April 2003

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Realigning Auditors’ Incentives

PATRICIA A. MCCOY

In the past year, accounting scandals have dominated the headlines, even rising to the status of New Yorker cartoons. We have been subjected to an unwelcome education in accounting abuses, including the booking of income from revenues that had not yet been received, the shifting of operating expenses into capital investments, the concealment of loans to officers, the hiding of loans through sham transfers to special purpose entities, the amassing of reserves to “manage” earnings, and document shredding.

Of course, many audits are conducted honestly and capably. My focus in this Article will be on audits at major public companies that were not, because the cost to the long-term financial welfare of Americans was so high. Not only did accounting abuses result in catastrophic welfare losses to shareholders, creditors, and employees at the companies involved, they resulted in staggering losses to Americans across-the-board, as the stock markets lost public confidence and spiraled downwards. We can put a price...
tag on this welfare loss by considering the decline of the broadest U.S. stock index, the Wilshire 5000 Total Market Index, which lost $7.4 trillion between its peak on March 24, 2000 and Dec. 31, 2002; that loss translated into a 43% decline or average losses of $26,000 for every American.\(^6\)

In this Article, I argue that accounting reforms to date have not come to grips with the basic problem afflicting the accounting industry, which is that accounting firms work for the companies they audit. We can conceive of an audit as a multi-period game, in which the immediate and future payoffs to the auditors from cooperating with management in questionable accounting practices exceed the discounted possibility of judgments and sanctions. To alter this payoff structure, it is necessary to reevaluate the employment tie between auditors and public companies. I evaluate three proposals to sever that tie: The Conference Board’s proposal for mandatory rotation of audit firms, the system of statutory auditors found in continental Europe, and a competing proposal by Julius Cherny and colleagues to have auditors work for malpractice insurers who insure financial statements.

I. THE ECONOMIC FUNCTION OF AUDITORS

Auditors have a straightforward job: To render an opinion on whether company financial statements are fairly presented in accordance with generally accepted accounting practices (“GAAP”). In performing that function, auditors are required to conduct their audits according to generally accepted auditing standards (“GAAS”). Thus seen, auditing has a substantive component and a process component. The substantive component—GAAP—governs the permissible accounting treatment for specific types of transactions. The process component—GAAS—specifies the standards and procedures for testing financial statements.

From the stance of economic theory, auditors serve four distinct functions.\(^7\) The first consists of monitoring. Auditors who find improper accounting are required to blow the whistle, either by insisting on corrections, rendering a qualified opinion, or resigning from the engagement with appropriate public disclosures. In this role, auditors help alleviate the well-known principal-agent problem at public companies by providing an important external constraint on management misconduct.

Second, auditors help assure transparency. By scrutinizing the accuracy of publicly reported financial information, they reduce the information


\(^7\) Some might argue that auditors have a fifth economic function—to insure audits. Proponents of this view point out that major accounting firms furnish a potential source of recovery for those who relied on defective audits to their detriment. Whether or not accounting firms serve this function is contingent on their net worth and level of malpractice insurance. Consequently, rather than treat insurance as an economic function, I discuss this consideration below in the discussion of incentives.
asymmetries that impede well-functioning markets.

Third, auditors serve a crucial signaling function. Accounting firms lend their reputation and backing to company financial statements, sending a signal that companies with clean audit opinions are credible investments. Likewise, accounting firms send a signal that companies with qualified opinions are questionable investments.

Finally, auditors act as gatekeepers. Certain major transactions involving potentially large information asymmetries cannot get off the ground without audit opinions, either as a matter of business necessity or of law. (It is further understood that such audit opinions must normally be clean). Raising equity or debt in the public capital markets, for example, requires audit opinions. As gatekeepers, auditors open or close the door to certain major transactions by companies.

In last year's financial scandals, all four functions broke down. Rather than blowing the whistle, some auditors aided and abetted dubious accounting treatments. Others lent their reputations to companies engaged in fraud. Still other auditors gave their blessing to offerings that never should have gone forward. As audit opinions lost credibility, public confidence in the markets crumbled.

II. THE INCENTIVE STRUCTURE OF ACCOUNTING FIRMS

So what went wrong? At the end of the day, the problem was this: auditors work for the company they audit. In the late 1990s, this problem was compounded by the fact that accounting firms parlayed their audit engagements into other, more lucrative consulting work. All too often, accounting firms felt compelled to pay the piper by signing off on doctored financial statements.

The *bête noire* of consulting has received the bulk of the blame for the breakdown in accounting controls. I will return to that problem in a moment. My larger concern, however, is with the incentive structures of audit engagements themselves.

To understand the incentives affecting auditors, it is useful to model the audit engagement as a three-period game. In that game, an external auditor is hired and must then decide whether to issue a going concern

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9 Most large accounting firms defended accountants malpractice lawsuits for audits of failed savings and loan institutions in the late 1980s and early 1990s, a time when consulting accounted for a far smaller share of firm revenues. See PUBLIC OVERSIGHT BOARD, PANEL ON AUDIT EFFECTIVENESS, REPORT AND RECOMMENDATIONS 112 (2000) (reporting that tax and other consulting services grew from 47% to 66% of Big Five accounting firm revenues from 1990 to 1999). In response to the enormous potential liability exposure, most or all of those firms strengthened their internal audit controls. The Arthur Andersen case illustrates how certain internal controls adopted earlier by Andersen were eventually overridden.
opinion for the company being audited.\textsuperscript{10} This game captures the decisions that the external auditors of Enron, WorldCom, and Adelphia had to make.

A. \textit{The Going Concern Opinion as a Strategic Decision}

The decision whether to issue a going concern opinion is highly sensitive and fraught with difficulty. For one thing, a going concern decision requires a prediction whether, in the coming year, the company will go insolvent.\textsuperscript{11} Such predictions are highly prone to error, with penalties either way for the company and auditor.\textsuperscript{12} Furthermore, a going concern decision can become a self-fulfilling prophecy that tips a solvent company into insolvency, both by impairing capital lines and supply sources and by triggering involuntary bankruptcy petitions by creditors.\textsuperscript{13}

\textsuperscript{10} A going concern opinion states that the auditor has substantial doubt that the company will continue to exist as a going concern (i.e., has doubt that the company will be able to pay its obligations as they come due) in the year following the date of the audited financial statements. \textit{The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern}, Statement of Auditing Standards, No. 59, § 341 (American Inst. of Certified Pub. Accountants 2002).

\textsuperscript{11} \textit{See\ AM. INST. CERTIFIED PUB. ACCTS, THE COMMISSION ON AUDITORS’ RESPONSIBILITIES: REPORT OF TENTATIVE CONCLUSIONS 29 (1977).}


\textsuperscript{13} \textit{See AM. INST. CERTIFIED PUB. ACCTS, supra note 11, at 30 (commenting that “[t]he auditor’s expression of uncertainty about the company’s ability to continue may make the company’s inability a certainty”). One research team concluded that a going concern opinion makes bankruptcy eight times more likely than an unqualified opinion on the same financial statements. See Carolyn R. George et al., \textit{A Longitudinal Study of the Going Concern Audit Decision and Survival Time}, 4 Advances in the Quantitative Analysis of Finance and Accounting 77, 95 (1996); see also D.R. Carmichael \& Kurt Pany, \textit{Reporting on Uncertainties, Including Going Concern}, in \textit{The Expectation Gap Standards: Progress, Implementation Issues, Research Opportunities} 35 (Dan Guy \& Alan J. Winters eds. 1993) (finding that “investors depend on audit research to highlight significant uncertainties”); Nicholas Dopuch et al., \textit{Abnormal Stock Returns Associated with Media Disclosures of Subject to ‘Qualified Audit Opinions}, 8 J. Acct. \& Econ. 93, 102 (1986) (detailing empirical evidence that media disclosures of qualified audit opinions are correlated with negative abnormal stock returns); Randall E. LaSalle \& Asokan Anandarajan, \textit{Auditors’ Views on the Type of Audit Report Issued to Entities with Going Concern Uncertainties}, 10 Acct. Horizons 51 (1996); Jane F. Mutchler, \textit{Auditor’s Perception of the Going Concern Opinion}, 3 Auditing: J. Practice and Theory 17, 24 (1984) (indicating that some auditors “were familiar with cases where [a] going-concern audit report had caused failure”); H. James Williams, \textit{Practitioners’ Perspectives on Going Concern Issues}, CPA J., Dec. 1984, at 12, 18-19 (finding that some practitioners considered the possibility of a qualified going concern being a self-fulfilling prophecy when deciding whether or not to issue a qualified opinion). But see Citron \& Taffler, supra note 12, at 338, 343-44 (finding no support for self-fulfilling prophecy in U.K. data, but noting that U.K. auditing guidelines instruct auditors not to consider a report’s propensity to cause the client to become insolvent).}
Numerous accounting scholars have concluded that strategic considerations affect the decision to issue going concern opinions. In a strategic model, auditors would weigh the anticipated payoffs from a clean opinion versus a going concern opinion against the expected penalties from making a mistake. Similarly, audit clients must confront the decision whether to switch auditors when they are informed that a going concern opinion is imminent. Increasingly over the past two decades, switches have become more frequent. Furthermore, some studies have concluded that new auditors are less likely than incumbents to be fully apprised of damaging information about their clients following a switch, often to the ultimate detriment of investors.

14 See, e.g., Paul Barnes & Hooi Den Huan, The Auditor's Going Concern Decision: Some UK Evidence Concerning Independence and Competence, 20 J. BUS. FIN. & ACCT. 213, 225-26 (1993) (indicating that auditors' decisions not to issue going concern opinions are marked by a lack of independence and influence from external economic pressures); Citron & Taffler, supra note 12, at 343 (concluding that there exists a correlation between the issuance of a qualified going concern opinion and the likelihood of auditor replacement); William Hopwood et al., A Re-examination of Auditor versus Model Accuracy within the Context of the Going-Concern Opinion, 10 CONTEMP. ACCT. RES. 409, 411-13 (1994) (positing that statistical research regarding going concern qualifications do not adequately take into account the economic environment of the auditor in making the decision to issue a qualified opinion); Jagan Krishnan & Jayanthi Krishnan, The Role of Economic Trade-Offs in the Audit Opinion Decision: An Empirical Analysis, 11 J. ACCT., AUDITING & FIN. 565, 583 (1996) (concluding that economic trade-offs are an important factor in an auditor's decision to issue a qualified going concern opinion).

15 For evidence finding a correlation between decisions to qualify and replacement of auditors, see Altman, supra note 12, at 17; Chee W. Chow & Steven J. Rice, Qualified Auditor Opinions and Auditor Switching, 57 ACCT. REV. 326, 334 (1982) (concluding that there exists a correlation between clients who receive qualified opinions and the decision to switch auditors); A.T. Craswell, The Association between Qualified Opinions and Auditor Switches, 19 ACCT. & BUS. RES. 23, 24-25, 27, 30 (1988) (finding that the association between qualified opinions and auditor switching is based largely on costs to the client, such as economic interests, transactional costs of switching auditors, and the expense of disclosing switches); Kenneth B. Schwartz & Krishnagopal Menon, Auditor Switches by Failing Firms, 60 ACCT. REV. 248, 252-53, 260 (1985) (providing empirical evidence that there exists a high incidence of auditor switching amongst failing firms).

16 See Robert R. Tucker & Ella Mae Matsumura, Going Concern Judgments: An Economic Perspective, 10 BEHAV. RES. ACCT. 179, 181 (1998). During the 1980s, auditor switches increased to over 800 per year in the United States.

17 See, e.g., Brian D. Kluger & David Shields, Managerial Moral Hazard and Auditor Changes, 2 CRITICAL PERSP. IN ACCT. 255, 269 (1991) (finding that auditor changes will typically result in a negative response by the market in part because auditor switching is often viewed as an attempt to suppress bad news); Michael C. Knapp & Fara M. Elikai, Auditor Changes and Information Suppression, 4 RES. IN ACCT. REG. 3, 7 (1990) (indicating that "predecessor auditors may be reluctant to disclose negative information concerning a former client to a successor").

In an effort to ameliorate this problem, the American Institute of Certified Public Accountants ("AICPA") adopted standards governing communications between incumbent and replacement auditors (SAS No. 7) and communications between auditors and prospective clients (SAS No. 50). See Knapp & Elikai, supra, at 7. In addition, clients must disclose changes in auditors in Form 8-K filings with the Securities and Exchange Commission. Id. at 5. The success of these provisions is subject to debate. Id. at 5-6.
B. The Game and the Payoff Structure

The game has two participants, the client and the auditor. For purposes of simplicity, I assume that the client and the auditor share identical information sets regarding payoffs and the client’s likelihood of insolvency in the year to come.

In the first period, the client must decide whether to hire the auditor. To win new audit engagements, accounting firms compete on three grounds: reputation, fees, and expertise. For the largest public companies, reputation all too often comes down to a question of Big Four status—in other words, size and clout—than the firm’s past track record for malpractice. Fee competition can undercut the ability to staff audits adequately. And expertise can boil down to the ability to devise “innovative” accounting treatments that new clients demand.

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18 This game is a modified version of the game presented in Ella Mae Matsumura et al., Strategic Auditor Behavior and Going Concern Decisions, 24 J. BUS. FIN. & ACCT. 727, 731-37 (1997). See also Ronald R. King, An Experimental Investigation of Self-Serving Biases in an Auditing Trust Game: The Effect of Group Affiliation, 77 ACCT. REV. 265, 267-71 (2002) (reporting the findings of an experiment which casts doubt on the theory that auditors cannot conduct impartial audits due to self-serving biases); Robert R. Tucker & Ella Mae Matsumura, Going Concern Judgments: An Economic Perspective, 10 BEHAV. RES. ACCT. 179, 213 (1998) (setting forth a game-theoretic model to analyze the strategic interaction between auditors and clients which concludes that auditors will issue fewer qualified opinions when possible successor auditors are more likely to issue clean opinions and when qualified opinions are more likely to be self-fulfilling). See generally John C. Fellingham & D. Paul Newman, Strategic Considerations in Auditing, 60 ACCT. REV. 634, 634 (1985) (reformulating the game theory problem to take into account 1) the strategic considerations for the auditor and client, 2) behavioral theories regarding the effect of an audit, and 3) audit phenomena such as randomized strategies).

19 See Schwartz & Menon, supra note 15, at 249.

20 See id.

21 Once an audit is underway, accounting firms generally seek to minimize costs by using the least expensive staffing. That means that the front-line work in audits is performed by young, inexperienced auditors with low billing rates, who all too often are recent college graduates. The new graduates lack the experience to unravel highly complex transactions. In holding company structures like Enron with complex tiers of subsidiaries, joint ventures and partnerships, relying on new accounting graduates increases the probability that major improprieties will go undetected. Meanwhile, audit partners are often more preoccupied with business development than with supervising young auditors in the trenches.

On the propensity for accounting firms to price audits below cost, see Allen T. Craswell & Jere R. Francis, Pricing Initial Audit Engagements: A Test of Competing Theories, 74 ACCT. REV. 201, 213 (1999) (testing competing theories of audit pricing discounts and finding that, at least based upon data from Australia, audit fee discounts do not generally occur in settings where audit fees are subject to public disclosure); Linda Elizabeth DeAngelo, Auditor Independence, Low Balling and Disclosure Regulation, 3 J. ACCT. & ECON. 113, 126 (1981) (finding that below cost pricing does not impair auditor independence); Ronald A. Dye, Informationally Motivated Auditor Replacement, 14 J. ACCT. & ECON. 347, 363 (1991) (concluding that a consequence of audit pricing discounts is that auditors will be more inclined to attest to favorable financial reports than they would be in the absence of a price discount).

22 This can be a crucial attribute of an auditor given the strong likelihood that clients will often undertake efforts to ensure the preparation of an opinion most beneficial to their interests. See Clive
If the client selects another auditor, the game comes to an end. If the auditor successfully competes and wins the engagement, the game proceeds to the second period.

In the second period, the newly hired auditor must decide whether to issue a going concern opinion, based on a noisy signal regarding the client's prospects for survival. Noise means there is a positive probability either way that the auditor could be wrong. At the end of the second period, the auditor informs the client whether it will issue a going concern opinion.

If the auditor decides to issue a clean decision, the client retains the auditor and the game comes to an end. Otherwise, the game enters the third period. In the third and final period, the client, knowing that the auditor plans to issue a going concern opinion, must decide whether to replace the auditor. The incumbent and the client are both aware that a going concern opinion has some positive likelihood of becoming a self-fulfilling prophecy. At the end of period three, the client decides whether to replace the auditor.

Conditioned on being hired, the auditor's potential payoffs consist of two components: The present value of future income from the client and a penalty if the audit opinion proves wrong. If the client goes bankrupt, the auditor will receive its audit fee plus fees for any work performed during liquidation. If the auditor is fired, it only receives a partial audit fee. If the client stays in business and retains the auditor, the auditor will presumably receive larger fees. Moreover, the larger the audit client, the larger the potential future fees. The promise of a possible revolving door leading to future employment with the audited company can also enhance payoffs.

In addition to fee considerations, the auditor faces penalties if the audit opinion proves to be wrong. Where a client receives a going concern opinion and survives, penalties include damage to the auditor's reputation, as well as firing and a possible lawsuit by the client. In the opposite situation where an auditor issues a clean opinion, but the client later goes bankrupt, penalties can include harm to reputation and lawsuits by shareholders and creditors.

Conditioned on hiring the auditor, the client's payoff structure essentially becomes the payoff structure of its management. Management's payoffs are strictly greater if the company survives than if the company goes bankrupt, and consist of the managers' expected compensation minus any transaction costs from switching auditors. Conditioned on the company's continued survival, if the auditor (either the original auditor or a replacement) issues a clean opinion, management's payoff will consist of the present value of future compensation from managing a going concern.
including salary, stock, stock options, and improved reputation. If, on the other hand, the auditor issues a going concern opinion, management will suffer a reduced payoff in the form of stock losses, lost salary, possible job loss, and a damaged reputation. In addition, the client faces substantial, positive transaction costs if it decides to change auditors to avoid a going concern opinion, which consist of out-of-pocket costs plus lower stock prices following a negative signal to the market.

C. The Threat of a Replacement

To recap, if the incumbent issues a clean opinion, the game comes to an end and the incumbent is retained. Alternatively, if the incumbent tells the client that it plans to issue a going concern opinion, the client could face one of three scenarios. In Scenario One, any replacement auditor would be certain to issue a going concern opinion as well. In Scenario Two, the incumbent and replacement auditors are of the same type, but there is a positive probability that the replacement auditor would issue a clean opinion, based on new information. Scenario Three is identical to Scenario Two, but involves the additional fact that the replacement auditor and the incumbent auditor are of different types.

In Scenario One, the client cannot make a credible threat to replace the incumbent because the replacement would issue a going concern opinion as well. The incumbent auditor knows that. Consequently, for a replacement threat to be credible, there must be some possibility that the replacement would disagree with the incumbent and actually issue a clean opinion.

In Scenario Two, unlike Scenario One, the client can make a credible replacement threat because there is a positive probability that the replacement auditor will disagree with the incumbent and issue a clean opinion. In this scenario, differing audit opinions are possible because the replacement has access to later information about the client that could result in a divergence of opinions.

Scenario Three builds on Scenario Two by further assuming that the replacement and the incumbent are of different types. The replacement may have deeper pockets or better liability insurance, a different payoff structure, different attitudes, or a different propensity toward risk. Like Scenario Two, the replacement, unlike the incumbent, has access to later information about the client that could change the opinion. Once again, the client can issue a credible threat.

In Scenarios Two and Three, since a credible threat can be made, the question becomes, how likely is the client to act on the threat and hire a replacement? Ignoring the self-fulfilling prophecy problem for the moment, the client is more likely to replace the incumbent: 1) as the likelihood of bankruptcy decreases; 2) as the replacement becomes less likely to issue a going concern opinion; and 3) as the audit profession becomes less likely
to issue going concern opinions as a whole. Anticipating that response, the incumbent may succumb to pressure and issue a clean opinion.\textsuperscript{23} Failing that, the client may hire a replacement.

The self-fulfilling prophecy effect further complicates the calculus. Assume that the company would survive for at least another year, absent a qualified opinion. The greater the effect of the self-fulfilling prophecy (i.e., the greater the likelihood that a qualified opinion would erroneously force a solvent company into bankruptcy), the more likely the client is to replace the incumbent. In anticipation of this reaction, the incumbent may become more reluctant to issue a going concern opinion in order to safeguard its future stream of fees.\textsuperscript{24}

\textsuperscript{23} One experimental study involving simulations by university students concluded that incumbent auditors are less likely than expected to succumb to client pressure to modify their audit opinions. Tucker & Matsumura, supra note 18, at 213-14. \textit{But see} Lennox, supra note 22, at 336 (suggesting that “switching auditor increases the probability of a change in audit opinion”). The laboratory setting makes it difficult to replicate payoffs structures accurately and the authors conceded that they did not attempt to model a realistic representation. Tucker & Matsumura, supra note 18, at 211. Similarly, the payoff structure in that study did not discount the threat of future accountants’ liability lawsuits for their hypothetical and distant nature. \textit{See} Zoe-Vonna Palmrose, \textit{The Joint & Several vs. Proportionate Liability Debate: An Empirical Investigation of Audit-Related Litigation}, 1 STAN. J.L., BUS. & FIN. 53, 56 (1994) (discussing the relative merits of imposing a joint and several system of liability upon auditors). The Tucker & Matsumura study also failed to take into account the availability and moral hazard implications of liability insurance. Future studies should also attempt more accurately to model the impact of threats to auditors’ undiversified investments in job security.

A later experimental study looked beyond economic considerations to psychological forces by modeling the effect of unconscious, self-serving biases of auditors toward the managers for whom they work. King, supra note 18, at 266. The study concluded that auditors were likely to trust managers who did not deserve their trust and that management puffery strengthened trust when it was not deserved. \textit{Id.} Countervailing peer pressure from audit team members and professional groups, however, helped diminish a false sense of trust. \textit{Id.} at 267; \textit{see} Max H. Bazerman et al., \textit{Opinion: The Impossibility of Auditor Independence}, SLOAN MGMT. REV., Summer 1997, at 89, 94 (advocating structural changes in the auditor/client relationship so to increase the likelihood of unbiased opinions, including the prohibition of audit firms providing related services to their clients, having external entities appoint auditors or establish fee structures, mandating the periodic rotation of auditors, and having governmental agencies conduct audits); S. Kachelmeier, Discussion of “Tax advice and reporting under uncertainty: Theory and experimental evidence,” 13 CONTEMP. ACCT. RES. 81 (1996).

\textsuperscript{24} See, e.g., Robert A. Prentice, \textit{The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing}, 61 OHIO ST. L.J. 1597, 1648-49 (2000) (stating that “[m]ost knowledgeable observers seem to believe what the studies suggest—that auditor independence and objectivity are affected by auditors’ self-interest in that, for example, the more revenue coming from a client the more likely auditors are to give in to client pressure for improper accounting treatment”); Bazerman et al., supra note 23, at 93 (noting that auditor independence is difficult in a competitive economy where auditors must “accept[] unprofitable audit fees in the initial year or two in order to ‘buy’ the business . . . [and then] are likely to be highly motivated to retain the client for several years”). \textit{But see} Lennox, supra note 22, at 322-23 (observing the lack of “convincing evidence” to support the contention that the fear of losing future income will compromise an incumbent auditor’s independence).
D. Creative Accounting and Consulting

In sum, where bankruptcy is uncertain, where the replacement auditor is likely to issue a clean opinion, or where the information about the client's future prospects is noisy, an incumbent auditor faces a credible threat to issue a clean opinion or be fired. The same is true where the self-fulfilling prophecy effect is strong. In such situations, auditors have incentives to "resolve" problem areas that stand as obstacles to a clean audit opinion. As was seen in Enron and WorldCom, this exerts pressure to produce "creative" accounting treatments that mask a sagging company's true financial condition.25

Such incentives are heightened when a company's financial fortunes are deteriorating, either due to internal weaknesses or a speculative stock bubble.26 Faced with extinction, a company has little to lose and everything to gain from painting a rosy picture. This is the time when management is most likely to pressure the auditor to issue a clean opinion. Pressure is more likely to succeed if the market still perceives the company as solvent or if a clean opinion could hoist the company over the one-year mark.27 The fact that positive payoffs seem imminent, while detection or malpractice lawsuits are of unknown likelihood and remote, can tip the payoff structure against a going concern opinion in favor of aggressive accounting.28

Furthermore, the elastic nature of accounting standards makes it easy for auditors to rationalize aggressive accounting treatments that favor management to the detriment of investors and creditors.29 This is the result of

25 See, e.g., James R. Duncan, Twenty Pressures to Manage Earnings, 71 CPA J. 32 (2001) (describing the pressures that induce auditors and company personnel to falsely inflate earnings reports to reflect a company's desires); Reed Abelson, Trying Not to Be the Next Enron, Companies Scrutinize Practices, N.Y. TIMES, Jan. 26, 2002, at C1 (noting that "[t]he independence of Enron's auditor, Arthur Andersen, has been questioned . . . Enron was one of Andersen's largest clients, and Andersen received substantial fees" for consulting work for Enron).

26 See CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 73-90 (4th ed. 2000) (explaining that the revelation of swindles, internal corruption, dubious practices, and speculative stock bubbles increases distress and often precipitates a financial crash and panic).

27 On the other hand, if the company's financial troubles are known to the market or will soon be apparent, the auditor is more likely to conclude that the game is in its final period and either issue a going concern opinion or resign (in the case of management opposition). An accounting firm that does so presumably has decided that future audit engagements are unlikely due to the company's imminent insolvency, while the risks from issuing a clean opinion are imminent and high.

28 See Prentice, supra note 24, at 1644 (observing that empirical and laboratory studies indicate that a higher risk of litigation makes an auditor more likely to issue a going concern opinion or resign from a lucrative auditing account).

the substantive flexibility built into GAAP and GAAS, a flexibility that gives wide berth for divergent treatments.30

This flexibility is not surprising, given that the accounting industry has historically formulated GAAP and GAAS. Until the passage of the Sarbanes-Oxley Act of 2002,31 GAAS was promulgated by the Auditing Standards Board, a body of the American Institute of Certified Public Accountants ("AICPA"). GAAP was promulgated by the private Financial Accounting Standards Board ("FASB"),32 with the assistance of the Accounting Standards Executive Committee ("AcSEC") of the AICPA.33 The FASB retains authority over GAAP today.34 In numerous cases in the recent past, FASB implemented ambiguous accounting treatments that allowed corporations and auditors to mask corporate weaknesses to management's benefit.35 Even companies with a traditionally conservative

30 D. Christopher Ohly, In GAAP We Trust, 72 CPA J. 8, 8, 10 (2002) (stressing that the application of GAAP and GAAS relies on auditor judgment).


34 See Herz's Remarks, supra note 33, at 29 (stating that "the maintenance and development of any industry-based standards in the future should reside with the FASB," with the effect that only the FASB may "create new GAAP").

35 Examples include rules on consolidation of financial statements of special purpose entities, creative revenue recognition, and the so-called "fair value accounting" applied to capacity swaps in the telecommunications industry. See, e.g., Floyd Norris & Joseph Kahn, Rule Makers Take On Loopholes That Enron Used In Hiding Debt, N.Y. TIMES, Feb. 14, 2002, at A1 (explaining that in response to the collapse of Enron "regulators, legislators, and the chief accounting rule maker [FASB] proposed changes . . . in the way companies do business and report their finances, including closing the loophole that Enron used to hid hundreds of millions of dollars of debt and inflate its profits"); Herz's Remarks, supra note 33, at 6-10 (explaining that the existing rules for special-purpose entities are subject to abuse, that there "are a variety of different and sometimes apparently inconsistent models for recognizing revenue," and that the FASB is "very cognizant of the potential operational difficulties, reliability concerns, and room for abuse in implementing a fair value [accounting] approach" for certain items).

In fairness, it is important to point out that in 1994 the FASB called for expensing of stock options, a reform that the business industry successfully thwarted. See, e.g., Richard A. Oppel, Jr.,
approach to financial reporting felt pressure to embrace aggressive accounting on grounds that "everyone else was doing it."36

Consulting only served to intensify these incentives.37 Faced with fierce competition in the 1980s and 1990s, accounting firms flocked to consulting as the mantra to profitability.38 The consulting arms of accounting firms advised corporations on everything from information technology to pension plans and taxes and regarded audit clients as natural targets for cross-marketing. As consulting revenues skyrocketed and surpassed fees from audits, retaining consulting business became the overriding goal, even at the risk of compromising audits.

Accountants fought off efforts to curb their consulting powers to the death. The accounting industry rousted its lobbying forces to deliver a resounding defeat to former Securities and Exchange Commission Chairman Arthur Levitt Jr., when he proposed prohibiting accounting firms from performing consulting services and accounting services simultaneously for the same company.39 Only after the fallout from Enron, in 2002, were the

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Options Foe Is Not So Lonely Now, N.Y. TIMES, Apr. 7, 2002, § 3, at 2 (noting that in 1994 the FASB proposed to "force companies to record stock options as an expense" but that the FASB backed down on this proposal because of "pressure from lobbyists and lawmakers in Washington"); Reed Abelson, Accounting Board Proposal On Derivatives Is Getting Heat, N.Y. TIMES, Sept. 2, 1997, at D1 (observing that in 1994, due to corporate pressure, the FASB was "forced to retreat after it proposed requiring companies to treat stock options . . . as an expense").

36 See, e.g., Floyd Norris, Let the Auditors Tell Us What They Know, N.Y. TIMES, Feb. 1, 2002, at C1 (arguing that "[i]f investors assume every company is pushing the accounting envelope, then those who use more conservative accounting derive no benefit from acting responsibly").


38 See PUBLIC OVERSIGHT BOARD, supra note 9, at 112 (documenting growth in consulting services by accounting firms).

39 See, e.g., Stephen Labaton, Auditing Firms Exercise Power in Washington: Teams of Lobbyists and Campaign Donations, N.Y. TIMES, Jan. 19, 2002, at A1; Floyd Norris, Accounting Firms Accept Rule to Limit Conflicts of Interest, N.Y. TIMES, Nov. 15, 2000, at A1; Leslie Wayne, Investors' Advocate at the S.E.C.: Departing Chief Leaves Legacy Of Activism, N.Y. TIMES, Jan. 30, 2001, at C1. In the course of his campaign, Levitt received phone calls from ten or eleven senators, warning that the Commission's appropriations would be cut if he did not back down. See Labaton, supra. The then-Big Five firms numbered among President George W. Bush's twenty largest donors in 2000. Stephen Labaton, Audit Changes Are Facing Major Hurdles: Power of Accountants Makes Congress Wary, Jan. 24, 2002, at C1; see also Shaila K. Dewan, Talk of Rules for Accountants Is Matched by Campaign Gifts, N.Y. TIMES, July 22, 2002, at B4 (reporting that although New York State lawmakers were considering ways to tighten oversight of accounting firms, reports revealed that the largest four accounting firms had contributed over $350,000 to candidates and legislative fundraising committees). The battle over Judge William Webster's appointment as chair of the Public Company Accounting Oversight Board demonstrated continued attempts by the accounting industry to exercise its formidable
Big Five accounting firms finally forced to divest most of their consulting activities. Even so, lessons can be learned from the tale of Arthur Andersen, which spun off its consulting arm in 2002 following arbitration of a longstanding dispute. The resulting pressure on revenues raised the ante for Andersen to replace its lost consulting arm with new consulting work and furthermore to keep its audit clients at any price.

In sum, in too many engagements, the employment tie between management and auditor proved inimical to the independence that is demanded of auditors. The time has come to reconsider that employment tie.

III. THE FAILURE OF CURRENT REMEDIES

Civil and criminal remedies for auditor negligence and fraud have been on the books for years. None of these remedies, either alone or together, was sufficient to deter the massive accounting irregularities we witnessed in the past two years. Why?

On the criminal side, accountants can be prosecuted and sent to prison for fraud. Occasionally, accountants deliberately falsify the books and some have gone to jail. However, that is a relatively rare occurrence. What was unprecedented, at least until Arthur Andersen, was for a major accounting firm to be prosecuted and convicted.

Until recently, the main remedies against accountants have been civil in nature. To begin with, accountants and their firms are regulated by state boards of accountancy. State boards have the power to bar accountants and firms that engage in misconduct from practice in individual states. However, boards exercise that power sparingly against individual accountants

lobbying strength. See Carl Emet, Demos Call for Ouster of SEC's Pitt: Agency Chief Faulted Over Nominee's Vetting, S.F. CHRON., Nov. 1, 2002, at A1 (reporting the concern of SEC members that consideration of Webster and other candidates is subject to the approval of the accounting lobby).


43 See, e.g., John M. Moran, Andersen Could Lose License in State: Board of Accountancy to Consider Conviction in Enron Case, HARTFORD COURANT, July 10, 2002, at E1 (reporting the Connecticut Board of Accountancy’s agreement to “consider suspending or revoking Andersen’s accounting license because of the company’s conviction on charges it obstructed justice”).
and almost never suspend the licenses of major accounting firms.\[44\]

For this reason, on the civil side, private lawsuits form the more important remedy. Civil plaintiffs can sue for damages, either in negligence for accountants’ malpractice or for federal securities fraud. In some cases, accountants and accounting firms have been exonerated, while in others they have been held liable. Accounting firms have paid large sums to settle still other cases, with settlements sometimes numbering in the tens and even hundreds of millions of dollars.\[45\] Some audit partners implicated in those cases have been fired.

Despite the enormity of some of those settlements and judgments, apparently it was business as usual up through Enron’s demise. Individual bad apples were let go and judgments were paid, but there was little evidence that the awards had a deterrent effect on firms, as epitomized by the largest scandals. What explained the resistance of accounting firms to change?

Ultimately, the answer is that the payoffs for acquiescing to management outweighed the financial penalties. In thinking about this problem, it is important to remember that potential financial penalties come in two forms: (1) judgments, settlements, and fines paid to plaintiffs and government authorities; and (2) lost business due to harm to reputation. I will address these elements in reverse order.

One would think that reputation would always be uppermost in the minds of the managers of accounting firms. After all, apart from human capital, goodwill is probably the largest single asset of an accounting firm, dwarfing the firm’s real estate holdings and computers. Until recently, however, major accounting firms were usually able to sustain repeated payouts in lawsuits with their business reputations unscathed, once the “bad” partners were removed. In a show of oligopoly power, the fact that they could do so emphasized that for large public companies, the former Big Five were the only game in town.\[46\]

\[44\] See id. (noting that “[i]n Connecticut, revocation of an accounting permit is unusual, but not unheard of... although such cases almost never involve a large, multinational accounting firm such as Andersen”).


\[46\] Today, eighty percent of all public companies in America are audited by one of the Big Four. CONF. BD. COMM’N ON PUB. TR. & PRIVATE ENTER., FINDINGS AND RECOMMENDATIONS 37 (2003) [hereinafter COMM’N REPORT].

The industrial organization implications of the accounting industry’s rapid consolidation over the past decade cry out for study. At the beginning of the 1990s, the Big Eight accounting firms dominated the industry. Id. Mergers reduced that number to the Big Five, and Arthur Andersen’s demise reduced it further to the Big Four. That same period produced the accounting abuses that form the subject of this Article. Today, at least some of these behemoths have over 100,000 employees, raising serious questions about abuse of market power and the ability of such a large firm to maintain a culture of high ethical values. See id. at 37-38.
The one exception was where an accounting firm or one of its partners was convicted of a crime. Arthur Andersen, of course, is the most stunning example. If any firm deserved criminal prosecution, it was Arthur Andersen. Not only did Andersen engage in document destruction, prosecutors were convinced that it was a recidivist, pointing to alleged violations of a Securities and Exchange Commission consent decree to refrain from future wrongdoing arising out of Andersen’s past audits of Waste Management.\footnote{See, e.g., Kurt Eichenwald, Andersen Is Said to Rule Out Plea: Indictment Over Enron Looms—Hope for Merger Fades, N.Y. TIMES, Mar. 14, 2002, at A1 (discussing Andersen’s difficult position in refusing the guilty plea in light of its prior settlement with the SEC involving Waste Management, whose audited financial statements proved to be deceptive); Floyd Norris, Loss of Leadership: Demise of Andersen Would Leave a Dent in the World of Accounting, N.Y. TIMES, Mar. 11, 2001, at A18 (describing Andersen’s position in agreeing to sign the SEC consent decree in the Waste Management auditing fraud suit).} To add insult to injury, Andersen rebuffed the prosecutors’ offer to enter into a consent decree in the Enron case.\footnote{See Kurt Eichenwald, Andersen Is Said to Rule Out Plea: Indictment Over Enron Looms—Hope for Merger Fades, N.Y. TIMES, Mar. 14, 2002, at A1 (reporting that in a letter to the Justice Department, Andersen’s law firm indicated that the government’s evidence did not merit holding the entire firm accountable for poor judgment on the part of several partners and employees).}

So why not step up criminal prosecutions of accounting firms in general? There are many reasons for counseling restraint in prosecuting accounting firms, but three stand out.\footnote{It is also worth noting that the shocking evidence of document destruction that doomed Arthur Andersen is rarely present in other cases.} First, entity liability—as opposed to criminal liability of individual accountants—is incompatible with the goal of compensation. As the Arthur Andersen debacle illustrates, an indictment (and certainly a conviction) destroys goodwill, thereby amounting to a death sentence for the firm. The moment an indictment is handed down, clients flee the firm and assets dissipate in thin air.\footnote{Once $4 billion and 28,000 employees strong, within three months after its conviction for obstruction of justice in June 2002, Andersen closed its doors. See, e.g., Arthur Andersen Is Fined $500,000, N.Y. TIMES, Oct. 17, 2002, at C3; Eichenwald, supra note 48, at A1.} Despicable as Arthur Andersen’s audits of Enron, Waste Management, and the like were, wouldn’t we be better off with Andersen intact and able to pay the judgments of innocent victims?

Second, any deterrent effect that Andersen’s conviction might have had on other accounting firms was undercut by the extreme repercussions of conviction, which resulted in Andersen’s collapse. Post-Andersen, whatever government prosecutors might do, accounting firms know that the government will be loath to drive one more worldwide accounting firm into bankruptcy.

Finally, Andersen’s prosecution and its resulting collapse raises grave concerns about entity liability’s effectiveness in reforming the conduct of

\footnote{Fraud prosecutions present the additional complication of having to choose between indictment or civil lawsuits, because a fraud conviction precludes civil recovery under most malpractice policies.}
the defendant's own accountants. If Andersen were still alive, the firm and
thousands of its accountants would no doubt be subject to a continuing
civil injunction to mandate reforms. Those reforms could have provided a
model for audit practices and procedures across the entire industry. In-
stead, with the destruction of the firm, Andersen's accountants scattered to
the four winds, outside the reach of a firmwide injunction specific to An-
dersen.51

In sum, in the accounting industry, reputational concerns failed to
serve as a powerful deterrent. Where accounting firms paid a price for
alleged negligence or misconduct, they usually paid for it in cash, not in
reputation. But there too, accounting firms were able to blunt the financial
impact of adverse settlements or verdicts in numerous ways.

Most accounting malpractice cases settle and those that do generally
settle within the policy limits.52 Because of this dynamic, accounting firms
can "manage" the risk of lawsuits by reducing most of their potential civil
liability to a liquidated stream of premium payments. In addition to dilut-
ing the deterrent effect of lawsuits, malpractice insurance can heighten
reckless conduct due to the increased risk of moral hazard.

In the past two decades, the accounting industry lobbied for and bene-
fited from cases and statutes rolling back standards for liability. In Central
Bank of Denver, N.A. v. First Interstate Bank of Denver N.A.,53 at the urg-
ing of accountants, the Supreme Court overturned aiding and abetting li-
bility in securities fraud cases under § 10(b) of the Securities Exchange
Act of 1934.54 Four years later, following a heavy lobbying campaign by
accounting firms, Congress severely reduced private plaintiffs' ability to
bring class actions for securities fraud under state law in the Securities
Litigation Uniform Standards Act of 1998.55 Accounting firms also per-
suaded many courts to extend the heightened loss causation standard in
federal securities fraud cases56 to accountants' malpractice claims under
state law.57

51 See Ameet Sachdev, More Rules, Transition, Turnover and Competition, CHI. TRIB., Dec. 24,
2002, at C1 (stating that "some of the individuals in Andersen partnership teams that quickly signed on
with new firms may now go their own way"); see also Paul Gores, Accountants Wanted: Demand for
CPA's Rising, MILWAUKEE J. SENTINEL, Feb. 10, 2003, at D1 (stating that the demise of Andersen led
many, but not all, Andersen accountants to go to their former competitors).
52 See, e.g., Mary Flood, Andersen Partners May Avoid Liability, HOUS. CHRON., May 3, 2002, at
1 (stating that "Andersen partners, like owners of most companies, hope to be protected in part by their
insurance policies, which could pay off some creditors or provide funds for settling with plaintiffs").
54 Id. at 191-92.
56 Id. § 78u-4(b)(4).
57 See, e.g., Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 104-05 (2d Cir.
2001) (holding that the plaintiff's complaint sufficiently alleged loss causation, "the analogue of the
Similarly, accountants succeeded in paring back the measures of damages that could be levied against them. In the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the accounting industry used its lobbying might to win a proportional liability cap on damages. This cap eliminated joint and several liability for accountants and limited damages against them in private federal securities actions to their proportional responsibility, except in cases of knowing violations. The PSLRA's provisions were modeled on similar proportional liability caps in many states.

Finally, accountants were one of the forces behind the adoption a decade ago of the limited liability partnership ("LLP"), which was designed to shield innocent partners' personal assets from recovery in the event of an adverse judgment against the firm. Because the LLP entity is so new and untested, it remains to be seen whether limited liability will attach where an accounting firm is guilty of systemic lack of oversight over errant accountants.

Wholly apart from these factors lies a more fundamental problem: negligent or fraudulent accountants often cannot be held fully accountable in damages for the harm that they have done. Total potential damages in cases as large as Enron or WorldCom—resulting in billions of dollars in stock losses to individual investors—can exceed the total capitalization of any one accounting firm. Consequently, accountants in major cases, cannot fully internalize any harm that they cause. That makes effective deterrence all the more crucial, because victims of major accounting scandals cannot expect to get repaid in full.

IV. HOW THE SARBANES-OXLEY ACT AFFECTS ACCOUNTANTS

By July 23, 2002, in the month following WorldCom's revelation that it had overstated its cash flow by $3.9 billion, the S&P 500 had dropped twenty percent and public furor over the accounting scandals had exploded. Under intense public pressure, Congress stopped its bickering and rushed through passage of the Sarbanes-Oxley Act of 2002.

Sarbanes-Oxley adopted a three-pronged approach to accounting reforms. First, Congress created a new body, the Public Company Accounting Oversight Board ("PCAOB"), to replace the former Public Over-
sight Board, an industry board established by the AICPA. The PCAOB’s main job is to regulate and discipline the accounting industry. Among other things, accounting firms must register with the PCAOB and are subject to Board inspections. In addition, Congress took away the power to promulgate GAAS from the Auditing Standards Board of the AICPA and gave it to the PCAOB. The PCAOB also has rulemaking, document request, and sanctions powers that the old Public Oversight Board did not have.

Unlike its predecessor, the PCAOB is structured to increase its independence from the accounting industry. The Board is subject to approval and oversight by the Securities and Exchange Commission (“SEC”). The SEC selects the Board’s five members, all of whom must serve full-time and refrain from other professional and business activity. Two, and only two, members of the Board must be CPAs, in order to avoid capture (although all members must be conversant with financial disclosure requirements and auditing standards). Any CPA who serves as Chair may not have practiced as a CPA in the past five years.

Second, Congress mandated provisions designed to bolster auditor independence. The Board was instructed to adopt regulations requiring a second partner to review and sign off on audit opinions. Lead audit partners must be rotated every five years and reviewing partners are prohibited from having performed audit services for the audit client in each of the past five years. To shut the revolving door, a company may not retain an accounting firm as its auditor if any of the company’s top officers had been an employee of the accounting firm in the previous year. On the topic of consulting, Congress prohibited accounting firms from providing certain enumerated consulting services to any public company while conducting the company’s audits. Prohibited consulting services range from design-
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ing financial information systems to providing advice on human resources, investment banking issues and legal affairs. If none of the committee members qualifies as a “financial expert,” the company must say why. The audit committee must give advance approval to all accounting firm services that are provided to the company and is directly responsible for the appointment, compensation, and oversight of outside auditors. The Act specifically states that henceforth, outside auditors will report directly to the audit committee, not to the full board.

These reforms look far-reaching on their face. However, they do little to address the incentive structure faced by accounting firms. For example, although the PCAOB will now promulgate GAAS, it will not formulate GAAP, which remains within the aegis of the Financial Accounting Standards Board. That is a problem, given that the highly elastic industry standards embodied in GAAP played a major role in the accounting abuses of the 1990s. And if the imbroglio over Judge Webster and Harvey Pitt is any indication, the PCAOB is embarking on life with its independence sorely in doubt.

Sarbanes-Oxley’s measures directed at accounting firm conduct also leave a lot to be desired. Congress should be lauded for requiring accounting firms to sever the many different types of consulting work that it did. However, Congress created a gigantic loophole for tax services, which account for up to one-third of the income of individual accounting firms. Those services, which in recent years have featured aggressively marketed, highly debatable tax shelters, tax strategies, and extensive offshore partnerships, pose a potential conflict of interest when they are audited by the same accounting firm that marketed the tax services.

Similarly, under Sarbanes-Oxley, auditors must report directly to the directors who comprise the audit committee, whom themselves are selected

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76 Id.
77 Id. § 301 (amending 15 U.S.C. § 78f(m)(3)).
78 Id. § 407 (to be codified at 15 U.S.C. § 7265(a)).
79 Id. § 202 (to be codified at 15 U.S.C. § 78j-1(i)); id. § 301 (amending 15 U.S.C. § 78f(m)(2)).
80 Id. § 204 (to be codified at 15 U.S.C. § 78j-1(k)); id. § 301 (amending 15 U.S.C. § 78f(m)(2)).
81 See COMM’N REPORT, supra note 46, at 39 (urging that “principles” rather than “rules” be adopted).
82 Id. at 36-37.
by management. In multi-year engagements, moreover, auditors are likely to develop strong relationships directly with management. Thus, the audit committee measures, like the audit partner rotation measures, do not address that fact that auditors still work for the companies they audit.

Unfortunately, Congress chose to proceed by half-measures in Sarbanes-Oxley. Nothing in the Act addresses the two major causes of accounting lapses in the late 1990s, i.e., GAAP’s susceptibility to manipulation and the employment tie to management.

V. CUTTING THE TIE THAT BINDS

Any truly meaningful reform of the accounting industry must reverse the incentive structure that impels auditors to curry favor with company management. To do that, it is necessary to directly address the built-in conflict of interest created by the employment tie between auditors and management. How to do that is the topic of the remainder of this paper.

One approach might be mandatory rotation of audit firms. In its recent report, the Conference Board Commission on Public Trust and Private Enterprise criticized Sarbanes-Oxley for stopping at mandatory rotation of audit partners, not entire audit firms. According to the Commission, auditors’ independence may be compromised where the audit firm has worked for the company for a long time (e.g., ten years), where one or more former audit partners or managers now work for the client, or where the audit firm also provides significant non-audit services to the company (even where approved by the audit committee).

In these and other circumstances where an auditor’s independence from management might be compromised, the Commission urged audit committees to consider rotating audit firms. Rotation would “reduce any financial incentives for external auditors to compromise their judgment on borderline accounting issues . . . since the audit engagement would no longer be perceived as permanent.” Furthermore, the Commission noted, “knowing their work will be reviewed by another firm at the end of the rotation period would also deter ‘questionable’ judgments and decision-making on the part of the auditor.” The Commission also advised that every five to seven years, audit committees choose auditors through com-

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84 COMM’N REPORT, supra note 46, at 33-34. Sarbanes-Oxley simply instructed the General Accounting Office to study the issue and to report back to Congress in a year. Sarbanes-Oxley Act of 2002, § 207.
85 COMM’N REPORT, supra note 46, at 33-34.
86 Id. at 33-35.
87 Id. at 34.
88 Id.
petitive bids and “focus on the quality of the auditors and audit, rather than on savings on audit fees,” in deciding whom to hire. \(^9\) The Commission further proposed prohibiting audit firms from marketing “novel and debatable tax strategies and products that involve income tax shelters and extensive off-shore partnerships or affiliates” to their audit clients. \(^9\)

The Commission’s sensitivity to the conflict-of-interest issues inherent in audit engagements is to be commended. However, its proposal may fall short. Essentially, the Commission tinkered with the payoff structure instead of realigning the incentives that drive those payoffs. Even with the five to seven year time frame espoused by the Commission, audit firms would still work for the clients they audit and would have an inside track and a cost advantage in competitive bidding. Although the Commission admonished audit committees to hire on the basis of quality, not cost savings, that sort of non-binding advice is likely to fall on deaf ears, particularly when companies are facing severe cost pressures.

Another possible approach is the system of statutory auditors found in many countries in continental Europe and Latin America. \(^9\) In countries with statutory auditors, auditors form a separate organ within the corporation, not outside of it. \(^9\) They are hired by shareholders, not the board, and are directly liable for damages to the shareholders for intentional harm or negligence. \(^9\) By law, management must produce all documents requested by a statutory auditor. \(^9\)

My concern with this approach is its highly context-dependent nature. Statutory auditors emerged in universal banking systems where company stock has traditionally been highly concentrated in the hands of a few large shareholders (generally banks). \(^9\) In those systems, the financial sophistication of those stakeholders and the size of their stakes make them effective monitors of auditors. In the United States, in contrast, our deep public capital markets mean that shareholdings are generally widely dispersed among numerous small shareholders. \(^9\) The average small shareholder does not have a sufficiently large stake or the skill to oversee a statutory auditor. \(^9\) Coordinating large numbers of shareholders for oversight responsibilities, moreover, is well nigh impossible. In all likelihood, institutional investors would reject any entrenched monitoring responsibilities

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\(^{89}\) Id. at 34-35.
\(^{90}\) Id. at 36.
\(^{92}\) Id.
\(^{93}\) Id.
\(^{94}\) Id.
\(^{95}\) JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 51 (5th ed. 2000).
\(^{96}\) Id.
\(^{97}\) See id.
that might impede rapid exit.

A third approach, advanced by Julius Cherny and others at New York University, takes a more radical approach, but one which holds out promise.\(^9\) Cherny and his coauthors propose requiring auditors to work for their malpractice insurers, not for the companies they audit.\(^9\) Under their approach, insurance companies would insure financial statements up to specified amounts for misrepresentations in financial statements.\(^10\) The insurance company would hire and fire a particular company’s auditors.\(^10\)

This proposal could have several advantages. It would make auditors answerable to an organization with a sizable financial interest in accurate financial statements. It would provide for a single, effective class of monitors of auditors with the power to hire and fire. And it would provide partial, but potentially substantial compensation to victims of financial statement fraud.

The devil of the proposal is in the details and many of the details of the Cherny proposal have yet to be worked out. A major issue is moral hazard.\(^12\) Two types of moral hazard could arise from financial statement insurance: moral hazard on the part of accountants doing the audits and moral hazard on the part of audited companies.

First, with respect to the moral hazard problem of auditors: Moral hazard is a concern in insurance because the insured—here, the auditor—may act carelessly because its conduct is insured. To curb moral hazard, the insurer would need to reward auditors who stand up to management and punish those who acquiesce to management. At a minimum, accounting firms and their auditors would need to be rewarded for effective audits with additional work. Bonuses should be considered for detecting financial frauds. Conversely, it would be imperative to fire errant auditors and accounting firms from the account and, in egregious cases, possibly from other engagements. (Auditors guilty of misconduct would also continue to face suspension of their licenses and criminal prosecution). Firings would be publicly reported to the SEC to send a signal to other insurance firms that the auditor’s work was compromised.

As for audited companies, several measures would be necessary to avoid moral hazard. The policy would only insure against auditor malpractice, not management misconduct. Financial statements are prepared in the

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\(^9\) Id.

\(^10\) Id.

\(^12\) See THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS 8 (Eric Brousseau & Jean-Michel Glachant eds., 2002) (stating that “moral hazard refers to uncertainty about the level of effort [a job seeker] will supply”).
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first instance by management, not auditors. \textsuperscript{103} Virtually every case of mis-leading financial statements involves complicity by officers and/or the board. For this reason, officers and directors would need to remain separately liable for their own misconduct. Furthermore, to forestall frivolous litigation, accountants' malpractice claims would need to be limited to suits by shareholders, not by management. \textsuperscript{104}

Premiums would also need to be structured to exert discipline on audited companies. Companies would be responsible for paying premiums to their insurers, both to defray auditing fees and any future legal liabilities of the insurer. Premiums would be risk-adjusted to penalize any past accounting fraud or irregularities by the company. Deductibles and coinsurance (styled as retention) could also be used to reduce risk.

Another potential problem is capture. Auditors spend weeks or months at the companies that they audit. It is not uncommon for them to develop close ties to company management. Rotating audit clients periodically could counteract the likelihood of capture. So could strict prohibitions against leaving to work for an audited company (for as long as five years). Auditors would also be barred from doing consulting (whether tax-related or otherwise) for the companies that they audit.

Additionally, any serious proposal to address accounting reform would need to address the issue of industry control over substantive accounting standards. Realigning auditors' incentives with those of their insurers would help guard against aggressive interpretations of GAAP. Likewise, it would be a mistake not to take advantage of the expertise that the accounting industry has to offer in formulating GAAP. The time has come, however, to subject changes to GAAP to SEC approval, as is true with amendments to the stock exchange rules. In addition, FASB's funding base needs to be expanded from accountants and publicly traded companies to all for-profit entities that benefit from its activities, including mutual funds and securities firms. \textsuperscript{105}

The final issue with the proposal is the most intractable. Without iron-clad statutory immunity from damages awards over the policy limits, insurers would be certain to refuse to hire accounting firms. Any statutory immunity would have to confront the murky question of how high the policy limits should be. Furthermore, even if Congress conferred immunity from damages over the policy limits by statute, insurers would remain fearful that innovative legal theories by plaintiffs' lawyers, such as negligent hiring or supervision of auditors, could somehow be used to circumvent the

\textsuperscript{103} RICHARD W. NICHOLSEN ET AL., BASIC ACCOUNTING FOR LAWYERS 151, 169 (1999).

\textsuperscript{104} For present purposes, I reserve judgment on if and when a conservator, receiver or trustee in bankruptcy should have standing to assert such claims against the insurer.

\textsuperscript{105} See COMM'N REPORT, supra note 46, at 39-42 (proposing other changes to the process of determining accounting principles to be used by businesses in reporting performance).
statutory damages cap and result in unlimited damages. Until that problem is solved, a market for financial statement insurance, however desirable, cannot become a reality.

VI. CONCLUSION

In response to recent accounting scandals that depleted the retirement savings of millions of Americans, Congress in Sarbanes-Oxley chose the path of gradualism. Little in Sarbanes-Oxley addresses the fundamental conflict of interest that permeates audit firm engagements with public companies. Until the payoffs that reward auditors’ complicity with management are reversed, we can expect repeat waves of the loss in public faith in audited financial statements that we are suffering today.