2001

The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting

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Working Paper No. 191

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<u>Abstract</u>

The role of "gatekeepers" as reputational intermediaries who can be more easily deterred than the principals they serve has been developed in theory, but less often examined in practice. Initially, this article seeks to define the conditions under which gatekeeper liability is likely to work - - and, correspondingly, the conditions under which it is more likely to fail. Then, after reviewing the recent empirical literature on earnings management, it concludes that the independent auditor does not today satisfy the conditions under which gatekeeper liability should produce high law compliance. A variety of explanations - - poor observability, implicit collusion, and high agency costs within the gatekeeper - - provide overlapping explanations for gatekeeper failure. What remedy should work best to minimize such failures? As a more appropriate and supplementary remedy to reliance on class action litigation, this article recommends fundamental reform of the governance of the accounting profession. In particular, it contrasts the structure of self-regulation within the broker-dealer industry with the absence of similar self-discipline in the accounting profession. While such reform may be unlikely, its absence strongly implies that earnings management is likely to remain a pervasive phenomenon.

Introduction

Corporate governance depends upon "gatekeepers" to protect the interests of investors and shareholders by monitoring the behavior of corporate "insiders" and by reporting the financial results of corporate performance in an accurate and unbiased fashion that permits objective valuation of the firm. Attorneys, investment bankers, and, most of all, auditors are the paradigmatic examples of "gatekeepers" - - that is, independent professionals who are interposed between investors and managers in order to play a watchdog role that reduces the agency costs of corporate governance.[1] Absent effective gatekeepers, it is reasonable to believe that market efficiency would be lower, the cost of capital higher, and our structure of corporate governance imperilled.[2] But the incentives to perform this watchdog role are not always adequate to the task.

So much for the obvious! The real issue is how great is the incentive deficit for gatekeepers and what can be done about it. Here, theory and practice diverge radically.

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1 In Securities Act Release No. 7870 (June 30, 2000), the SEC recently noted that " the federal laws ... make independent auditors 'gatekeepers' to the public securities markets." 2000 SEC LEXIS 1389 *11. For a more complete definition of this concept of gatekeeping, see text and notes infra at notes 7 to 9. The earlier literature on gatekeepers includes a number of important articles, including R. Kraakman, Corporate Liability Strategies and the Costs at Legal Controls, 93 Yale L.J. 857 (1984); R. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239 (1984); R. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986); S. Choi, Market Lessons for Gatekeepers, 92 Nw. U.L. Rev. (16 (1998).

2 For a fuller, more theoretical statement of this assertion that contemporary corporate governance relies on unbiased financial information and which focuses on the special "gatekeeping" role of the accountant and auditor, see R. Bushman and A. Smith, "Financial Accounting Information and Corporate Governance" (Working Paper, Nov. 2000) (available on SSRN Electronic Library at id=253302).

Although a well-known theoretical model posits that the gatekeeper is a reputational intermediary who will strive diligently to preserve its credibility,[3] the anecdotal evidence has recently been overwhelming that gatekeepers may be undermotivated to protect their reputations. For example, over the last year, one only has had to open a newspaper to learn of pending SEC investigations involving serious accounting irregularities at otherwise reputable corporations -- for example, Lucent or Xerox[4] - - or to encounter record class action settlements in accounting fraud cases.[5] Although it is possible to discount such data as largely anecdotal, this article will assemble more reliable evidence, based on surveys and in-depth interviews with auditors, that both corroborates

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[3] See Kraakman, supra note 1, for the original, seminal contribution.

[4] See, e.g., S. Romero, "Lucent's Books Said to Draw the Attention of the SEC," N.Y. Times, February 10, 2001, Section C, p. 1 (noting commencement of formal investigation of Lucent by SEC); C. Deutsch and R. Abelson, "Xerox Facing New Pressures Over Auditing," N.Y. Times, February 9, 2001, Section C, p. 1. Even General Electric has recently become the target of similar criticisms that it has managed earnings, see Jeremy Kahn, "Accounting in Wonderland: Jeremy Kahn Goes Down the Rabbit Hole with G.E.'s Books," Fortune, March 19, 2001 at p. 37.

[5] See <u>In re Cendant Corporation Sec. Litig.</u>, 109 F. Supp. 2d 235 (D.N.J. 2000) (approving record $3.18 billion settlement in securities class action based on accounting fraud). Although <u>Cendant</u> set a record for the financial recovery, it is not qualitatively different from the allegations made in recent SEC enforcement proceedings (or criminal indictments) in a host of recent accounting irregularity cases, including HBOCMckesson, Livent, Mercury Finance, Rite Aid, Boston Scientific, Informix, Sunbeam, Donnkenny, Paracelsus Healthcare. For a list of recent such cases, see M.Young, ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD: A Corporate Governance Guide (2000) at p.1. Most recently, in May, 2001, the SEC brought a highly publicized securities fraud action alleging accounting irregularities against former officers of Sunbeam and its outside auditors. See Floyd Norris, "S.E.C. Accuses Former Sunbeam Official of Fraud," N.Y. Times, May 16, 2001 at A-1. Much of the press attention in this case has focused on the fact that the SEC also sued a partner at the firm's outside auditors for conscious participation in the fraud. See Floyd Norris, "They Noticed the Fraud, But Figured It Was Not Material," N.Y. Times, May 19, 2001 at C-1.

the conventional wisdom that earnings management has become pervasive and that suggests that this pattern will persist, unless more aggressive regulatory interventions are made.[6]

Deterrence theory provides an even stronger reason to predict an increased rate of failures by gatekeepers: the litigation risks that gatekeepers face have diminished, while the expected benefits from acquiescing in earnings management and accounting irregularities have almost certainly increased as a result of organizational changes within accounting firms. Hence, at least in a world of rational actors, the rate of "earnings management" and accounting irregularities

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[6] See, e.g., Eli Bartov, Dan Givoly and Carla Hayn, "The Rewards to Meeting or Beating Earnings Expectations," (Working Paper October 2000) (finding increased pressure upon issuers to meet or exceed earnings expectations and that firms that meet or exceed such expectations enjoy an average quarterly return that is 3% higher than that of peer firms that fail to do so) (available on SSRN Electronic Library at id = 247435). The Panel on Audit Effectiveness, which was appointed by the Public Oversight Board ("POB") of the American Institute of Certified Public Accountants, summarized recent developments in this area in a quiet understatement in its final report in 2000:

> "Over the past few years, several major instances of misstated earnings resulted in headlines reporting massive declines in market capitalization ... This revelation frequently leads to restatements of those financial statements, suggesting that the financial reporting system may not, in fact, promote the most efficient allocation of capital."

See The Panel on Audit Effectiveness Report and Recommendations (August 31, 2000) at 2. In fact, the creation of the Panel on Audit Effectiveness was itself testimony to the SEC's growing concern that the process of auditing is not today generally capable of detecting or preventing earnings manipulation by senior management. The Panel was established by the POB at the request of the SEC's Chairman to assess the adequacy of current auditing practices and procedures. Id. at __.

should predictably increase.[7] Worse yet, the possibility surfaces that there may be a rational incentive for the gatekeeper to market its reputation as in effect a wasting asset, rather than to preserve it in perpetuity, as a reputational intermediary is expected to do in theory.

The real puzzle is less why there might be a shortfall in deterrence than what realistically can be done about it. In the abstract, audit failures can be attributed either to (i) knowing, reckless, or at least negligent acquiescence by auditors in accounting irregularities, or (ii) inherent limitations on the auditor's role or capacity. Under this latter heading falls an increasingly popular explanation for the pervasiveness of earnings management: namely, that generally accepted accounting principles empower corporate management to engage in earnings management by allocating them discretionary authority that the auditors cannot in effect reverse or challenge.[8] Over the last decade, the accounting profession and the SEC have debated the causes of auditing failure, with the profession aggressively pushing its view that an "expectations gap" exists between the unrealistic hopes that the public places on the ability of auditors to detect errors in the issuer's own financial statements and their actual capacity.[9] Without denying the claim that

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7 The threat of litigation does appear to have a close correlation with the rate and volume of "earnings management." See, e.g., William Heninger, The Association Between Auditor Litigation and Abnormal Accruals, Accounting Review (January 2001) (finding a positive relationship between measures of earnings management and litigation against auditors) (available on SSRN Electronic Library at id=248136). Hence, as litigation risks diminish, accounting irregularities should predictably increase.

8 See Paul Rosenfeld, "What Drives Earnings Management? Generally Accepted Accounting Principles," 190 Journal of Accountancy 106 (October 1, 2000).

9 See Michael H. Young, supra note 5, at 29. Young notes that in response to the report of the Treadway Commission in 1987, the accounting profession made a "concerted effort ... to make clear to the public that it was performing ... only a 'secondary' role." Id. This sense that the public expected too much of the

GAAP confers broad discretion on corporate management to engage in earnings management, this article will assess the recent evidence that now suggests that auditors have a fairly good understanding of when earnings management is in progress, but often lack sufficient incentives.

Such a conclusion, however, only begins the analysis. If audit failures do not escape the attention of auditors, a governance problem is posed: What responsibilities should the profession have for monitoring its own? Traditionally, public policy assumed that the threat of litigation could drive the process, deterring those who could be influenced by incentives and bankrupting those too incompetent to be deterred. But even if litigation works, it is a costly remedy -- and, more importantly, a politically vulnerable one. During the 1990's, the high costs of a litigation-driven system of monitoring mobilized the accounting profession to seek political relief, which they obtained in part in the form of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). In its aftermath, the litigation risks for the auditor have now subsided, and other enforcement mechanisms must realistically be considered. From this premise follows the agenda of this article: to assess what additional or supplementary leverage points are available that public policy could exploit as alternatives to reliance on large-scale private litigation in order to constrain earnings management?

In particular, because the responsibility for earnings management seems to be shared by corporate management and the auditor, a simple deterrence approach directed at the auditor will not work well in isolation, and will sometimes hold the auditor vicariously liable for financial

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profession became known as the "expectations gap" and lead to a revision of the auditor's standard report to state that "financial statements are the responsibility of the company's management" with the auditor's responsibility being only to "express an opinion on these financial statements based on our audit." Id.

manipulation that it is powerless to correct. Given this shared responsibility, legal incentives should instead seek to compel the auditor to appraise the corporation's audit committee of its awareness of earnings management, regardless of whether it has proposed audit adjustments or believes the deviations to be immaterial.[10] Failure to do so should subject the individual auditor and the firm to professional sanctions, ranging from public censure to expulsion, that would be imposed by the AICPA, but under the general oversight of the SEC. But this goal of meaningful industry self-discipline would require fundamental restructuring of the governance of the accounting profession. Of course, this article cannot predict that such reform is likely, but it does conclude that lesser measures or complete reliance on litigation remedies are unlikely to work by themselves.[11] As a result, the ideal of the auditor as a self-enforcing gatekeeper has inherent limitations that need to be more carefully understood.

I. Auditors As Gatekeepers: Defining the Boundaries of the Model

a. The Gatekeeper Model: When Will the Watchdog Bark?

[10] The AICPA has already moved part way in this direction with Statement on Auditing Standards No. 89: Audit Adjustments, which was adopted in 1999. See Thomas Ratcliffe, "Understanding SAS No. 89: Audit Adjustments," The CPA Journal (April 1, 2000). SAS No. 89 requires both management and the auditor to inform the audit committee about uncorrected adjustments that the auditors proposed but that management has declined to make. See text and notes infra at note __.

[11] For this reason, among others, I cannot endorse the "strict liability" model advocated by Professor Partnoy in his article in this volume. See Partnoy, Barbarians At the Gatekeepers: A Proposal for a Modified Strict Liability Regime, __ Wash. U. L. Rev. __ (2001). Not only do I see strict liability as politically infeasible, I also consider it inappropriate if existing GAAP principles permit management to manage earnings. Put differently, the auditing firm is not in all circumstances the best cost avoider from a tort law perspective - - that is, the person who can most easily and at lowest cost prevent the injury.

It is now commonplace to speak of underwriters, auditors, attorneys and certain others as "gatekeepers."[12] But not everyone who uses this term has the same meaning in mind. Essentially, the gatekeeper model is a third party enforcement strategy that relies on the fact that it may be easier to deter a third party who has little to gain than an entrepreneur who has a significant stake in a questionable transaction. Given such a stake, the entrepreneur may misrepresent or omit material facts about that transaction, even in the face of high legal liability. Yet, if the law conditions the entrepreneur's ability to consummate the planned transaction on some form of certification by an independent professional that the entrepreneur has complied with the law, it may be easier for the law to deter this third party and cause it to report non-compliance than it is to deter the entrepreneur.[13]

Still, what keeps the third party enforcer from being bribed by the entrepreneur to give the requested certification? Two answers are possible, and they can be given in combination. First, the third party enforcer may face legal liability in an expected amount that is greater than any inducement that the entrepreneur could offer, and, second, the third party may have made a significant investment in its own reputation, which it may forfeit if it falsely or inaccurately certifies compliance by the entrepreneur.

Although both motivations - - liability and reputation - - can overlap, they are not necessarily always present or sufficient. Sometimes, the risk of liability may be remote, and other

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12 Professors Gilson and Kraakman were probably the first to employ the concept, without then naming it, when they described underwriters as "reputational intermediaries." See Gilson and Kraakman, <u>The Mechanisms of Market Efficiency</u>, 70 Va. L. Rev. 549, 619 (1984).

13 This is the essence of Professor Kraakman's original model. See Kraakman, supra note 1, 2 J. L. Econ. & Org. 53, at 54.

times the gatekeeper's failure may not result in the necessary reputational loss. In this light, the gatekeeper model is likely to be most effective when three elements are present in combination:

> (1) The gatekeeper provides a legally mandatory certification whose accuracy the protected class can directly observe. Essentially, the gatekeeper is a skilled, independent professional who fulfills an obligatory certifying function that either the law or the conventional practice necessitates before a particular transaction can be consummated; the gatekeeper is in effect interposed between the entrepreneur and the investing public to serve as a watchdog for the latter. But it is critical that investors, shareholders, or any other protected class be able to judge whether the gatekeeper's certification was accurate. In short, failure must be observable.
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> (2) The gatekeeper is a "repeat player," whose reputational capital is effectively pledged to secure its faithful performance. The gatekeeper must not engage in "one shot" transactions for clients, which would enable it to evaluate the expected gains and losses from acquiescence on an individual transaction basis. Nor should the optimal gatekeeper ever reach a "final period" at which it can defect and abandon its investors clients in return for a single, final payment from management.[14] In theory, any scandal or irregularity clouds its reputation and should significantly impact its future earnings. By the same token, however, recurrent scandals in a very concentrated profession are a signal of dysfunction.
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> (3) The gatekeeper expects only nominal fees from any individual client. Because it serves many clients, the gatekeeper will normally earn a fee for its services from any individual client that is relatively modest, both in relation to the potential gains from the transaction

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[14] A standard problem in game theory is that game participants who seek to maximize their reputational capital during most of the game lose that incentive once the game's "final period" is reached, because reputational capital will no longer benefit them and hence they have an incentive to behave opportunistically. It has been suggested that larger firms (both law and accounting firms) have incentives to restrain and check the behavior of individual partners who are entering their "final period" in order to preserve the firm's reputational capital. See L. Ribstein, Ethical Rules, Agency Costs and Law Firm Structure, 84 Va. L. Rev. 1707, 1715-19 (1998).

> to the client and to the potential liabilities that the gatekeeper will face to those investors who have relied upon its certification. The more the gatekeeper becomes economically entangled with the client and the larger the fees become in relation to potential liabilities, the less the model works.

When these elements are present,[15] it is logical to believe that the expected gains to the gatekeeper from acquiescing in fraud or misconduct that primarily benefits others will be outweighed by the expected costs. Although some rate of audit failure will persist, it will more likely be the product of other causes (sophisticated fraud, auditor incompetence, etc.), not insufficient motivation.

That's the theory anyway. Although this gatekeeper model potentially applies to all three professions (law, investment banking, and accounting), the congruence between the model and reality is closest in the case of the auditor. Given the highly concentrated character of the accounting industry,[16] the major accounting firms would seem to be structurally independent of their clients, because each of the "Big Five" has several thousand clients and each provides essentially similar, almost standardized services to them, with no one client thus being material to the large accounting firm's revenues.[17] This cannot be said for law or investment banking firms,

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[15] This three-part definition is the author's own, but probably adds only marginally to Professor Kraakman's original analysis by stressing the observability of the gatekeeper's failure and the assumption of nominal income from the client. See Kraakman, supra note 1, 2 J.L. & Econ. at 54 (focusing on certificates that are necessary for the principal's wrongdoing to be consummated).

[16] In 1999, the "Big Five" Accounting firms - - Arthur Anderson LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and Pricewaterhousecoopers LLP - - audited approximately 76% of U.S. public registrants. See Panel on Audit Effectiveness, supra note 6, at p.182. When the next three largest audit firms are added, these eight firms in 1999 audited 82% of U.S. public registrants.

[17] The average size of a Big Five firm in the United States is approximately 90 offices, 2,000 partners and 24, 000 professionals. Globally, these firms average 100,000 professionals serving clients in 130 countries. Id. at 182. Hence, their

which often have dominating clients and which also provide more specialized, less fungible services. In addition, the risk of malpractice or other liability faced by law and investment banking firms has historically been well below the litigation risk faced by the accounting firms.

But which motivation - - liability or reputation - - primarily deters the auditor as gatekeeper today? In the past, auditors were clearly subject to intense litigation pressure. Prior to the passage of the Private Securities Litigation Reform Act at the end of 1995, the volume of auditor litigation appeared to be growing at an exponential rate and was staggering in proportion to the resources possessed by auditor defendants. By one estimate, the then "Big-Six" accounting firms faced legal liabilities by the end of the 1980's of "around $30 billion – roughly $3.8 million per partner."[18] Even then, despite these enormous potential liabilities, cases of financial fraud surfaced with regularity throughout the 1980's and early 1990's. Thus, even at the peak of this high litigation era, the general deterrent threat of class actions and other litigation against auditors often did not work. This apparent shortfall in deterrence raises the further possibility that, even if the firm is deterred, individuals within it may not be, and hence supplementary sanctions and remedies aimed at these individuals would be desirable.

What flaws in the gatekeeper model could account for insufficient motivation in gatekeepers, even under circumstances when the prospect of liability seemed real? In the abstract, several scenarios suggest themselves:

1. <u>Poor Observability Because of Imprecise Standards or Ambiguous Certifications</u>. It is

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scale dwarfs even the largest law firm and implies that no single client's auditing fees should be material to such a mega-firm.

18 See Michael H. Young, supra note 5, at 23.

critical to this model that the public be able to judge accurately whether the gatekeeper has failed. Some frauds or deceptions are beyond its ability to detect and prevent. Much depends on what it has promised to do. In this light, the more that the certification provided by the gatekeeper is limited and/or qualified, then the greater the possibility that the gatekeeper could remain blind to misfeasance or malfeasance by the client without incurring any penalty (either financial or reputational). Ambiguous standards compound this problem by again making it uncertain what are the auditor's responsibilities.[19] In short, the greater the latitude that GAAP permits the client, the less the risk of liability to the auditor and the less the reputational injury.[20]

2. Implicit Collusion. The gatekeeper may be able to market itself less as a faithful and diligent watchdog for the shareholders than as an accommodating and flexible friend of management. The reputational injury in having tolerated irregularities may thus be acceptable, if the real competition is for the favor of managers, not shareholders. Moreover, in a concentrated industry in which all five significant competitors may be following this same basic strategy in parallel, each might assume that the others would incur a similar rate of reputational injury, thus advantaging none. Although such a strategy can only work if the gatekeeper is able to absorb the predictable costs of the litigation that it will attract, the PSLRA may have made these litigation

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19 For a study finding precisely this (namely, that earnings management increases the more that a particular accounting standard is imprecise or relies on management discretion or judgment), see M. Nelson, J. Elliott, and R. Tarpley, "Where Do Companies Attempt Earnings Management, and When Do Auditors Prevent It?" (Working Paper October 22, 2000) (available on SSRN Electronic Library at 248129).

20 Alternatively, reputational injury may only be experienced by the auditor when and if some authoritative decision-maker (such as the SEC) determines that the auditor misbehaved. This would also imply that imprecise standards protect the auditor from reputational injury as well as legal liability.

risks acceptable.

3. Economic Coercion. Corporate managers may find means by which they can seduce gatekeepers into acquiescence, such as by linking material amounts of other business to the auditing engagement, which business can be withdrawn if the auditor fails to acquiesce in the client's aggressive accounting policies. The more developed and material the business relationships between the client and the gatekeeper, the less the likely independence of the latter. This diagnosis leads to an obvious reform: restrict the ability of auditing firms to offer non-audit services to their clients. Still, the SEC has essentially pursued this approach, only to be forced to back significantly off it in the face of pressures from Congress, which the accounting industry effectively lobbied.[21]

4. High Agency Costs: The Undeterred Individual Within the Firm. Even if the gatekeeper firm can be deterred, it does not follow that individuals within it will also be. For example, the costs of reputational injury may fall on the gatekeeper firm as a whole, while the gains from acquiescence in accounting irregularities may be disproportionately captured by a few critical actors within this firm.[22] If so, remedies focused on the individual professional within the

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[21] The political process leading up to the new definition of auditor independence in Securities Act Release No. 7919 (November 21, 2000) can be reasonably characterized in different ways. Former SEC Commissioner Roberta Karmel has described it as "a backroom deal among the large accounting firms in which not all parties were satisfied." See R. Karmel, "Transition: SEC Chairman Arthur Levitt's Tenure, The Future," New York Law Journal, February 15, 2001 at 3, 6. Yet, she also correctly describes the new rule (i.e., Rule 2.01 of Regulation S-X) as "sweeping." Id. While this author believes that the new rule does arm the SEC with an important new weapon, he agrees that the SEC was forced to concede much in these negotiations because of the industry's political clout with Congress.

[22] Some research suggests that the audit engagement partner has the most to gain from acquiescence in a client's aggressive accounting policies. See W. Kinney, Jr.,

auditing firm may be needed. Uniquely, this is the one approach, it will be suggested, that has not yet been meaningfully pursued.

b. The Model Applied to Auditors

All these possible scenarios for client "capture" of the gatekeeper find "real world" corollaries in the recent experiences of auditing firms. As the next section of this article will discuss in more detail, the expected costs associated with auditor acquiescence have declined, while the expected benefits have increased, both for the firm and for certain critical actors, such as the audit partner. There are multiple elements to this story, which need only be briefly reviewed at this stage.

First, the passage of the PSLRA reduced the auditor's legal exposure; in addition, other legal developments may have done even more to make the auditor an unattractive litigation target. Today, a combination of judicial and legislative developments makes it unlikely that the securities plaintiff's bar will sue the auditor of a publicly-held firm, unless it can find a rare "smoking gun" that is apparent at the outset of the case.

Second, the organizational structure of the now "Big-Five" accounting firms has correspondingly changed, with auditing becoming an increasingly less significant sector of these rapidly growing financial conglomerates. Not only are auditing revenues becoming modest in proportion to other revenues received by these firms,[23] but auditing is recognized to be a low-

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Auditor Independence: Burdensome Constraints or Core Value?, Accounting Horizons (March 1999); G. Trompeter, The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Audit Partner Judgment, Auditing: A Journal of Practice and Theory (Fall 1994).

[23] In 1999, the "Big Five" collectively had U.S. revenues of approximately $26 billion, of which only $9.5 billion (or 36.5%) was attributable to accounting and

growth business, with the competition among "Big-Five" firms resembling a static, zero-sum game. That is, for each client won from one of its four competitors, the Big Five firm can expect that there is another client that it is correspondingly likely to lose to one of its competitors. Hence, it makes increasingly less sense to invest heavily in such a competition when other lines of business offer much higher growth rates.

Even if characterized by low growth, the auditing practice of the Big-Five firms does have one characteristic that is highly valued by these firms: auditing is a portal of entry through which the accounting firm can access high level corporate management within its audit client in order to cross-sell its other services. Because the auditor's services are obligatory, they provide the "Big-Five" with a unique opportunity by which to market other, higher profit margin services to their auditing clients.

This marketing of non-auditing services to audit clients has greatly concerned the SEC, which in series of highly publicized statements between 1998 and 2000 warned that the provision of non-audit services to audit clients could compromise the independence of the auditor.[24] In particular, to the extent that the auditing partner for the client is compensated on the basis of his or her ability to cross-sell other firm services to the client (a practice that now seems common) , the audit partner has an increased incentive to acquiesce in management's desires to manipulate earnings. Ultimately, the accounting firm could rationally come to see its auditing services as a

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auditing services. See Panel on Audit Effectiveness, supra note 6, at p. 182.

[24] See, in particular, Securities Act Release No. 7870 (June 30, 2000) and Securities Act Release No. 7919 (November 21, 2000). These releases first proposed and then adopted amendments to Rule 2-01 of Regulation S-X, which rule governs auditor independence. See 17 C.F.R. § 210.2-01.

"loss leader" on which it makes a minimal profit in order to market other services.[25]

Yet, if the SEC has clearly seen the dangers in the provision of non-audit services to audit clients, it has had only mixed success in attempting to halt this trend. Although it boldly proposed last year to bar the provision of such non-audit services, it quickly found itself outgunned on Capitol Hill, as the accounting industry, assisted by a phalanx of lobbyists, was able to threaten the SEC's budget if it were to adopt its proposed rule barring auditing firms from offering specified non-audit services to audit clients. The net result of this confrontation has been described by many as a fairly weak compromise, which kept many of the old prohibitions in place that restrict or preclude the provision of certain limited non-audit services to an audit client, but largely left auditing firms free to market the newer and more profitable lines of business (most notably, the marketing of information technology systems and software consulting services).[26]

The SEC did, however, achieve one potentially important procedural victory as the result of its recent compromise with the accounting industry: the client's audit committee must review the total mix of relationships between the firm and its auditor and then approve the auditor's

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[25] I do not suggest that auditing is today a "loss leader." My understanding is that it remains a profitable, if low growth, line of business for the major auditing firms. Some evidence does suggest, however, that auditing firms "lowball" their audit fees to obtain other business from the client. See Securities Act Release No. 33-7919 (Nov. 21, 2000) at 27n. 85 (citing testimony of Presiding Officer of Texas State Board of Accountancy and others that some firms now "low-ball" their audit fees to obtain market share).

[26] Under revised Rule 2-01(c)(4)(ii), the auditor may offer services to an audit client in connection with the assessment, design, and implementation of internal accounting controls. However, the auditor may not operate or supervise the operation of an audit client's information technology ("IT") system. See 17 C.F.R. § 210.2-01(c)(4)(ii).See also Securities Act Rel. No. 33-7919 at *__ to *__. This compromise thus lets the auditor design an IT system for the client, but not operate or supervise it.

independence in light of them.[27] Still, unless all audit committees behave the same, it seems likely that some corporate clients will soon be in the position of purchasing non-audit services from their auditor whose value dwarfs their auditing fees. To the extent that this happens, such an auditor is no longer the classical gatekeeper whose revenues from the client are too immaterial for the auditor to rationally risk a loss of reputational capital from acquiescence in an accounting irregularity. In short, the more that an individual client becomes material to the auditor in terms of its total contribution to the firm's revenues, (or expected future revenues), the more that the auditor's "independence" becomes questionable and the greater its incentive to acquiesce in management's desire to pursue an "aggressive" accounting policy. Finally, even if the auditing firm, itself, does not have such an incentive to acquiesce, some critical actors within it (such as an audit partner who is compensated on the partner's ability to cross-sell other services) may.

The final relevant change over the last decade involves a matter of degree, rather than a difference in kind. As the stock market became more volatile and unforgiving in the 1990's and as corporate managements were increasingly compelled to predict future earnings, the penalty for failing to meet a projected earnings target level has grown: that is, a sudden stock price drop has become predictable. In turn, management's incentive to engage in preventive "earnings

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[27] Literally, the SEC has required only that the proxy statement disclose "whether the audit committee considered whether the principal accountant's provision of the information technology services and other non-audit services to the registrant is compatible with maintaining the principal accountant's independence." Securities Act Rel. No. 7919 at p. 174. However, because the Panel on Audit Effectiveness had earlier recommended that the audit committee pre-approve non-audit services that exceed a threshold set by the audit committee (id. at 174 n. 477), it will be highly unlikely that any audit committee will disclose that it has not considered this issue.

management" has correspondingly increased.[28] The term "earnings management" covers a broad continuum of activities, ranging from the lawful to the unlawful, which all share the common characteristic of enabling corporate management to intentionally affect the firm's earnings.[29] Given the diversity of techniques by which to achieve earnings management, it is easier to begin by explaining the motives for earnings management. Considerable evidence supports the proposition that investors prefer a time series of smoothly increasing income to a more uneven series of fluctuations.[30] If this is what the market wants and rewards, corporate managers can often find ways to appease the market by smoothing earnings fluctuations.

For example, if the earnings per share for the first and second quarters of a hypothetical corporation's fiscal year were $.10 and $.13, respectively, and if the third quarter promised to be a huge $.40 per share quarter, cautious corporate managers might anticipate that the market would not especially value, or respond positively to, this one-time bonanza quarter. Thus, they might instead seek to suppress this sharp one-time spike in earnings by delaying recognition of 50% of this record third quarter until the fourth quarter (or later). Indeed, if the fourth quarter appeared likely to return to the level of the first and second quarters (i.e., 10¢ to 13¢ per share),

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28 This was the basic diagnosis offered by former SEC Chairman Arthur Levitt in a now famous speech, entitled "The 'Numbers Game'" (NYU Center for Law and Business, September 28, 1998). For similar assessments, see M. Young, supra note 5, at 6-15; Bartov, Givoly, and Hayn, supra note 6 (providing empirical corroboration of earnings management).

29 For an overview of the debate about this term, see P.M. Healy and J.M. Whalen, <u>A Review of the Earnings Management Literature and Its Implications for Standard Setting</u>, 13 Accounting Horizons 365 (1999); see also Panel on Audit Effectiveness, supra note 6, at 77 to 83.

30 See, e.g., M.E. Barth, J.A. Elliott, and M.W. Finn, <u>Market Rewards Associated with Patterns of Increasing Earnings</u>, 46 Financial Analysts Journal 387 (1999).

the impact of delaying 20¢ from the third quarter to the fourth is to produce a smoothly increasing progression from $.10, to $.13, to $.20, to $.33. This may be far more re-assuring to the market than a rapid series of fluctuations over the last three quarters from $.13 to $.40 to $.13. A variety of well-known accounting techniques can be used to accomplish this goal, and SEC Chairman Arthur Levitt's much publicized strictures in his November, 1998 speech against "cookie jar" reserves describe simply the most common technique.[31] Often, the consequences of such smoothing seems innocuous to both the company's managers and its auditors, because income recognition is often being delayed, not accelerated. Still, the result may be to hide from the market what is in reality a disastrous slide in earnings. In any event, noise enters the system, and the credibility of reported results is eroded (not just for the individual company, but potentially for all public companies because if the auditors acquiesced in one case, the market must anticipate that they will likely acquiesce in other cases as well).

The principal focus of the SEC's campaign against earnings management has been on upgrading the audit committee. Thus, 1999 also saw the publication of the Report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.[32] This body, formed at the clear instigation of the SEC, issued a series of recommendations, which were quickly adopted by the New York Stock Exchange, the National Association of Securities Dealers ("NASD"), and the American Stock Exchange as listing standards for large publicly held

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[31] See Levitt, supra note 28.

[32] See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999). For a concise review, see G. Backman, "Audit Committees: The Proposed Regulations," Corporate Governance Advisor (Nov. - Dec. 1999) at p. 1.

corporations.[33] The entirely laudable intent of these new requirements has been to strengthen the independence of the audit committee and to structure the corporate client's relationship with its auditor so that the latter was required to present its evaluation of the quality (and not just the acceptability) of the company's chosen accounting principles to the audit committee.

The common denominator in all these coordinated reforms has been the assumed centrality of the audit committee. Although this article accepts the importance of the audit committee as a critical actor and does not challenge the desirability of any of these recent reforms, it is skeptical that the audit committee can fully shoulder the burden that has been delegated to it. The problem is not just that the audit committee is composed of outside directors, who are by definition part-time players with other, more demanding responsibilities, but that the new reforms have asked the audit committee to simultaneously monitor the behavior of corporate management <u>and</u> the independence of the outside auditor. This places the audit committee in the difficult role of monitoring both the other parties in what is essentially a three player game. The result may be to invite the latter two players in the corporate financial reporting process (both of whom are committed full-time to the process, unlike the audit committee) to form a polite conspiracy to resist active monitoring by the audit committee.

In any event, the goal of this article is to evaluate alternative regulatory strategies that are potentially available to supplement the SEC's somewhat reflexive reliance on the audit committee. To the extent that little more can be done to enhance the effectiveness of the audit committee, the focus should naturally shift from it to the auditors themselves. Here, the most obvious target for

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[33] The SEC quickly approved and adopted these proposed changes in listing standards. See SEC Releases Nos. 34-41987, 41982, and 41981 (October 6, 1999).

reform involves the governance structure of the accounting profession, itself. If accountants misbehave (either on the individual or firm level), the first and most logical remedy might be professional discipline from within the industry. In addition, to the extent that private litigation today represents less of a deterrent threat, then self-regulatory sanctions administered by the profession would seem the most logical means of compensating for this deterrence shortfall. Yet, although all professions have mechanisms for professional discipline, a distinctive fact about the accounting profession is the extent to which its disciplinary capacity is and remains underdeveloped. This disciplinary and self-regulatory void becomes especially conspicuous if we contrast accountants with broker-dealers. Broker-dealers constitute a highly organized profession that is in many respects similar to the accounting profession. Both perform a "gatekeeping" function, and both are relied upon by public investors. Yet, in terms of governance structure, perhaps the most notable institutional difference between the two professions is the massive investment made by the broker-dealer industry in self-regulation and professional discipline. In contrast, professional discipline within the accounting profession amounts to little more than a cottage industry. Not only are the number of cases brought relatively insignificant in terms of the size of the industry (or the obvious losses in some notorious recent financial scandals involving accounting irregularities), but there is no comparison in the size of the professional staff and resources committed to the detection of misconduct.[34]

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[34] For example, NASD Regulation, Inc., the enforcement area of Nasdaq, "spends millions of dollars each year educating, testing, and disciplining the brokers and dealers and their thousands of associated persons who are allowed to enter the trades and quotes..." shown on Nasdaq. See Joel Wolfson, Contract and Copyright Are Not At War, 87 Calif. L. Rev. 79, 89 (1999). As part of a settlement with the SEC, the NASD was required to spend $100 million on enforcement and surveillance improvements for the Nasdaq market. See S.

This comparison becomes even more timely when one recalls the SEC's reaction when it became dissatisfied with the performance of the NASD in the mid-1990's. During this period, the SEC found that NASD had failed to enforce certain disciplinary rules with the apparent result that the bid/asked spreads on Nasdaq had become artificially wide. In response, the SEC essentially sought governance reform.[35] In due course, the NASD was compelled under SEC pressure to conduct an internal review of its system of governance, which review ultimately concluded that NASD's existing governance structure had failed to observe properly the necessary distinctions between operating a competitive market and regulating virtually all broker dealers in the industry.[36] As a result, an independent enforcement arm – NASD Regulation, Inc. – was created with its own board, in large part to insulate professional discipline from the natural desires of those regulated to soften the penalties.[37] Much this same criticism might be leveled at the AICPA: namely, its desire to increase the revenues for its industry comes into conflict with its role as self-regulator and protector of the public. Yet, the possibility of enhanced self-regulation in the case

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Manning and R. Wilmer, "NASD Settles SEC Charges Over Alleged Abuses in Nasdaq Market," 28 Sec. Reg. & L. Rep. (BNA) 967 (August 9, 1996).

35 See SEC, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1935 Regarding the NASD and the Nasdaq Market (1996) (hereinafter, "SEC Report").

36 Essentially, the NASD agreed under intense pressure to split its oversight and regulatory functions by creating two separate subsidiaries. See NASD, Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors (1995); see also "NASD Board Agrees to Split Oversight, Regulatory Functions," 27 Sec. Reg. & L. Rep. (BNA) (Dec. 1, 1995), Sec. Exch. Act. Rel. No. 34-37107 (April 11, 1996).

37 The board of NASD Regulation, Inc. is today equally divided between "public" and "industry" representatives. See SEC Report at 4-5.

of the accounting profession has only begun to receive serious attention (most notably, in the recently released report of the Panel on Audit Effectiveness[38]), and the topic has been largely ignored by academics.

Of course, the fact that a topic has been ignored does not imply that, on closer consideration, it will prove feasible or attractive. Important differences clearly exist between the broker-dealer industry and the accounting profession, including the facts that (i) broker-dealers deal directly with (sometimes unsophisticated) individual clients, while auditors work with highly sophisticated (if sometimes ill-intentioned) corporate clients, and (ii) the SEC has considerably greater statutory power over both brokers-dealers and the NASD than it has over either accountants or the AICPA. Moreover, there is also a standard academic critique of self-regulation, which assumes that it naturally leads to anti-competitive behavior.[39]

Nonetheless, the more one learns about the organizational behavior involved in earnings management, the more that multiple responses and a graduated continuum of sanctions seem desirable. Where once earnings management was discussed only in pejorative and rhetorical terms, it has now begun to be seriously studied by academics.[40] As discussed later, a "new

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[38] See note 6 supra.

[39] This fear is greatest when the industry is already concentrated, as the accounting industry certainly is. See M. Priest, The Privatization of Regulation: Five Models of Self-Regulation, 29 Ottawa L. Rev. 233, 256 (1997).

[40] This article will give special attention to a recent student by financial economists at Cornell and George Washington Universities. See M. Nelson, J. Elliott, and R. Tarpley, "Where Do Companies Attempt Earnings Management, and When Do Auditors Prevent It?," (Working Paper October 22, 2000) (available on SSRN Electronic Library at id. = 248129); see also T. Koch and L. Wall, "The Use of Accruals to Manage Reported Earnings: Theory and Evidence" (Federal Reserve Bank of Atlanta Working Paper 2000-23 November 2000) (available on SSRN

learning" is developing about earnings management, which has identified the following common denominators: (1) earnings management appears to be pervasive (in part because some techniques involve entirely permissible structurings of transactions to achieve the desired accounting treatment and hence impact on earnings); (2) auditors often are aware that earnings management is being attempted, but nonetheless waive any audit adjustment on a variety of grounds, including the practice's asserted immateriality; and (3) some forms of earnings management – most obviously, those that are income decreasing – are not likely to be deterred by other sanctions (such as the threat of private civil litigation or SEC enforcement actions). Finally, there is evidence that self-regulation can work because the dominant firms in the industry appear to monitor and restrict their partners and employees more successfully than do the smaller firms in the industry.[41] When this is the case, self-regulation can work because the industry can be expected to discipline the behavior of the outliers who are seeking to compete by illicit means.

Part II: The Shifting Legal and Institutional Context

A. The Diminished Legal Threat. Once, within recent memory, the prospect of private civil litigation threatened the very solvency of the accounting industry. Yet, five legal developments within the last half dozen years have largely eclipsed this threat:

(1) The Private Securities Litigation Reform Act of 1995 (the "PSLRA") erected substantial pleading barriers that particularly work to the advantage of the auditor, as defendant, because it is difficult to plead facts giving rise to a "strong inference of fraud" on the part of the

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Electronic Library at id = 252756).

[41] See text and notes infra at notes103 to 104.

auditor at the outset of the case;[42] also, some Circuits have begun to require a showing of intent that is closer to actual knowledge than to the traditional recklessness standard in order to satisfy the requisite scienter requirement under Rule 10b-5.[43] This development particularly protects accountants, because even the most fraudulent of corporate issuers is usually prudent enough not to share its intent with its auditors.

(2) The PSLRA also substituted proportionate liability for joint and several liability as the normal standard of damages under the Securities Exchange Act of 1934,[44] and this change works particularly to the advantage of auditors, who, even if culpable, are usually much less so than members of management. As a practical matter, an accounting firm now knows that, so long as its actual knowledge of the fraud is not proven, its maximum exposure to damages has shrunk from joint and several liability for 100% of the losses to a likely liability level probably below 25%.

(3) The PSLRA also ended the use of the private civil RICO statute as a means of seeking

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42 See Section 21(D)(b)(2) of the Securities Exchange Act of 1934. A burgeoning literature has developed, mainly in student notes, analyzing the interpretation of this provision by the different Circuits. See [citation to endless student notes]

43 The best known and most stringent of these decisions is In re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970, 979-80 (9th Cir. 1999). Although the majority of the other Circuits to face this same issue have disagreed with the Ninth Circuit, some movement toward a more conservative definition of "recklessness" is discernible in other Circuits as well. See, e.g., Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1283 (11th Cir. 1999) and In re Comshare Inc. Sec. Litig., 183 F.3d 543, 550-51 (6th Cir. 1999). But see Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000) (affirming traditional Second Circuit standard).

44 See Section 21(D)(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(g).

treble damages in securities fraud cases.[45] Where once a RICO claim was a standard feature in securities class actions, because it increased the potential damages by a factor of three, the PSLRA denied plaintiffs the ability to assert a RICO claim in any case that could have been pled as a securities fraud claim in connection with the purchase or sale of a security.

(4) Even prior to the PSLRA, the Supreme Court's decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,[46] eliminated liability for aiding and abetting a securities law violation as a potential cause of action that an auditor could face in private litigation. This theory of liability had been the preferred weapon of the plaintiffs' bar in Rule 10b-5 litigation against accountants. Although the SEC has regained the right to sue for some "aiding and abetting" violations pursuant to the PSLRA, private parties have not.

(5) Although securities fraud litigation in state court became a substantial risk for accountants in the 1990's, that risk was effectively ended in 1998 by the passage of the Uniform Standards Act, which preempted class actions and certain consolidated actions that assert causes of action, based on either state law or the common law, that allege a misrepresentation or omission of a material fact in connection with a purchase or sale of a security.[47]

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[45] The PSLRA amended Section 1964(c) of RICO to eliminate securities fraud as a predicate act for civil RICO claims, absent a criminal conviction of the defendant.

[46] 511 U.S. 164 (1994).

[47] Section 28(f) of the Securities Exchange Act of 1934 precludes any "covered class action based upon the statutory or common law of any State or subdivision" that alleges "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." A similar provision is set forth in Section 16(b) of the Securities Act of 1933. Neither provision preempts an individual suit, standing alone, but the term "covered class action" includes any "single lawsuit in which ... damages are sought on behalf of more than 50 persons." Hence, sizable consolidated actions are also barred.

The bottom line is that, although litigation involving accounting irregularities remains common, accounting firms themselves are unlikely to be named as defendants in these suits.

B. Organizational Changes Within the Auditing Profession. Auditing firms have long marketed three general types of services to their clients: (i) auditing, (ii) tax services, and (iii) management advisory services. The last category - - management advisory services (or "MAS") - - has expanded dramatically over roughly the last decade in a manner that has transformed the accounting firm from the traditional firm of accounting professionals to a multi-disciplinary service organization. In 1981, MAS accounted for only thirteen percent of the Big Five's total revenues, but that figure has grown to fifty percent or more by 2000.[48] Over the period from 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services has been twenty-six percent, while the comparable growth rates for audit and tax services has been only nine percent and thirteen percent, respectively.[49] In short, MAS has been growing at roughly three times the rate of the traditional audit service. Finally, in 1999, the U.S. revenues for management advisory and similar services for the Big Five amounted to over $15 billion.[50]

A more ominous transition involves the relative balance between audit fees and MAS fees. Not until 1997 did the percentage of audit clients who paid MAS fees in excess of their audit fees to Big Five firms exceed 1.5%.[51] Yet, by 1999, this figure had grown from 1.5% to 4.6% - - an

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48 See Securities Act Release No. 33-7919 at p. 18; see also Securities Act Release No. 33-7870 (June 30, 2000) at Appendix 13, Tables 1 and 2.

49 Id. at p. 18; see also Securities Act Release No. 33-7870 at Table 1 in Appendix B.

50 Id.

51 See Securities Act Release No. 33-7870 at Table 3 in Appendix B; see also Securities Act Release No. 33-7919 at p. 19.

over 200% increase in only two years.[52] Moreover, average MAS fees received by the Big Five firms came to ten percent of all revenues in 1999.[53] Thus, because only one quarter of Big Five audit clients purchased MAS from their auditors in 1999,[54] this implies that those audit clients that did purchase such services alone paid fees amounting to ten percent of the Big Five's total revenues. In short, for at least some audit clients, the amount of non-audit revenues paid to their auditor already dwarfs their audit fee. At least in the case of these clients, intransigence by the audit partner with regard to some "aggressive" accounting treatment proposed by the client could expose the firm to the loss of much greater non-audit revenues, which the client could presumably purchase (or threaten to purchase) elsewhere.

Not only are non-audit revenues received by auditors from their audit clients beginning to exceed audit fees from the same clients, but the SEC's noted in its latest Release on auditor independence that some audit firms may be pursuing a marketing strategy under which the firm "low-balls" the audit fee (even offering to perform it at a loss) "in order to gain entry into and build a relationship with a potential client for the firm's non-audit services."[55] Once auditing becomes a de facto "loss leader" for the multi-services consulting firm, there is less reason for such a firm to resist questionable accounting practices. To be sure, some threat of liability to third parties remains, but in considering resignation, the auditing firm must now balance the threat of liability against not only the loss of its audit fees, but also the loss of far larger present and

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[52] Id.

[53] Id.

[54] Id.

[55] Id. at 27.

expected future non-audit revenues from the client. Other things being equal, this implies that the threat of liability (even if it were undiminished) would less often be adequate to deter. C. Governance of the Accounting Profession. Because the governance of the accounting profession has not been analyzed in any detail in the legal literature, this section will begin with the basics and cover a terrain that has changed rapidly in recent years. The governance structure that regulates the accounting profession is complex. Within the basic professional organization - - the American Institute of Certified Public Accountants ("AICPA") - - are a variety of standard setting bodies, including the Auditing Standards Board ("ASB"), the Financial Accounting Standards Board ("FASB"), the Independence Standards Board ("ISB"). Although the SEC largely defers to the standards enunciated by these bodies, they are outside the scope of this article. Its focus will instead be on the structure of the disciplinary and enforcement function within the AICPA. Here, the critical body is the SEC Practice Section of the AICPA (or "SECPS"). Any auditing firm that audits a U.S. client that is an SEC "reporting" company must belong to SECPS. In contrast to the organization of the broker-dealer industry (but similar to the legal profession), SECPS is a self-governing body, without any direct oversight role being accorded to the SEC or any other federal body.[56]

SECPS was established in 1977 as part of the AICPA's Division for CPA Firms.[57]

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[56] Under Section 19(c) of the Securities Exchange Act of 1934, the SEC "may abrogate, add to, and delete from ... the rules of a self-regulatory organization ... as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization ...." This far-reaching power to amend the rules of self-regulatory organizations applies to the New York Stock Exchange and Nasdaq but not to the AICPA, because it is not a self-regulatory organization for purposes of Section 19(c).

[57] See Panel on Audit Effectiveness, supra note 6, at Appendix C.

Although initially a voluntary membership body, membership in SECPS has been mandatory since 1988 for any AICPA member who provides attest services to an SEC client.[58] Currently, SECPS has approximately 1,285 members,[59] who audit more than 99% of U.S. based SEC registrants.[60] Each SECPS member firm is required to install a quality control system to provide reasonable assurance that the firm conforms with professional standards in conducting its accounting and auditing practice.

To generate public confidence in the seriousness of SECPS's self-regulatory commitment, several additional ground rules were written into SECPS's charter. First, SECPS is monitored by a Public Oversight Board (or "POB"), which is composed of five independent public members, who elect their own successors. However, the POB does not directly control or regulate SECPS, which is instead administered by its own Executive Committee. Rather, the activities of SECPS are only "subject to oversight and public reporting by the POB." As a practical matter, this means that, although the POB can criticize or publicly report on the activities of SECPS, it cannot directly approve, reverse or modify any SECPS decision.

More central to the actual functioning of SECPS is its Peer Review Committee ("PRC"). The SECPS peer review process requires each member audit firm to have its quality control system reviewed by a peer firm every three years.[61] The peer reviewer examines both the design of the system and its actual operation, including a review of internal firm documents and selected

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[58] Id. at 188.

[59] Id. at Appendix B, at p. 181.

[60] Id. at Appendix C, p. 188.

[61] Id. at 192.

audit reports and working papers. At the end of this process, the peer reviewer issues a report, which is copied to the PRC along with the subject firm's response and any proposed corrective action. This report and the subject firm's response is reviewed also by the POB's staff, which can comment to the PRC. In principle, the PRC can require corrective measures by the subject firm to ensure that any detected quality control deficiencies are corrected.

The degree of scrutiny actually exercised by the SECPS and the POB is open to serious doubt. The SEC recently heard testimony that the peer review process within SECPS lacked "teeth."[62] Although such characterizations are subjective, the objective evidence at least suggests that SECPS has left few visible teethmarks in those whose conduct it has reviewed. The following summary of actions taken by the SECPS since its inception indicates at a minimum that punitive actions or drastic interventions have been rare.[63]

Action	Year Ended June 30, 1999	Since Inception
1. Accelerated Peer Review	1	54
2. Employment of an outside consultant to perform preissuance review of financial statements or other specified procedures	11	110
3. Oversight by the peer reviewers or a PRC member to monitor progress made by the firm in implementing corrective actions.	11	220
4. Oversight of the firm's internal monitoring program	32	402

62 See Securities Act Release No. 33-7919 (November 21, 2000) at 31 n. 97 (testimony of Wanda Lorenz, CPA on September 30, 2000).

63 Panel on Audit Effectiveness, supra note 6, at 193.

5. Changes made to the firm's quality control document or other guidance materials	1	44
6. Continuing professional education in specified areas	4	62[64]

In overview, the most that the Peer Review Committee has done is to require more monitoring (either in the form of required use of consultants, revised guidelines, or at most an acceleration of the usual three year time table for peer review). That is, if PRC monitoring detects a problem, it can monitor some more. This process does not resemble in any meaningful way the disciplinary process within the NASD, which can easily result (and does regularly result) in financial penalties, suspension or expulsion from the industry.

Actual discipline can, however, be imposed, at least in principle, through the coordinated action of two other AIPCA bodies: the Quality Control Inquiry Committee ("QCIC") and the Ethics Division. Originally, the QCIC was established as a mechanism to deal with audit failures that occurred in the three-year interim between an auditing firm's peer reviews. AICPA member firms are required to report to the QCIC, within thirty days of being served, any allegations of audit failure involving the firm's SEC practice which appear in either private civil litigation or regulatory investigations. The allegations are then investigated by the QCIC (which consists of twelve representatives of member firms, who tend to be retired partners) in order to determine whether deficiencies exist in the reporting firm's system of quality control. This investigation typically involves in-depth inquiries with firm personnel, review of the firm's quality control manual and related materials, and possibly a review of the actual documentation relevant to the

[64] This number 62 covers only the period since July 1, 1988; earlier data is no longer available. See Panel on Audit Effectiveness, supra note 6, at 193.

allegations. The QCIC does not attempt, however, to judge the liability (or innocence) of the reporting firm. If the QCIC is not satisfied with the firm's quality control system, a "special review" can be ordered. In any event, at the conclusion of its investigation, the QCIC assigns a rating, ranging from a "1" to a "4," with the "1" rating signifying that the case is "frivolous" and a "4" rating meaning that the QCIC believes that ethical issues relating to the firm's personnel have been raised which should be investigated by the AICPA's Ethics Division. As with the Peer Review Committee, the QCIC is not itself authorized to impose sanctions, but only to seek corrective measures or closer monitoring of a firm's practices.

A division of labor exists between the QCIC and the AICPA's Ethics Division under which the former investigates firms for quality control deficiencies, while the latter investigates individuals within these firms for ethical violations. Since December 1997, when the QCIC entered into a Memorandum of Understanding with the AICPA's Ethics Division that reflected this division, some 125 cases have been rated by the QCIC, with the following breakdown of outcomes:

Rating	No of Cases
1	12
2	64
3	38
4	11

The Ethics Division does not review cases that have been rated either "1" or "2" by the QCIC. For those cases rated "3," the Ethics Division forms its own panel to review the QCIC files and to determine whether it should commence an investigation (or, alternatively, close its file). A case rated "4" will lead, however, to an automatic investigation by the Ethics Division.

Investigations by the Ethics Division are subject to considerable delay, because the Ethics Division historically granted individual members the right to a deferral of any ethics investigation so long as a civil litigation or a criminal investigation relating to the same subject matter was in progress.[65] Thus, while the Panel on Audit Effectiveness found that, as of August 2000, the Ethics Division had reviewed 36 of the 38 cases rated as a "3" since December, 1997, and had opened a case file on 28 of those cases (or 78%), no data was provided in the Panel's report on the outcome of these investigations.

In principle, the Ethics Division can expel an individual member from the AICPA and it can publish this action in its publication, the CPA Letter, which publication is believed to be monitored by state boards of accountancy, which can in turn revoke the practitioner's license.[66] No evidence is available, however, that either the AICPA or state boards of accountancy frequently act in this fashion. Rather, as the AICPA's Panel on Audit Effectiveness noted recently, many state boards of accountancy "have not been effective in disciplining substandard conduct."[67]

Thus, in the absence of any other sanction, only the process itself seems the punishment. The AICPA investigates both the firm (through the QCIC) and the individual member (through the Ethics Division), and perhaps the firm will be led to take action against an offending individual

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65 This policy of delaying the Ethics Division investigation is partly based on the fact that the files of the QCIC and the Ethics Division are subject to subpoena. Id. at 150. The logic of this position is, however, debatable, because if the QCIC's files are subject to subpoena, its attitude toward the case will be known in the civil litigation anyway, even if the Ethics Division's findings have not yet been made.

66 See Panel on Audit Effectiveness, supra note 6, at 150.

67 See Panel on Audit Effectiveness, supra note 6, at 150.

partner or manager because of the cost or embarrassment that the process generates for it. But even this scenario is speculative, as it is also possible that the firm may have induced or pressured the individual into the ethical violation. In any event, what is most conspicuous in this structure is the absence of any penalty or sanction that is imposed on the firm because of the individual partner's or manager's misconduct. This is in sharp contrast to the NASD where the firm will be punished for the misconduct of its employees and where superiors of the errant employee can be penalized for a failure to supervise. Indeed, it is almost as if the normal civil law principle of respondeat superior has been repealed within the AICPA.

Part III. The Nature of Earnings Management

As a term, "earnings management" has been more the target of condemnation than the object of serious study.[68] While the techniques of earnings management are well known - - "cookie jar" reserves, premature recognition of income, deferral of costs - - the degree of involvement of the outside auditors in this process has been more uncertain. This section will seek to understand the process of earnings management in order to set the stage in the next section for an analysis of possible reforms.

Several new sources of data have recently added significantly to our understanding of the auditor's involvement in earnings management. First, a study by Professors Mark Nelson and John Elliott of Cornell University and Robin Tarpley of George Washington University assembled a database of 526 earnings-management attempts based on a survey of audit managers and partners at one Big Five firm.[69] Second, the Panel on Audit Effectiveness, a blue ribbon

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[68] This point is well made in P.M. Healy and J.M. Whalen, supra note 29.

[69] See Nelson, Elliott and Tarpley, supra note 40.

committee appointed by the AICPA's Public Oversight Board ("POB") at the request of SEC Chairman Arthur Levitt, conducted a wide-ranging and detailed study of the "current audit model,"[70] which study included a "Quasi Peer Review" of the public company audits performed by the eight largest accounting firms.[71] Other studies have described unique, even idiosyncratic styles of earnings management that appear to relate to the special needs of different management teams,[72] and still other researchers have found that the market can detect and partially discount for earnings management, but still rewards those firms that meet earnings expectations.[73]

The Nelson, Elliott and Tarpley study is noteworthy for documenting the experiences of one "Big Five" audit firm in connection with 526 incidents in which the firm's audit partners or managers clearly recognized that the client was attempting earnings management. Overall, the audit firm required an audit adjustment of the earnings management attempt ("EMA") in some 43% of the cases, but waived adjustment in the remaining cases, either because (i) it concluded (in 22% of the total cases) that the EMA was consistent with GAAP, or (ii) it concluded (in another 17% of the total cases) that it "had no convincing evidence that the company's position was incorrect," or (iii) it found (in another 18% of the total cases) that an audit adjustment was not required for some other reason, including most frequently (in 13% of the total cases) because it

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70 See Appendix E to Panel on Audit Effectiveness, supra note 6, at 211.

71 See Appendix F to Panel on Audit Effectiveness, supra note 6, at 223.

72 See Koch and Wall, supra note 40 (describing "Live for Today" and "Occasional Big Bath" techniques of earnings management and relating them to managerial preferences at Sunbeam and Citicorp, respectively).

73 See Bartov, Givoly, and Hayn, supra note 6.

deemed the EMA to have been immaterial.[74] Whatever the reason, the bottom line is that recognized EMAs were waived by the auditor in some 57% of the cases reported. Moreover, because cases in which an auditor expressly recalls that the client was attempting earnings management may represent only the tip of the iceberg, the actual rate of waiver should logically be even higher. In addition, there may be many other cases in which the auditor has some suspicion but is unwilling to confront the client or question its proposed treatment. Hence, the 43% audit reversal rate on EMAs found by Nelson, Elliott and Tarpley probably represents the ceiling, with the actual rate of audit adjustments decreasing still further once borderline EMAs are added to the denominator.

Why do auditors waive the majority of EMAs that they recognize? Multiple reasons appear to exist: First, although most EMAs are income increasing, roughly 40% are income decreasing.[75] Auditors were found to be more likely to waive EMAs that decrease current-year income, in part because they tend to consider them immaterial.[76] Indeed, the most common form of EMA detected was reserve-related,[77] and these tended to decrease current-year income in 72% of the cases observed.[78] Correspondingly, reserve-related EMAs were found to be waived by the

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74 Nelson, Elliott and Tarpley, supra note 40, at 3-4.

75 Nelson, Elliott and Tarpley found that of the 429 EMAs for which they could identify an effect on current-year net income, 60% increased income, thus implying that 40% did not. Id. at p. 2.

76 Id. at p. 2.

77 Of 429 EMAs having a current-year income effect, 133 were reserve related. Id. at 3.

78 Id.

auditor in 62% of the cases observed.[79] This pattern is, of course, highly consistent with the much publicized charge of "cookie jar" reserves, that is, reserves that are increased when there is a spike in income in order to smooth earnings in order to "save up" "excess" earnings for a future "rainy day" when the reserves can be used in order not to recognize a cost.[80]

Another finding of the Nelson, Elliott and Tarpley study was that "[a]uditors are more likely to waive EMAs that are attempted by large clients, even after controlling for whether or not the EMA is considered material."[81] Earlier research had similarly found that the probability that an adjustment would be waived by the auditor increases with client size.[82] To be sure, other things being equal, an EMA is also less likely to be material as client size increases. Still, Nelson, Elliott & Tarpley found that:

> "[R]egardless of whether an auditor considered an EMA to be material or immaterial, the EMA was more likely to be waived if it was attempted by a large client ... Particularly for income-increasing, material EMAs, waiver is more likely for large clients than for small clients."[83]

Two general conclusions emerge then from this study to the extent that one is primarily concerned with the phenomenon of earnings management. First, the perceived materiality of an EMA principally determines whether the auditors will waive it. When auditors considered an

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79 Id.

80 See Levitt, supra note 28.

81 See Nelson, Elliott & Tarpley, supra note 40, at 2.

82 See A. Wright and S. Wright, <u>An Examination of Factors Affecting the Decision to Waive Audit Adjustments</u>, 12 J. of Accounting, Audit & Finance 15 (1997).

83 See Nelson, Elliott, & Tarpley, supra note 40, at 25-26.

EMA to be immaterial, they waived it 83% of the time, but when it was deemed material, it was waived only 48% of the time.[84] Second, auditors are far more likely to waive EMAs that are income-decreasing than EMAs that are income-decreasing.[85] Thus, adjustments to reserves tend to decrease current-year income (in 72% of the cases observed) and tended to be waived (in 62% of the cases observed).[86]

Neither conclusion should be surprising. The academic accounting literature has long noticed that auditors tend to prevent income-increasing EMAs but do not focus on income-decreasing adjustments.[87] Both tendencies can be easily explained: auditors do not perceive it likely that they will be sued in private litigation or subjected to SEC discipline because of either immaterial EMAs or the understatement of income.[88]

But at the same time, such a pattern also underscores the legitimacy of the SEC's public policy concerns. Modest, individually immaterial additions to a loss reserve may decrease income, but they give also rise to the phenomenon of "cookie-jar reserves" that SEC Chairman Levitt has publicly criticized. Once the "cookie jar" is filled, management may be effectively able to raid

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84 Id. at __.

85 Id. at 28 and 31.

86 Id. at 28.

87 See, e.g., W.R. Kinney and R.D. Martin, <u>Does Auditing Reduce Bias in Financial Reporting?: A Review of Audit-related Adjustment Studies</u>, 13 Auditing: A Journal of Practice and Theory 149 (1994).

88 Earlier research has shown that most SEC enforcement actions against auditors have primarily involved acquiescence in income-increasing efforts by management. See S.E. Bonner, Z. Palmrose, and S.M. Young, <u>Fraud Type and Auditor Litigation: An Analysis of SEC Accounting and Auditing Enforcement Releases</u>, 73 The Accounting Review 503 (October 1998).

these reserves in a later period in a manner has a material income-increasing effect. Moreover, to the extent that EMAs by large clients are apparently less effectively resisted by auditors, earnings management becomes a practice that at least the large client has considerable discretion to pursue.

In short, this research points up a fundamental asymmetry in auditing: small income-decreasing additions to reserves tend to encounter auditor acquiescence, while larger, income-increasing EMAs are typically resisted. Yet, today's small, income-decreasing additions to a loss reserve add up in the aggregate and enable tomorrow's material, income-increasing use of that reserve as a "piggy-bank" from which the now financially-stressed client can make a withdrawal in order to camouflage an earnings decline.

The Panel on Audit Effectiveness came to functionally similar conclusions in its recent report, but expressed them on a considerably higher level of generality. Using in-depth interviews and a review of the work papers normally reviewed in the peer review process, the Panel focused its inquiry on the auditor's responsibility for the detection of fraud.[89] In general, it reported that "auditors interviewed in focus groups and other settings expressed uncertainty about their responsibility to detect fraud."[90] In particular, "fraud involving collusive activities or falsified documentation"[91] was seen as largely beyond either their ability or responsibility to detect. Yet, as the Panel recognized, "management generally is the party that precipitates fraudulent financial reporting,"[92] and senior executives, typically including the chief executive officer, are usually

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89 Panel on Audit Effectiveness, supra note 6, at 84.

90 Id. (emphasis in original).

91 Id. at 85.

92 Id. at 86.

deeply involved in this process.[93] As a result, the Panel's essential diagnosis was that generally accepted auditing standards ("GAAS") failed to give adequate attention or priority to the dangers of fraudulent financial reporting. Specifically, its Report reached the following conclusions in its summary:

> "• GAAS do not provide sufficient guidance to adequately implement the concept of professional skepticism because management usually is judged as possessing integrity (despite the fact that management may have at least some motivation to perpetrate fraudulent financial reporting) ...
>
> • GAAS dismiss collusion as impossible or too difficult to detect and pointedly explain the lack of expertise of auditors with respect to the determining the authenticity of documents ... [T]he reality is, however, that all or most financial reporting frauds involve collusion and many involve falsified documentation."[94]

Politically, this may have been a more diplomatic and less stigmatizing way to call for reform within the accounting profession: in effect, it is not auditors who are at fault, but auditing principles. Yet, the Panel's recommendations still stressed the need for significantly revised auditing standards that would employ additional controls in areas where management has been traditionally permitted "to make judgments involving subjective estimates."[95] At this point, its recommendations dovetail with the findings in the Nelson, Elliott and Tarpley study, because the clearest example of an area where management today makes subjective estimates to which the

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93 The Panel cites earlier research finding that in 72% of the cases reviewed, the chief executive officer was considered to be responsible by the SEC, and in 43% of the cases "the chief financial officer was associated with the financial statement fraud." Id. at 86. n. 26.

94 Id. at 86.

95 Id. at 87.

auditors typically must defer uncritically is the determination of the adequacy of reserves. Thus, the Nelson, Elliott and Tarpley study found that auditors commonly waive EMAs when they are "dealing with judgmental transactions" involving client judgement, and they recommended that auditors need instead to "develop independent expectations concerning appropriate balances in reserves."[96]

Although the feasibility of broad conceptual reforms can be debated, the bottom line is that both studies concur that auditors find earnings management to be an on-going, pervasive phenomenon, which auditors recognize is occurring but can only sometimes prevent, either because they are limited by artificial auditing conventions that presuppose management's probable integrity or because they are constrained by the conflicts of interest that the multi-service consulting firm necessarily encounters.

Part IV. <u>Partial Reform: What Can Feasibly Be Done to Constrain Earnings Management</u>?

Give or take some incidental qualifications, the picture painted so far of the contemporary auditing firm as a gatekeeper can be reduced to three general conclusions:

> (1) Earnings management is common, and perhaps pervasive. It is driven both by the fact that corporate managements are under pressure to meet projections and to smooth period-to-period earnings fluctuations and by the inability (or limited incentive) of auditors to challenge judgmental determinations by management (such as, most notably, the adequacy of reserves).
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> (2) Organizational changes within the auditing profession are likely to place the concept of auditor independence under increasing strain, as some auditing firms increasingly mature into full-service consulting organizations. Although audit committees may show some desirable skepticism toward such relationships, neither enhanced activism by audit committees nor the threat of private

[96] Nelson, Elliott & Tarpley, supra note 40, at 32.

> civil litigation is likely to fully offset this trend, which leaves us with the prospect of the auditing firm becoming increasingly compromised.
>
> (3) The governance of the accounting profession is characterized by a near total absence of meaningful professional discipline or credible sanctions.

This description is not intended to imply that auditors, either individually or in firms, are corrupt or cynically committed to certifying whatever financial results management wants. Much of the problem undoubtedly begins with the likelihood that existing GAAP and GAAS give management an excessive degree of latitude that enables it to practice earnings management, while leaving the auditor with little principled basis for objecting.

But, even if so, what regulatory strategy follows from these premises? It is simplest to begin by ruling some strategies out. Increased litigation risk might motivate the auditor to object more often to earnings management, but, absent major political shifts, no legislative or judicial movement in this direction seems likely. Neither the Central Bank decision nor the PSLRA is likely soon to be reversed. Nor is it normatively clear that the enhanced auditor liability is appropriate if the underlying problem is that GAAP and GAAS permit management broad latitude to manage earnings. Even if it were feasible to enhance the litigation risk that auditors faced, this step could still potentially result in some arguably counter-productive consequences. For example, the Big Five might spin off their low-growth auditing operations in order to protect their higher-profit consulting business from this new litigation risk. Under circumstances of high litigation risk, some firms might behave as risk-preferrers, in effect relying upon limited liability to protect their short-term profits. To some extent, SEC enforcement actions might provide an adequate substitute for private litigation through class actions, but the SEC is, as always, logistically constrained and its enforcement efforts seldom result themselves in large enough financial penalties to deter sizable entities, such as a "Big Five" firm.

A realistic assessment of the regulatory constraints thus leads to a simple, but basic enforcement strategy: it may often be more cost-effective and feasible to focus on deterring the individual within the auditing firm than on deterring the firm as a whole. Three separate reasons converge to support this suggestion that the individual partner or audit manger may offer the best leverage point.

First, there is reason to believe that potential reputational penalties, which may be adequate to deter the firm, do not work as well on the individual partner or audit manager.[97] In part, this is because the individual within the firm may lack any significant reputational capital and so cannot suffer any significant reputational loss. To be sure, if the partner or audit manager involves the firm in a scandal, such person may be fired. But, because this person would be equally subject to dismissal if the client were to switch to another auditing firm (possibly because this individual had refused to waive an audit adjustment), the loss is the same. Hence, this individual is not typically subject to a greater expected sanction from involving the firm in a scandal than from losing the client. Rather, either is likely to be a "career-killer," and hence these relative threats balance out.

Second, the individual auditing partner or manger within the auditing firm may be subject to intense situational pressures from colleagues within the firm to satisfy the client because

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97 The SEC makes this same point in Securities Act Release No. 33-7919 (November 21, 2000), which adopted its new auditor independence rules. Id. at 31-32. Academic experts in accounting have also made it repeatedly. See sources cited supra at note 22.

otherwise substantial non-audit revenues from the client are exposed to loss by its "intransigence." This is the natural consequence of the cross-selling of audit and non-audit services. If substantial non-audit fees from the client that dwarf the client's audit fee are exposed to loss if the client becomes dissatisfied with the auditor's "inflexibility" on auditing or accounting issues, those who market these non-audit services will predictably pressure the audit partner or manger to be more "cooperative."

Third, the individual partner or audit manager faces little risk of individualized sanctions or penalties today. This is true simply by virtue of the fact that the AICPA does not truly administer self-regulatory sanctions today and lacks any real enforcement staff.[98] The audit partner or manager is thus in a very different (and less deterred) position than is an employee or officer of a broker-dealer, who is subject to the real potential of SRO discipline (from either the NASD or the NYSE) for professional misconduct. Apart from the field of accounting regulation, focusing penalties on the individual within the firm has become a preferred (although not necessarily exclusive) strategy of public enforcers in fields as diverse as environmental law and antitrust law.

But, even if greater attention should be given to deterring the individual within the firm, how does society (or the SEC) implement such a policy? Here, it is necessary to return to the level of industry governance and propose two controversial policy priorities:

First, the SEC and/or Congress must prod the AICPA to become a far more serious self-regulatory organization, in particular by developing an independent enforcement arm. Of course, this is easier said than done. Although the SEC has sought to provoke governance reform within the accounting profession, the results to date have been modest. For the long-term, the

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[98] See text and notes supra notes 62 to 68.

benchmark for measuring success is supplied by the SEC's efforts in redesigning the corporate governance structure of the NASD and Nasdaq.[99] Admittedly, the SEC's position vis-a-viz the AICPA is not comparable to its more authoritative and statutorily recognized position vis-a-viz the NASD. Numerous as the differences are, the key point to be made here is that the SEC currently lacks a viable long-term strategy for dealing with the accounting profession. A clear goal is useful even if it is not immediately attainable, and that goal should be that maturation of the AICPA into an independent self-regulator, rather than simply an industry trade organization. Reform in the field of securities regulation is often scandal driven; thus, it is important to have a scenario for reform ready when the predictable scandal erupts.

A second basic goal for the SEC should be to refine its new definition of auditor independence so that it focuses on the incentives and pressures within the firm that will increasingly make the individual audit partner or manager less than independent. A deficiency in the SEC's approach to auditor independence has been its exclusive focus on the firm's independence and its relative obliviousness to the independence of the individual within the firm. Yet, the existing definition is potentially capacious enough to accommodate such an expanded focus. .

A. <u>Reforming The Profession's Governance Structure</u>. At present, the AICPA bears no more than a faint resemblance to self-regulatory organizations, such as the NASD or the New York Stock Exchange. Missing are two critical elements: (1) the participation of "public" directors in the governance of the industry's principal organization (the AICPA), and (2) a serious commitment to self-regulatory enforcement. Although the AICPA does have a Public Oversight

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[99] See text and notes supra notes 34 to 38.

Board and certain other specialized standard-setting bodies (such as the Independence Standards Board), the POB is simply an advisory body without real authority and with only limited incentives to investigate or criticize the industry that created it. Similarly, although the AICPA's Ethics Division can expel an accountant from membership, this appears to be a rare step, with the AICPA instead deeming professional discipline to be the responsibility of the state boards of accountancy that license the individual accountant.

As a practical consequence, the absence of meaningful enforcement through the AICPA makes the SEC virtually the sole enforcer of accounting and auditing improprieties.[100] In turn, this both implies that the total volume of enforcement proceedings is much less than in the case of the broker dealer industry (where the annual number of NASD proceedings vastly exceed the modern history of AICPA actions).[101] and that the core anti-fraud rules enforced by the SEC are

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100 The SEC has authority to impose a "cease and desist" order under Section 21C of the Securities Exchange Act of 1934, or to impose a civil penalty under Section 21B of that Act, or to suspend or disbar an accountant pursuant to Rule 102(e) of its Rules of Practice. Indeed, Rule 102(e) was specially revised in 1998 to focus on accountants by including within its term "improper professional conduct" negligent conduct consisting of either "[a] single instance of unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted" or "[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." See Rule 102(e)(iv). See Securities Act Release No. 33-7593 (October 26, 1998). Because this quoted language applies exclusively to accountants, the SEC now seems legally well-armed to suspend an accountant for even a single, serious act of earnings management. Finally, Section 10A(d) of the 1934 Act specifically requires auditors to report certain illegal acts by a client to its management, then to its audit committee, and eventually to the full board and the SEC.

101 Directly comparable statistics on a year by year basis are difficult to assemble, but the disparity is immense. Loss and Seligman report that, in 1988, the NASD resolved 5, 319 customer complaints and ordered 937 formal disciplinary actions,

not surrounded by a penumbra of self-regulatory rules developed by the industry.[102]

The accounting profession can, of course, reply that the AICPA is not a statutorily created body, such as the NASD, but rather is a private organization, which has evolved over time according to its own needs - - much like the American Bar Association ("ABA"). In truth, the ABA similarly lacks any public oversight structure and makes no more than a modest effort (compared to the NASD) at professional discipline. But any claim of equivalence between the legal and accounting professions breaks down under closer analysis. In reality, auditors and accountants are inherently "gatekeepers," while attorneys only occasionally find themselves in this role. The point then is that auditing inherently involves responsibilities to third parties, most notably including public investors, while attorneys are generally advocates for clients who, as such, are subject to a duty of confidentiality that is entirely inconsistent with the auditor's responsibilities. Thus, the case for a more "public" governance structure for the accounting profession than the legal profession hinges then on the fact that public accountants are relied upon

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including the expulsion of eleven firms from the industry, the barring of 158 individuals and the suspension of 112 individuals and five firms. See L. Loss and J. Seligman, SECURITIES REGULATION (3rd ed. 1990) at 2820 n. 65. Since 1997, the AICPA's Ethics Division has reviewed and rated some 36 of 38 cases referred to it by the QCIC. See Panel on Audit Effectiveness, supra note 6, at 150. See also text and notes supra at notes 65 to 67.

102 Under Section 15A(6) of the Securities Exchange Act of 1934, the NASD's rules (or that of any other "registered securities association") must "promote just and equitable principles of trade." The NASD has traditionally interpreted this requirement to entitle it to adopt rules that paternalistically protect investors, even in the absence of fraud, and as a result the NASD's Rules of Fair Practice, which regulate virtually every broker-dealer and associated person in the United States, extend well beyond the prohibition of fraud. See C. Weiss, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, 23 Iowa J. Corp. L. 65, 87-89 (1997).

by a dispersed audience of investors, while attorneys generally have clients who can adequately monitor their performance. Because the costs of collective action prevent investors from directly negotiating with accountants for greater oversight and self-regulation, it is appropriate that the industry (either on its own initiative or under SEC prodding) provide greater assurances of such collective oversight than in the case of a profession in which the clients can adequately monitor their agents.

To be sure, the analogy between broker-dealers and accountants (and correspondingly between the NASD and the AICPA) can be pushed too far. Much of the collective investment made by the broker-dealer industry in self-regulation is probably attributable to the fear that "rogue" brokers would enter the industry, overreach small unsophisticated investors, and thereby inflict reputational injury on the industry as a whole. Clearly, fear of disreputable competitors is justified in the case of the broker-dealer industry, where entry is relatively easy and "boiler shops" are a well-known phenomenon, but such a fear has seldom, if ever, characterized the "public" accounting industry, which has formidable barriers to entry and is concentrated to a probably unique degree. Nonetheless, the significance of industry concentration is two-edged. There is growing (but not yet conclusive) evidence that "Big Five" accounting firms are more able to resist client attempts at earnings management than are smaller firms.[103] Although this may sound inconsistent at first glance with the SEC's fear that the marketing of non-audit services will erode

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[103] See, "Big Firms Less Likely to Be Compromised Offering Non-audit Services," International Accounting Bulletin, February 28, 2001 at p. 1 (discussing studies by U.K. researchers at Lancaster University that find smaller firms are more likely to acquiesce in earnings management).

auditor independence,[104] this disparity is also consistent with the tendency for smaller firms to receive a larger proportion of their aggregate revenues from a single auditing client and hence to be more easily captured by such client. In any event, this evidence suggests that the largest firms do share some collective interest in enforcing rules against earnings management - - if only to protect themselves from aggressive, but shady, competition from smaller firms that may be more willing to bend the rules. Such a finding is, of course, consistent with the traditional liberal fear of self-regulation: namely, that the large firms in an industry will collude to exclude new competitors.[105] But here this assumed vice may be more a virtue. From a public policy perspective, one wants the industry to suppress earnings management (or at least the more egregious forms of it), whatever its motivation for doing so.

The real point then is that because self-regulation could potentially mature into a quasi-collusive, NRA-style body for erecting barriers to entry, it should be closely governmentally supervised. The high degree of concentration within the accounting industry further necessitates such governmental oversight, because the accounting profession is in this respect very unlike the legal profession. Because law is a highly atomized profession (even in this age of multi-branch law firms), bodies such as the ABA (or state bar associations) cannot be controlled by a small group of law firms (and they are clearly not so controlled). Indeed, the ABA is a relatively

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[104] That is, because large firms are more likely to market non-audit services to clients than small firms, one might hypothesize that large firms had greater incentives to acquiesce. The research was done, however, in the U.K. where the marketing of non-audit services seems less developed than in the U.S.

[105] This fear is greatest in industries characterized by high concentration. See M. Priest, The Privatization of Regulation: Five Models of Self-Regulation, 29 Ottawa L. Rev. 233, 256 (1997).

transparent organization whose internal processes and considerable politics are largely open to public view. This is not the case in the accounting profession, which is dominated by the "Big Five."

A further implication of this level of concentration is that society cannot confidently rely upon the principal contemporary mechanism of self-regulation within the accounting profession: namely, the three year peer review process. In a less concentrated industry, peer review might work well (although the incentive to criticize a business rival could easily remain modest, unless the reviewer stood to gain from such criticism in some respect). But in an industry dominated by the Big Five (and in which eight large firms audit the vast majority of public companies), peer review is inherently compromised by the fact that the peer reviewer knows instinctively that "what goes around, comes around." Criticism invites criticism in turn. As a result, norms of reciprocity can logically develop. The bottom line then is that the peer review process can become "toothless."[106]

What forms of institutional restructuring then are needed? Based on the rationale discussed above, the highest priority goal should be to induce the SEC Practice Section of the AICPA (or "SECPS"), to which any auditor auditing public companies must belong, to undertake a more meaningful self-regulatory responsibility to investigate possible audit failures and assign responsibility. Currently, SECPS basically must be notified in the event of any private litigation or enforcement proceeding involving the auditor of a public company. This is a useful start, but the process then bogs down in interminable delays, caused in part by the bifurcated structure of the

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[106] See Securities Act Release 33-7919 (November 21, 2000) at 31 n. 97 (quoting industry commentator that peer review was "without teeth").

review conducted by both the QCIC and the Ethics Division and in part by the individual defendant's right to request a delay until all civil or regulatory proceedings against him have been completed.[107]

Optimally, this convoluted structure should be replaced by an independent regulatory arm, modeled after NASD Regulation, Inc., which would be overseen by a board at least equally divided between "public" and "private" directors and, more importantly, equipped with a professional enforcement staff, with full authority inhering in SECPS to suspend or expel individuals from SECPS after a requisite hearing. Such action would render them ineligible to work for some period on the audit of a publicly held, "reporting" company. Even short of this goal, it would be a useful reform for SECPS to employ full-time forensic accountants who would investigate financial frauds involving member firms and report publicly on the causes of the fraud and the realistic responsibility of management and the auditors.

The predictable response of the AICPA to either proposal will be that they are a private body without statutory authority to suspend, expel or penalize any person. Yet, the short answer to this position is that any private club has the authority to suspend or expel its members, or to condition their continued membership on the observance of rules clearly specified in advance. The only legal authority that the AICPA truly lacks is authority to impose financial penalties, and even in the case of the NASD, financial penalties are only enforced in reality by the threat of expulsion. Because all SECPC member firms, and their associated persons, would be required to consent to such rules as a condition of membership, a SECPC member firm would thus commit itself in advance to suspend an employee or partner found to have breached professional norms.

[107] See text and notes supra at notes 64 to 67.

The real issue involves not the AICPA's authority over its members, but its motivation to assume such a self-regulatory role. Clearly, the SEC has only limited authority over the AICPA, whereas it has broad statutory authority over self-regulatory organizations that fall within its oversight.[108] One possible answer is that the AICPA might prefer self-regulation to expanded and more aggressive SEC regulation of accountants through enforcement proceedings. Were the SEC to initiate a policy of deferring to industry self-regulatory efforts, while vigorously enforcing cases that were not subjected to internal discipline within the profession, the profession might quickly come to see the advantages in a more developed self-regulatory structure. For the short-term, however, it must be conceded that the prospect of increased SEC activism is not currently in view.

Carrots, as well as sticks, are also possible by which to lure the industry into acceptance of a greater self-regulatory role. For example, the SEC could seek to protect the work product of such a self-regulatory body from subpoena or discovery on the grounds that such discovery would

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[108] Section 15A of the Securities Exchange Act of 1934 defines the criteria that an entity must satisfy to become a "Registered Securities Association" (to date Nasdaq is the only body to have applied to meet this definition). Section 15A(6) requires that "[t]he rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, ... and, in general, to protect investors and the public interest ...." Section 15A(7) further provides that the rules of the association must "provide that ... its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this title ... or the rules of the association, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction." Finally, Section 19(c) of the 1934 Act authorizes the SEC to "abrogate, add to, and delete from" the rules of any self-regulatory organization as it deems necessary or appropriate to insure "the fair administration of the self-regulatory organization" or to satisfy certain other tests. Suffice it to say that the SEC has none of these powers over the AICPA.

interfere with the SEC's own enforcement work. Even any public findings reached by any AICPA body could be made inadmissable in private litigation.[109] Alternatively, the SEC could exempt SECPS member firms from Rule102(e) proceedings if such cases were instead to be resolved by a system of industry self-regulation that it considered adequate. Finally, as next discussed, the SEC's ultimate authority might be to deem an auditing firm that had been involved in repeated audit failures not to be "independent" of its client – unless the firm was subject to an adequate system of industry self-regulation.

B. Focusing the SEC's New Concept of Auditor Independence. The core of the Commission's new rule on auditor independence is set forth in Rule 2-10(b), which states:

> "The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."[110]

Much of the remainder of the rule then sets forth "a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section."[111] Generally, the revised rule finds the accountant not to be independent when the accountant (1) has a mutual or conflicting interest with the audit client, (2) audits his or her own firm's work, (3) functions as management or an employee of the audit client, or (4) acts as an advocate for the audit client.[112]

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[109] This is the one step that would probably require legislation.

[110] See 17 C.F.R. § 210.2-01(b) (emphasis added).

[111] See 17 C.F.R. § 210.2-01(b).

[112] This is a summary of the SEC's own executive summary of the rule.

In addition, a special subsection of the rule, which does not quite fit any of these categories, deems the accountant not to be independent if the accountant "receives a contingent fee or commission from an audit client."[113] Release No. 33-7919 explains this provision with the justification that contingent fees give the auditor "a mutual interest with the client."[114] But, contingent fees having a similar effect can arise within the firm as well. For example, let us shift the focus from the auditor (i.e., the firm) to the audit partner or manager (i.e., an individual within the firm). Assume that fifty percent or more of this partner's compensation comes from cross-selling incentive compensation (that is, the partner receives a cash bonus to the extent that the audit client buys services or products from non-audit divisions of the accounting firm). This is a form of contingent fee, but one paid by the firm, not the client. Obviously, it gives the partner a strong economic interest in selling other non-audit services to the client and, to the extent that it is sufficiently large, an incentive to subordinate the interests of the audit division to the interests of other divisions within the firm and to the client's interests.

Should such a contingent fee be deemed to render the accounting firm less than "independent"? The answer under rule 2-01 would seem to come from the objective appearance test framed by Section 2.01(b): that is, would "a reasonable investor with knowledge of all relevant facts and circumstances ... conclude that the accountant is not capable of exercising objective and impartial judgment."[115] The premise here is obvious: if the partner in charge of the

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[113] See 17 C.F.R. § 210.2-01(b).

[114] See Securities Act Rel. No. 33-7919 (November 21, 2000) at p. 153. This prohibition was long-standing and was only revised in incidental ways in the new rule.

[115] See text supra at note 110.

audit is compensated more based on the partner's sales ability than on the partner's auditing ability and if the client can dramatically affect this partner's compensation by buying (or declining) other services, the objectivity of the partner (and of the firm) has been compromised.

The objective appearance test framed by Rule 2.01(b) actually can reach many more cases than just this example of a compensation system that biases the individual audit partner towards satisfying the client. Suppose the "reasonable investor" in Rule 2.01(b)'s language were to learn that the audit firm had proposed thirty audit adjustments over the past three years, all of which would have reduced the earnings of the client, but had retreated from requiring adjustments in every case when the client objected (and threatened to cancel non-audit business). Does such spinelessness make the auditor look less than the "objective and impartial" under Rule 2.01(b) - - at least in the eyes of the "reasonable investor"? Such a conclusion seems well within the reach of the new rule.

Concededly, Rule 2.01 was not previously read in this fashion, but the rule did not previously have an objective appearance test. Seemingly, under this new rule, the SEC can look backwards and sometimes deem an accountant not to have been "independent" based on facts that would never have previously been relevant to the issue of independence.

The real question thus posed is how the SEC should use this new power. A strong argument can be made that rather than pushing this new "objective appearance" test to the limits of its logic, the SEC might establish a safe harbor or some similar defense under which facts that might cause a reasonable investor to doubt the auditor's independence would not result in any retroactive loss of "independence" if the AICPA had established adequate procedures to investigate and assign responsibility for audit failures and such a standard were being actually enforced. In effect, this approach uses the arguable overreach of this new definition as a means for prodding the AICPA to assume a more active self-regulatory role. Of course, the industry may not consider this incentive adequate. Indeed, in all likelihood, it will not - - unless and until the Commission demonstrates that the new definition of independence can and will be enforced aggressively.

CONCLUSION

The theory and the reality of gatekeeping have diverged, most dramatically in the case of the auditor. Although academia still largely views the gatekeeper as a reputational intermediary, the industry increasingly perceives the paradigmatic gatekeeper (the auditor) as a portal for entry into the client.[116] As the independence of the gatekeeper is thus eroded, externalities are likely to follow: the cost of capital may rise slightly, market efficiency should suffer, and corporate governance will increasingly be distorted by inaccurate informational inputs.

Although the problem is easy to state, the appropriate answer involves an immense problem of implementation: how to get there from here? The SEC has unquestionably been alert to this problem, but its primary answer has been to seek to upgrade the audit committee. Even if one concedes that such a reform is desirable, it cannot bear the full burden that the SEC has assigned it. Inevitably, the audit committee is a remote and part-time monitor, with limited capacity and incentive to correct deficiencies within the gatekeeper.

A second possible policy option would be to seek to enhance the threat of private

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116 An aptly titled and revealingly unselfconscious AICPA publication illustrates this point. See AICPA Practice Aid Series, Make Audits Pay: Leveraging the Audit Into Consulting Services (1999) (cited in Securities Act Release No. 33-7919 at n. 83).

litigation against gatekeepers. While this might work,[117] it runs squarely against the political tide and involves the high ex post costs of litigation. Indeed, to the extent that this strategy relies upon another set of agents (i.e., the plaintiffs' bar) who are known to have high agency costs, there is an irony and a redundancy in setting one team of shareholder agents to watch another team. Arguably, other externalities could follow from overreliance on litigation: (1) auditors might become excessively risk averse and might understate income; (2) fly-by-night, risk-preferring new entrants might enter the auditing field, seeking to charge higher fees and relying on limited liability to protect them from the inevitable large judgment; and (3) the major auditing firms might spinoff their auditing subsidiaries in order to protect their other, higher profit activities from liability.[118] Finally, reliance on litigation might achieve little if the underlying problem is that existing GAAP and GASS confer excessive latitude and discretion upon management to make subjective judgments that the auditor is powerless to reverse.[119]

In any event, because political constraints make a "scorched earth" litigation policy unlikely (and because a heightened litigation threat in the past did not fully eliminate accounting irregularities), other options need to be explored, both as alternatives and as supplements. One such option is to seek a stronger system of self-regulation and disciplinary enforcement within the

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117 For data suggesting that auditors are responsive to changes in the risk of litigation, see Heninger, supra note 7.

118 While this would reduce conflicts of interests, it would predictably leave the spun-off auditing divisions in a demoralized position, less able to recruit new personnel, and probably unable to retain many of their best personnel. Arguably, such a compelled divestiture would impair the quality of financial reporting.

119 To state this last argument is not to accept it fully. Faced with high litigation risks, auditors might well insist on better documentation and be less willing to accept judgmental estimates by management of reserves.

accounting profession. This approach would both multiply the SEC's effective resources (and reduce its dependence on uncertain Congressional appropriations) and utilize the natural incentives of competitors to police each other. The countervailing danger in this approach is that the incentive to police can sometimes yield to, or merge with, the incentive to collude, and the existing system of peer review may illustrate this danger. Yet, self-regulation has sometimes worked well in related contexts, both at the NASD and the NYSE. Properly designed, a self-regulatory enforcement arm could investigate all cases of audit failure within publicly held companies and seek to allocate and assign responsibility, both between the client and the auditor and in terms of the specific individuals responsible. Ultimately, this system would impose primarily non-monetary penalties (suspension, expulsion, censure, and possibly probation-like monitoring sanctions). As here contemplated, it is not proposed as a substitute for private or public litigation, but as a supplement. In the last analysis, if reputational intermediaries are to work, reputational penalties may be needed to motivate and discipline them and also to inform the market for their services.

This article's last proposal is that the SEC's new definition of auditor independence should be interpreted so as to apply not only to the relationship between the auditor and the client, but also to conflicts within the firm that can equally disable objective and impartial judgment. Indeed, to assert this is only to say that the rule should be read literally. This proposal is, however, primarily a transitional one. Faced with close SEC scrutiny of compensatory arrangements within the firm, the accounting profession might begin to see the advantages in meaningful self-regulation. The carrot to motivate such a transition would be greater SEC deference to a truly independent self-regulatory body.

The gatekeeper model of the reputational intermediary has begun to show some fissures in its foundation. So do most models over time. This article has not argued that the model should be junked, but only that it is not self-enforcing under current institutional conditions. Market incentives alone appear to be inadequate to motivate the reputational intermediary, while legal incentives appear to be increasingly eroding. In all candor, it is difficult to be optimistic about the prospects for auditor independence today. Although marginal improvements are possible, earnings management appears likely to remain a pervasive phenomenon.