has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies."¹⁴⁰ While the previous rules still apply, the Final Rule significantly extends the presumption's reach. The Final Rule, as required by the Act, not only requires a one-year "cooling-off" period but also extends the loss of independence to situations in which "any member of the audit . . . team who provides more than ten hours of audit, review or attest services for the issuer accepts a position with the issuer in a financial reporting oversight role."¹⁴¹

"Financial reporting oversight role" is defined as including those individuals who have direct responsibility for or supervise the preparation of the financial statements and related information included in documents filed with the SEC.¹⁴² Such a broad definition would provide a model that would preclude audit seniors¹⁴³ from employment with an ongoing audit client. Given that audit seniors are often used for brief periods on clients that are not "theirs," this seems like a heavy burden for both the auditors and the clients to bear. For example, small public clients often hire more experienced seniors as the personnel responsible for financial accounting and reporting. Given the rate of attrition in accounting firms, and the companies' need for competent financial reporting personnel, this definition appears too restrictive.

Another change implemented by the Final Rules, but not expressly required by the Act, is the prohibition of audit partner compensation "based on the act of selling non-audit services."¹⁴⁴ The prohibition's rationale is that such compensation would impair an auditor's objectivity because it may create financial self-interest.¹⁴⁵ Although compensation based on a percentage of sales provides a more direct relationship

139. See Strengthening the Commission's Requirements Regarding Auditor Independence, *supra* note 134.

140. *Id.*

141. *Id.* at 6008.

142. *Id.* at 6026.

143. Generally, an audit senior has three to six years of experience. He or she is the daily liaison between the audit partner and the client. Further, he or she is responsible for planning the audit, with partner and manager oversight, coordinating and training junior staff, and managing the daily audit operations.

144. Strengthening the Commission's Requirements Regarding Auditor Independence, *supra* note 134, at 6024.

145. See, e.g., AICPA, Practice Alert 99-1, Guidance for Independence Discussions with Audit Committees (May 1999).

between effort and reward, the suggestion that such a prohibition substantially dissipates any financial self-interest is not warranted. Even with such a prohibition, the economic incentive to sell non-audit services remains. Because partners share profits of the partnership, their selling efforts, while benefiting other partners, also serve their own self-interests.

There is little doubt that restrictions on non-audit services, employment relationships, and mandatory audit partner rotation under Title II of the Act are a commendable start. These measures, however, do not adequately address key disincentives to perform quality audits or the public's perception that auditors secretly swear allegiance to their clients. Additional reforms are needed to cure the structural infirmities that threaten quality audits and to change the public's perception of auditor-client relationships.

VI. A VISION OF THE FUTURE: ADDITIONAL REFORMS

Based on the public's outcry and congressional response, it appears that the auditor's perceived role has morphed again. Whereas auditors once were viewed as watchdogs, now lawmakers are trying to breed a new type of canine, a bloodhound.¹⁴⁶ Congress has made explicit the critical role auditors play as guardians of the financial markets. Given the auditor's starring role in a global production, the time is ripe for legislators to point their compass in a new direction. Because the appearance of independence is of primary concern, two additional reforms are needed: mandatory rotation of audit firms every seven years and a movement to structured hourly-based fees.

Section 207 of the Act requires the Comptroller of the United States to "conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms."¹⁴⁷ Such a requirement illustrates congressional concerns that audit quality may be impaired by long-standing relationships between auditors and their clients. Proponents of mandatory rotation make three significant arguments. First, because auditors grow too close to their client's management, they lose the requisite skepticism.¹⁴⁸ Second, auditors become desensitized to the client, therefore anticipating results rather than keeping alert to subtle circumstantial changes.¹⁴⁹ Third, in order to maintain

146. See Kostant, *supra* note 118, at 1243 (2000).

147. Pub. L. No. 107-204, § 207, 116 Stat. 745 (2002).

148. See AICPA, Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies, available at <http://www.aicpa.org/members/div/secps/lit/sops/1900.htm>.

149. *Id.*

the client relationship, auditors are tempted to smooth over problems.¹⁵⁰

In contrast, critics of mandatory rotation argue that audits are strengthened by institutional continuity, rotation is disruptive and would increase overall audit costs, and rotation of principal individuals occurs naturally.¹⁵¹ While critics offer valid concerns, given the current state of corporate affairs, public confidence in auditor independence must override such concerns. In this section, I will endeavor to show that these concerns are not as significant as critics would have us believe, and, in any event, they do not override the need to regain the appearance of independence. Further, the current fee structure, discussed in Part IV, requires restructuring.

The assertion that audits are strengthened by institutional continuity appears to have merit on its face. When viewed in conjunction with the assertion that rotation of principal individuals occurs naturally, however, it does not withstand attack. Though it is difficult to argue that continuous audit relationships provide little benefit, a deeper look at the relationship belies the continuity of which critics speak.

As discussed above, most audit work is performed by senior and staff auditors. Given that the rate of attrition is between twenty-two and twenty-eight percent for national accounting firms and seven and ten percent for local firms,¹⁵² most audit clients experience frequent rotation of audit personnel. Further, most of this rotation occurs at the junior and senior levels. Because junior staff and seniors are responsible for the majority of the audit work, most of the efficiencies are gained, or lost, at this level. With respect to partner and manager continuity, although it would suffer somewhat, current regulations already require rotation of engagement partners.¹⁵³

After accounting for admitted attrition, the critics' efficiency argument is little more than empty rhetoric. It is difficult to believe that any significant efficiency could be gained from such things as audit file location, baseline fees, and preprinted labels.

No doubt, information may be shared more easily among partners in the same firm, as in the case of a partner rotating off of an engagement, than between successor and predecessor auditors.¹⁵⁴ Nevertheless, informational barriers between firms are minimized by the fact that

150. *Id.*

151. *Id.*

152. David Satava, *The A to Z of Keeping Staff*, 195 J. Acct. 4 (2003). Anecdotally, I began work in 1997 with approximately 35 staff auditors; by the middle of 2001, roughly 10 remained.

153. Strengthening the Commission's Requirements Regarding Auditor Independence, *supra* note 134.

154. Professional Standards require that a successor auditor communicate with the predecessor auditor before accepting a new engagement. SAS 84, *supra* note 31, at AU § 315.03-.11.

professional standards recommend,¹⁵⁵ and sound firm policies demand, that successor auditors review predecessor audit work papers before accepting a new engagement. Further, sharing client information between rotating audit partners in an effort to gain greater efficiency strengthens the proposition that mandatory audit partner rotation is insufficient to provide a “fresh look” to the audit. Much of the remaining inefficiencies attributable to a change in audit firms could be recouped in the ensuing seven years, to the extent allowed by natural attrition.

Because the appearance of independence is integral to the audit’s function in the capital markets, the minimal efficiencies gained merely by leaving the “institution” in place, do not justify the diminution of the appearance of independence. In fact, given public animosity toward longstanding audit relationships, it seems likely that investors would rather pay slightly higher audit fees in exchange for additional assurance that auditors were not in bed with their clients.

Mandatory rotation also would serve to divorce accounting firms from their audit clients. Because the audit relationship would no longer be permanent, the temptation to acquiesce to aggressive accounting policies for fear of being replaced would decrease sharply.¹⁵⁶ Mandatory rotation, combined with already significant public and regulatory scrutiny when changing auditors,¹⁵⁷ would leave management with little leverage when pushing aggressive accounting policies. Some argue, however, that mandatory rotation is not enough to sever the ties that bind auditors to their clients.¹⁵⁸

Those who believe that stronger measures are appropriate contend chiefly that objectivity and independence are illusory so long as the auditor is paid by the entity under audit.¹⁵⁹ One interesting alternative suggests that auditors should work for insurance companies rather than the audited entities.¹⁶⁰ Under this proposal, financial statements would be insured against misrepresentations up to specified amounts.¹⁶¹ This suggestion is appealing because it would disconnect auditors from their clients while at the same time provide oversight by insurers, which have strong economic incentives to have the financial statements free of mis-

155. *Id.* at AU § 315.11.

156. McCoy, *supra* note 108, at 1008.

157. SEC registrants are required to file form 8-k upon a change of auditors. *See* 17 C.F.R. § 249.308 and Form 8-k.

158. *See* McCoy, *supra* note 108, at 1008.

159. *Id.* at 1009.

160. JULIUS CHERNY ET AL., FINANCIAL STATEMENT INSURANCE (Working Paper Abstract, Mar. 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_i=303784.

161. McCoy, *supra* note 108, at 1010.

representations.¹⁶² Nevertheless, this proposal is not without its costs.

One such cost is the potential problem of moral hazard.¹⁶³ Because auditors' work would be insured, there would be less incentive to act with care. Also, audit quality would be jeopardized further because auditors, realizing the potential for a permanent relationship with the insurer, would low-ball their bids in order to gain access to insurers, therefore increasing the squeeze on engagement profitability. As discussed above, decreases in audit profitability provide incentive to reduce costs by reducing audit procedures. Lastly, contractual arrangements between the insurers and audited companies would end up looking like any other liability policy. Insurers, seeking to reduce risk through reductions in coverage, systematically would begin to exclude certain types of misstatements, thereby shifting risks back to investors and multiplying litigation with respect to excluded risks.

Though changing one of the contracting parties to the audit relationship addresses certain concerns about the independence of auditors, it fails to recognize the impact of engagement profitability on audit quality and the impact of longstanding institutional relationships on the appearance of independence.

In addition to, and perhaps more important than, mandatory rotation, standardized, hourly-based fees are needed to provide greater economic incentive for quality audits.¹⁶⁴ Low-balling and fixed-fee arrangements are inconsistent with the performance of more rigorous audit work. Consequently, engagement profitability can be improved only by doing less work or the same work more quickly. Even among auditors of the highest integrity, these factors are bound to result in compromised quality.¹⁶⁵

Because the current fee structure contains an inherent impediment to audit quality, the structure should be revisited. History has shown that accounting firms, when faced with intense competition for audit clients, will consistently underbid to "buy" the client.¹⁶⁶ Because the market cannot remedy the inherent conflict between engagement profitability and audit quality, the fee structure should be regulated by

162. *Id.*

163. *Id.*

164. Though Robert Chatov and others argue that standardized fees, *inter alia*, are needed, *supra* note 23, this suggestion has not been seriously considered.

165. See Bazerman, *supra* note 103 (arguing that under current auditor-client relationships audit failures are inevitable); James L. Costello, *The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safer Harbor?*, 43 ME. L. REV. 265, 268 n.11 (1991) (stating that there are certain factors, such as fee incentives, that work against detection of fraud).

166. Bazerman, *supra* note 103.

the PCAOB through implementing a fee floor based on time studies and other standard factors.

Audit procedures, and therefore audit fees, are largely driven by the size and type of entity under audit. For example, certain industries require large capital outlays for tangible personal and real property, while the balance sheets of others are rife with goodwill and other intangible property. Because financial statements within an industry tend to share common characteristics, a fee floor initially could be established by industry class and entity size.¹⁶⁷ The fee floor would resemble a cost plus fee structure by including a given profit margin. Though audit fees would be permitted to exceed the fee floor applicable to the size and industry of the client, they would not be permitted to fall below such floor. Because the Act already grants the PCAOB authority to investigate accounting firms and review audit procedures¹⁶⁸ and accounting firms already track engagement profitability, compliance with fee floors could be monitored with little additional cost.

Hourly-based fee floors would address a number of concerns about audit quality and auditor independence. First, they would reward diligence and create an incentive to more thoroughly investigate audit issues.¹⁶⁹ Second, audit profitability would not be so tightly squeezed. As shown by the restriction on non-audit fees, Congress was concerned that accounting firms would be more willing to bend to client demands for fear of losing lucrative fees. Because audits would be more profitable and auditors would be required to rotate every seven years, the temptation to acquiesce to client demands would be diminished.

Undoubtedly, audit clients would oppose the fee floor because they would no longer be able to drive audit fees down to the level allowed by a highly competitive market. Nevertheless, the benefit of increased public confidence in the efficacy of the audit and independence of the auditor ultimately would reduce those very clients' cost of capital, therefore compensating for the increased audit fees. Further, because the audit has been made vital to the welfare of our economy, and because the audit's genesis lies in the Securities Acts, regulation of audit profitability is hardly inappropriate.¹⁷⁰

In summary, the urgent need to regain public confidence in auditor

167. Admittedly, the financial statements of entities in the same industry may vary drastically. Nevertheless, industry classification would merely serve as a baseline for a fee range.

168. Pub. L. No. 107-204, §§ 101, 102, 116 Stat. 745 (2002).

169. Some may argue that costs would skyrocket. Given, however, the pressure to keep fees down and the required scrutiny of accounting firms by both audit committees and the PCAOB, serious abuses would be highly unlikely.

170. Government regulation of profit is not a new concept. Many companies bidding for government work are required to enter into cost plus contracts.

independence requires bold new steps, however unpopular with the accounting profession and its clients. Regardless of whether auditor independence and audit quality have actually been impaired by auditor-client relationships, the public believes they have, and public perception is what matters.

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* J.D. candidate, 2004, University of Miami School of Law. The author would like to thank his family for supporting him in his decision to change professions, and his friends who have made the law school experience so much richer. Special thanks go to Professors Anthony Alfieri and Harriet Rubin Roberts, University of Miami School of Law, for their contributions to this Comment.