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## Strengthening Auditor Independence: Reestablishing Audits as Control and Premium Signaling Mechanisms

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# STRENGTHENING AUDITOR INDEPENDENCE: REESTABLISHING AUDITS AS CONTROL AND PREMIUM SIGNALING MECHANISMS

Sean M. O'Connor\*

*Abstract:* As recent scandals have demonstrated, ensuring the independence of auditors from the publicly traded clients whose books they inspect is one of the most vexing problems in the financial world today. Arguably, the imposition of a mandatory audit system through the 1930s federal securities laws created the modern problem of auditor independence. The core issue is that the statutory audit is simply a commodified cost of doing business for issuers that imposes an impossible obligation to serve an unspecified “investing public” on the auditors. Yet, this investing public neither hires, fires, nor controls the auditors. Instead, the audit relationship is managed by the board of the company being audited. The resultant conflict of interest has proven to be insurmountable even after multiple reform efforts. The conceptual solution is to both “decommodify” the audit and place control of it squarely in the hands of shareholders. To achieve this, the author proposes a tripartite remedy: first, the SEC should retire its “statutory audit” rules under the 1934 Securities Exchange Act (while retaining the public offering audit requirements of the 1933 Securities Act) in favor of market-driven private audits; second, state corporations law or federal securities law should be altered to give an express audit right to shareholders that they would exclusively control, with expenses reimbursed by the company; and third, the licensing and regulation of CPAs must be strengthened and either harmonized or unified.

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## INTRODUCTION

Auditors must be independent from the individuals whom, or businesses which, they have been hired to audit. This may not be self-evident at first glance, but it becomes axiomatic when one considers that the long history of audits—reaching across feudal, municipal, and business precedents—is based on the simple notion that a master/principal needs a highly trusted agent on whom she can rely to verify the activities of her other servants/agents.<sup>1</sup> An auditor who is *dependent* in some way on these other servants/agents would intuitively seem to be more susceptible to corruption by the latter than an auditor who is fully *independent* of them. This simple concept is the heart of the surprisingly complicated issue of “auditor independence” that has been a major focal point of reform efforts, such as the Sarbanes-Oxley Act of 2002 (“SOX”),<sup>2</sup> which seek to prevent the next wave of corporate accounting scandals.

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1. Sean M. O’Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 756–58 (2004).

2. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of Titles 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2006)).

As I have argued elsewhere, the problem of auditor independence was created by the imposition of a mandatory audit system under the 1930s federal securities laws.<sup>3</sup> The laws' drafters erred in adopting certain portions of the British Companies Act, 1929 out of context. The Companies Act, 1929 was a comprehensive set of provisions for corporate, securities, and business bankruptcy laws in the United Kingdom that had no analogue in U.S. state or federal law.<sup>4</sup> In addition, the accounting profession at the time was less well organized and regulated.<sup>5</sup> Unlike the accountants in the United Kingdom, accountants in the United States had relatively low professional status and were not chartered by the government.<sup>6</sup>

For several reasons, many accountants advocated for the new mandatory audit system in the U.S. federal securities laws. They hoped that the system would elevate their profession to the status of other learned professions such as law or medicine.<sup>7</sup> These accountants and others also supported the mandatory audit system because it seemed to be an important feature of the highly regarded "British system," as codified in the Companies Act, 1929.<sup>8</sup> Finally, because the British audits were usually performed by highly prestigious "chartered accountants," the U.S. accountants hoped to cement in the public's mind that U.S. certified public accountants (CPAs) were every bit the equal of U.K. chartered accountants.<sup>9</sup>

In seeking this prestigious government franchise, however, the accounting profession got more than it bargained for. It traded what had been a fairly lucrative premium service of supplying privately contracted audits for the new mandatory audits. Over time, such audits became a low-margin service perceived by clients as merely a commodified "cost of doing business" such as other regulatory costs and taxes that the government imposed on businesses.<sup>10</sup> At the same time, accountants who took on these new mandatory audits also took on the impossible

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3. See generally O'Connor, *supra* note 1.

4. See *id.* at 781, 823; Companies Act, 1929, 19 & 20 Geo. 5, c. 23; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 46–63 (3d ed., Aspen Publishers 2003) (1982).

5. See O'Connor, *supra* note 1, at 751–55, 775–78.

6. See *id.*

7. See *id.*

8. See *id.* at 790–91, 799–809.

9. See *id.* at 751–55, 775–78.

10. See *infra* Part I.

obligation of working as part of the public trust for an unspecified “investing public.”<sup>11</sup> The resultant conflict of interest has proven to be insurmountable even after multiple reform efforts.<sup>12</sup>

Part I of this Article begins with a brief review of the historical roots of the auditor independence issue<sup>13</sup> and outlines the process that, in effect, commodified the statutory audit. Part II discusses the subsequent growth and consolidation of the accounting profession which led to a bramble bush of different auditor independence rule systems. Part III proposes a tripartite solution to reduce the problems of auditor independence by reestablishing the audit as a premium signaling mechanism for firms and as a control mechanism for the firms’ shareholders.

## I. THE CREATION OF A NEED FOR INDEPENDENCE: COMMERCIALIZATION OF THE AUDIT

The roots of the modern problem of auditor independence can be traced back to the passage of the federal securities laws in the 1930s. This Part first summarizes historical research I have written about elsewhere.<sup>14</sup> It then explicates the concept of “commodifying” the statutory audit.

### *A. Origins of Auditor Independence*

The following exchange occurred between Colonel Arthur H. Carter and Senator Thomas P. Gore during Senate hearings on the Securities Act of 1933<sup>15</sup> (‘33 Act):

Mr. CARTER. My experience would be that the average company pays around \$500 or \$600 or \$700 for its auditing, that is, taking the large and small together.

Senator GORE. How often do they resort to that?

Mr. CARTER. Every year. And the largest organizations of our country do it and have been doing it for the last 15 years.

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11. See *infra* Parts II, III.A.

12. See *infra* Part III.A.

13. A more in-depth treatment of this topic is set forth in O’Connor, *supra* note 1.

14. See *generally id.*

15. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000)).

Senator GORE. But they have not been available for any public authority to examine and afford no safeguards?

Mr. CARTER. They have been published in their annual reports and distributed to all of their stockholders, to the newspapers and anyone who calls for them.

Senator GORE. And have not done any good?

Mr. CARTER. Yes, sir; I think they have.

Senator GORE. We have had all this debacle here in spite of that.

Mr. CARTER. You still have some very sound companies and industries in this country.<sup>16</sup>

Colonel Carter, a CPA and the President of the New York State Society of Certified Public Accountants, had taken it upon himself to advocate for the inclusion of a mandatory audit provision in the '33 Act.<sup>17</sup> But interestingly, the annual auditing practice he spoke of was a voluntary "best practice" that was emerging particularly among New York Stock Exchange (NYSE) listed companies.<sup>18</sup> Eighty-five percent of these listed companies were choosing to undergo an audit by an outside accounting firm whose report would then be made available to anyone in the public for the asking.<sup>19</sup> Further, such use of audits had been developing for 15 years prior to these hearings—well before the Great Crash of 1929.<sup>20</sup>

Yet, as Senator Gore pointed out, this practice seems to have done little to prevent the accounting scandals and deceitful behavior that was alleged to have played a major role in the Crash. Further, as Senator Duncan U. Fletcher noted: "Most of these people applying to be registered already have an independent audit. It is not necessary to put them in the law. That is their practice now; that is, they are supposed to have already."<sup>21</sup> To which Carter backpedaled a bit by responding: "I

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16. *Securities Act of 1933: Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73rd Cong. (1933)* (statement of Col. Arthur H. Carter), reprinted in 2 *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934*, at 59–60 (comp. by J.S. Ellenberger & Ellen P. Mahar, 1973) [hereinafter Carter Statement].

17. O'Connor, *supra* note 1, at 800 (citing JOHN L. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL, 1896–1936*, at 184–85 (1969)).

18. O'Connor, *supra* note 1, at 800, 806–07.

19. *Id.* at 807.

20. *Id.*

21. O'Connor, *supra* note 1, at 807 (quoting Carter Statement, *supra* note 16, at 60).

think the trend has been decidedly in that direction in the past five years, and especially in the last three years, and I certainly think it is a safeguard that should not be discouraged.”<sup>22</sup> Of course, there is a world of difference between not discouraging an activity and enshrining it in federal law.

The audit provision codified as part of the ‘33 Act was a one-time certification of the financial statements that an issuer must submit to the Federal Trade Commission (FTC) (later changed to be submitted to the newly created Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (the ‘34 Act)<sup>23</sup>) and in the prospectuses accompanying what would now be deemed a “public offering” of stock (what I am calling the “offering audit”).<sup>24</sup> The historical record indicates that this offering audit requirement may have simply come along for the ride when a raft of provisions for registering securities was copied from the British Companies Act, 1929.<sup>25</sup> This is unfortunate because, as the brief review of the history of the British general audit practice given below reveals, a rich and nuanced cultural practice gave weight and credibility to the company audits required under the Companies Act, 1929.<sup>26</sup> Simply importing the audit provisions from British to U.S. law could not magically bring along this rich cultural practice. This was especially true given the evidence that many unscrupulous individuals in the United States held themselves out as auditors or accountants but performed very shoddy audits.<sup>27</sup> It should not be surprising then that the American public was a bit skeptical of the purpose and value of audits.<sup>28</sup>

Further, the rich, widespread, and apparently well-understood role of the British auditor (in Britain) was actually based on the development of a different kind of audit that first appeared in earlier versions of the Companies Act in the mid-1800s. This “statutory annual audit”

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22. *Id.*

23. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)).

24. Securities Act of 1933, Pub. L. No. 73-22, sched. A, ¶ 25, 48 Stat. 74, 90 (codified at 15 U.S.C. § 77aa, sched. A, ¶ 25 (2000)). The notion of a “public offering” is not well defined in the ‘33 Act itself, even though it was intended to be a central concept in the new securities regulation system established by that law. See generally James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

25. See O’Connor, *supra* note 1, at 809–17.

26. O’Connor, *supra* note 1, at 773.

27. *Id.* at 783 (citing JOHN L. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL, 1896–1936*, at 83–84 (1969)).

28. See JOHN L. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL, 1896–1936*, at 76, 83–84 (1969).

provision required that an annual audit be performed by auditors, at least one of whom was appointed directly by the shareholders.<sup>29</sup> However, based on longstanding British auditing tradition, there was no requirement that these auditors be accountants.<sup>30</sup> Rather, “auditors” were simply trusted agents of a principal who would literally listen to the account reports of other agents of that principal in order to help the principal detect cheating or inappropriate use of the principal’s assets.<sup>31</sup> In the Companies Act, 1929, the auditor was the agent of the shareholders collectively and, in some earlier versions of the Companies Act, at least one of the auditors must be a shareholder himself.<sup>32</sup> However, the auditors were allowed to hire accountants to help them if so desired.<sup>33</sup>

At the same time, the Companies Act, 1929 provided a single statute for laws regarding nearly all aspects of corporations in Britain—it included the corporations, securities, and bankruptcy laws that would develop separately in the United States.<sup>34</sup> It was not until 1928, when the Companies Act had been substantially revised from an earlier version, that the new “prospectus audit” was added.<sup>35</sup> This differed markedly from the existing statutory annual audit in that the prospectus audit was expressly for the purpose of certifying economic information to be put out into the markets for prospective investors to use when considering whether to invest in the company.<sup>36</sup> The statutory annual audit, on the other hand, was primarily a mechanism to verify financial and management information to existing shareholders at the annual meeting so that the shareholders could exercise their significant governance

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29. O’Connor, *supra* note 1, at 758.

30. *Id.* at 758–59.

31. *Id.* at 757–58.

32. *Id.* at 758–73.

33. *Id.*

34. *See id.* at 749, 773.

35. The prospectus audit required an auditor’s report on the profits of the company for the preceding three years as well as the rates of dividends, if any, paid on each class of stock in each of the three covered years. O’Connor, *supra* note 1, at 769.

36. Shann Turnbull, How Audit Practices Got Muddled in the US and UK 4, 7 (May 1, 2005) (working paper delivered at the 10th Annual Meeting of the Financial Management Association, Bocconi University, Milan, Italy), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=717021#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=717021#PaperDownload); see also Tim Bush, ‘Divided by Common Language,’ *Where Economics Meets the Law: US versus Non-US Financial Reporting Models*, INST. OF CHARTED ACCTS. IN ENG. AND WALES, June, 2005, at 6–9, <http://www.icaew.co.uk/index.cfm?route=115933>.



rights, including the right to remove all or some of the directors.<sup>37</sup> Thus, as some commentators summarize it, the statutory annual audit serves a governance function, while the prospectus audit serves an economic information function.<sup>38</sup> Other commentators categorize the statutory annual audit as a “stewardship audit” and the prospectus audit as a “transparency audit.”<sup>39</sup>

By the time the ‘33 Act was drafted and passed in the United States, the statutory annual audit in the Companies Act, 1929 was tied to another provision that required the shareholders to elect an auditor—either one of their own number or an outsider—each year to perform that audit.<sup>40</sup> While this auditor was formally an officer of the company, he was beholden only to the shareholders who had appointed him, and who could then call for the company to pay his fees.<sup>41</sup> His report was primarily for their eyes, although it could be made available to others.<sup>42</sup> But this audit did not have to be executed pursuant to a duty to any one other than the shareholders.<sup>43</sup> At the same time, the auditor had access to company records and could interview other officers on demand.<sup>44</sup> The prospectus audit was not as clearly tied to what I will call the shareholder auditor, although it may be that companies used the shareholder auditor for the prospectus audit as well. Finally, both the statutory annual audit and the prospectus audit must be distinguished from “internal audits” that management might choose to perform through either inside or outside auditors. In that case, the auditor would

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37. Shann Turnbull, *How Audit Practices Got Muddled in the US and UK* 4, 7 (May 1, 2005) (working paper delivered at the 10th Annual Meeting of the Financial Management Association, Bocconi University, Milan, Italy), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=717021#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=717021#PaperDownload); see also Tim Bush, ‘*Divided by Common Language, Where Economics Meets the Law: US versus Non-US Financial Reporting Models*, INST. OF CHARTED ACCTS. IN ENG. AND WALES, June, 2005, at 6–9, <http://www.icaew.co.uk/index.cfm?route=115933>.

38. Shann Turnbull, *How Audit Practices Got Muddled in the US and UK* 4, 7 (May 1, 2005) (working paper delivered at the 10th Annual Meeting of the Financial Management Association, Bocconi University, Milan, Italy), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=717021#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=717021#PaperDownload); see also Tim Bush, ‘*Divided by Common Language, Where Economics Meets the Law: US versus Non-US Financial Reporting Models*, INST. OF CHARTED ACCTS. IN ENG. AND WALES, June 2005, at 6–9, <http://www.icaew.co.uk/index.cfm?route=115933>.

39. John A. Hepp & Brian W. Mayhew, *Audits of Public Companies* 3–4 (2004) (working paper, on file with author).

40. O’Connor, *supra* note 1, at 765–71.

41. *Id.* at 765–71, 774.

42. *Id.* at 774.

43. *Id.*

44. *Id.* at 766.

consider management to be the client and the audit would primarily be intended for management.

In the United States, incorporation and primary corporate governance had been left to the states.<sup>45</sup> Inspired by Louis Brandeis' *Other People's Money and How the Bankers Use It*,<sup>46</sup> as well as the larger Progressive Movement of the 1910s, President Roosevelt hoped to "federalize" U.S. corporate and securities law.<sup>47</sup> Fearing constitutional challenges, the drafters of the federal securities laws grounded the '33 Act on the Commerce Clause of the U.S. Constitution by limiting it to securities transactions involving the "instrumentalities of interstate commerce."<sup>48</sup> Ultimately, the Roosevelt Administration did not attempt to introduce legislation to federalize corporations law and governance both because of a changing political climate and a lingering suspicion that it would be unconstitutional to do so.<sup>49</sup> This left the United States with an uncomfortable hybrid system of laws concerning corporations. It also meant that the drafters of the '33 Act could not have included a global requirement for a company auditor elected by the shareholders as in the British model even if they had so desired. The critical question of who would control the audit relationship remained unanswered. In other words, who would have the power to hire and fire the auditors? The audit provision of the '33 Act merely stated that the required financial statements for registration had to be certified by an independent public or certified accountant.

A second shortcoming of the partial adoption of the Companies Act, 1929 into the '33 Act was that it underestimated the strength and credibility of the chartered accountant system in the United Kingdom. By the late 1800s, the U.K. accounting profession had been formally organized under a royal charter system.<sup>50</sup> This system collected examination, licensing, and regulation functions under two geographically oriented chartered organizations: the Institute of Chartered Accountants of Scotland (ICAS) and the Institute of Chartered Accountants in England and Wales (ICAEW) for their respective

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45. O'Connor, *supra* note 1, at 775–76.

46. LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (Bedford Books of St. Martin's Press 1995) (1914).

47. O'Connor, *supra* note 1, at 790, 793–94, 796–98.

48. *See, e.g.*, Pub. L. No. 73–22, § 5, 48 Stat. 74 (1933); *see also* SELIGMAN, *supra* note 4, at 45–60.

49. SELIGMAN, *supra* note 4, at 45–60, 73–100.

50. O'Connor, *supra* note 1, at 751–52.

eponymous territories.<sup>51</sup> Contrast this with the situation in the United States where examination requirements for those wishing to use the new title of “CPA” did not even begin until the 1900s, after which a number of states took a decade or so to pass such laws.<sup>52</sup>

Even if the drafters of the ‘33 Act had consciously wanted to emulate all of these aspects of the prospectus audit from the Companies Act, 1929,<sup>53</sup> the differences between the two countries’ legal systems may have prevented this. First, it likely would not have seemed possible to pre-empt state corporations laws to add either a new officer to corporations or a new shareholder right to elect an auditor. At best, this could only have been an extra federal requirement for companies who wished to register shares for a public offering under the ‘33 Act. Second, there was no single group of licensed professionals who could be called upon to provide audits under uniform standards and regulations.

Instead, the final language of the ‘33 Act called for certification by an “independent public or certified accountant.”<sup>54</sup> But at the same time, it contained no definition of either the phrase or its constituent elements. When is an accountant “independent”? How is a “public accountant” different from a “certified accountant”? And why not just use the accepted emerging title of “certified public accountant”?

Intriguingly, the term “independent” was not part of the Companies Act, 1929.<sup>55</sup> Except for the new prospectus audit in the British system,<sup>56</sup> auditors were always elected or hired by the party for whom they would be providing the audit service and who was the intended primary beneficiary of the audit.<sup>57</sup> This was as true for the auditors who performed the statutory annual audit as it was for those who performed internal audits or investigative audits on behalf of creditors or the government.<sup>58</sup> Thus, there was no need for “independence” in the British system, only standard remedies for fraud and breach of contract, and indeed there was no formal concept or requirement for “independence” in that system. In other words, auditors might allow themselves to be

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51. *Id.*

52. *Id.* at 752–53.

53. I have encountered no evidence that they did.

54. Securities Act of 1933, Pub. L. No. 73-22, sched. A, ¶ 25, 48 Stat. 74, 90 (codified at 15 U.S.C. § 77aa, sched. A, ¶ 25 (2000)).

55. O’Connor, *supra* note 1, at 809.

56. *Id.* at 769.

57. *Id.* at 773–75.

58. *Id.*

corrupted or bribed by the very individuals they were hired to monitor, but this constituted a general agency problem. Because neither British nor American law seem to have a concept or requirement for “independence” of agents generally, it is not clear why such a concept or requirement would be needed for auditors as agents. Instead, one might talk in terms of trying to elevate the auditor’s duties to his principal as those of the fiduciary (a standard term in agency law), but such a conception differs markedly from creating a new duty of “independence” in agency law.<sup>59</sup>

Perhaps the drafters of the ‘33 Act were simply trying to find a way to designate that the auditor for the new offering audit should be an external auditor and not merely the internal accountant, auditor, or controller of the company. Or perhaps they really did mean “independent” in the way that term has evolved for accountants/auditors: an auditor with dual allegiance to both a party who controls the audit engagement and third party beneficiaries, where the auditor must then somehow exercise “independent” judgment apart from the desires of either party. We may never know the exact reasons for including this troublesome term in the ‘33 Act, but we do know that it resulted in the creation of a bramble bush of “auditor independence rules” by differing bodies with different levels of influence over auditors.<sup>60</sup>

U.S. accountants seemed to welcome the legitimizing effect of the “independent public or certified accountant” language.<sup>61</sup> Unlike their U.K. chartered accountant counterparts, U.S. accountants were often considered by business owners and investors to be “mere bookkeepers.”<sup>62</sup> The royal imprimatur of a formal charter in no small way enhanced the prestige of the U.K. chartered accountants.<sup>63</sup> Thus, a key theme of the nascent accounting profession in the United States during the late 1800s and early 1900s was a quest for recognition as a true profession—ideally, the equal of the medical and legal professions,

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59. For earlier discussions of an agency model of the audit relationship and its relationship to auditor independence, see generally Rick Antle, *Auditor Independence*, 22 J. ACCT. RES. 1 (1984) and Rick Antle, *The Auditor as an Economic Agent*, 20 J. ACCT. RES. 503 (1982).

60. See *infra*, Part II.B.

61. O’Connor, *supra* note 1, at 820. However, U.S. accountants were decidedly unhappy about the potentially severe liability that came along with their new statutory role in securities offerings. *Id.* at 817–19.

62. *Id.* at 776.

63. *Id.* at 753–54.

but at least the peers of their U.K. chartered accountant brethren.<sup>64</sup> This quest manifested itself in part by various segments of the profession seeking out weightier public service roles for themselves.<sup>65</sup> One promising avenue for this was in the area of audits—which heretofore bore only a pale resemblance to the rich British audit tradition—such as those enshrined in the Companies Act, 1929.<sup>66</sup>

In the United States, prior to the '33 Act, audits were simply a private engagement of an accountant or bookkeeper by an investor or manager to check up on the books of a debtor or subordinate.<sup>67</sup> Such audits were largely akin to the category of “internal audits” mentioned above, except that some were investigative audits by external parties.<sup>68</sup> The distinguishing feature of these audits, for purposes of this Article, was that there was direct privity between only the auditor and the primary beneficiary, who controlled the audit engagement (e.g., who had the full authority to hire, fire, and/or pay the auditor). Generally, there were no intended third party beneficiaries of these audits. Even in cases where the auditor and the client acknowledged some third party beneficiary (e.g., a bank or other creditor), there was no privity between the auditor and the third party beneficiary. Furthermore, no fixed legal requirements for audits existed, although some agencies were beginning to explore the use of audits in very particular instances.<sup>69</sup> But in the first two decades of the twentieth century, some major corporations experimented with “public audits” that created large classes of third party beneficiaries—public disclosures of private audits that they had commissioned for internal or shareholder purposes.<sup>70</sup> This may have been an attempt to forestall government regulatory action with regard to complaints that the massive trusts and companies like U.S. Steel and the American Tobacco Company were misleading average investors. But whatever the actual impetus, the new public profile of audit work commissioned by these very companies proved a boon to the accounting profession.

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64. *Id.* at 776–78.

65. *Id.* at 783–95.

66. *Id.* at 775–76.

67. *Id.* at 754–55.

68. ARTHUR ANDERSEN & CO., A VISION OF GRANDEUR 18–20 (1988) [hereinafter VISION OF GRANDEUR] (history of Arthur Andersen & Co. published for the firm’s 75th anniversary).

69. O’Connor, *supra* note 1, at 779.

70. *Id.* at 778.

### B. Commodification of the Audit

This emerging best practice of “public audits” was then cited by Colonel Carter in his testimony at the Senate hearings for the ‘33 Act.<sup>71</sup> Accountants were advocating for this trend as a way to elevate their public reputation, along the lines of what today we might think of as a “Consumer Reports”-type entity.<sup>72</sup> At the same time, many large corporations viewed public audits favorably as a prophylactic against unwelcome government regulation and/or a premium signaling device (or, more cynically, a marketing ploy) for the quality of their shares in the marketplace.<sup>73</sup>

Left to its own devices, the trend toward public audits may well have led to a true reputational marketplace for auditors—one in which auditors essentially “rented” their reputations for objectivity and integrity to companies who were trying to raise money in the capital markets.<sup>74</sup> Instead, the theory of reputational intermediaries was developed to explain the audit environment *after* the federal securities laws were passed, when the new mandatory audits displaced the voluntary public audits.<sup>75</sup> But this theory, as applied to this later period, seems to have foundered on the record of actual history and behavior. One study found that reputational intermediaries such as auditors act in reputation depleting ways to a degree not predicted by the theory.<sup>76</sup> Other commentators suggest that it is unlikely that an efficient

71. See O’Connor, *supra* note 1, at 800–08 (citing Carter Statement, *supra* note 16, at 59–60).

72. *Id.* at 777–78, 800–09. The Consumer Reports analogy was introduced by Professor Gilson in his seminal article that established the idea of “reputational intermediaries” or “gatekeepers,” discussed *infra*, without actually using those terms. See generally Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

73. For a contemporary discussion of signaling theory, see HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES–OXLEY DEBACLE: HOW TO FIX IT AND WHAT WE’VE LEARNED* 28–30 (2006).

74. The literature surrounding the theory of reputational intermediaries and marketplaces is extensive. See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 888–98 (1984); see generally Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916 (1998); John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid”*, 57 BUS. LAW. 1403 (2002); Gilson, *supra* note 72; Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

75. See O’Connor, *supra* note 1, at 787–88.

76. See Brian W. Mayhew et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, AUDITING: J. PRAC. & THEORY, Sept. 2001, at 49–70.

marketplace for reputational intermediaries can exist in today's highly concentrated market dominated by a small number of firms.<sup>77</sup>

Yet through the 1920s, a fairly ideal environment for the development of a reputational marketplace existed. Nearly all the firms were still pure-play accounting/audit firms.<sup>78</sup> The only substantial non-accounting/audit service was a budding tax practice developed in the wake of the new federal tax legislation of the early 1900s.<sup>79</sup> Companies apparently were beginning to believe that obtaining the "independent" certification of the company's financial statements would give them an edge in the increasingly crowded equity markets of the Roaring Twenties.<sup>80</sup> Even after the Great Crash, and perhaps because of it, the use of public audits increased.<sup>81</sup> The NYSE began to require the certification of financial statements of all listed companies in 1932.<sup>82</sup> While this may have started the trend toward commodification of the public audit—by making it routine—it may also have simply been a way for the NYSE to signal its own "quality" in the marketplace for exchanges by having higher listing standards than competitors.<sup>83</sup> Arguably, so long as public audits were not legally required of *all* companies, this reputational marketplace for auditors would have continued to flourish in the same way that quality signaling markets seem to work today for selection of underwriters and even law firms.

Nonetheless, with what might best be characterized as an insignificant decision overshadowed by more momentous considerations, the emerging best practice of voluntary public offering and annual audits was locked in place by its codification—at least as to initial offerings—by the audit provisions of the '33 Act.<sup>84</sup> While this codification did not

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77. See Coffee, *supra* note 74, at 1413–15; Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1176–82 (2003); Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* 64–67 (working paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=303181](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181); Partnoy, *supra* note 74, at 491, 527.

78. O'Connor, *supra* note 1, at 788.

79. *Id.* at 783–85; VISION OF GRANDEUR, *supra* note 68, at 16–18.

80. O'Connor, *supra* note 1, at 778, 806–07 (discussing auditor signaling experimentation by U.S. Steel and American Tobacco and quoting debate between Senator Gore and Colonel Carter about the efficacy of independent auditors).

81. *See id.* at 790.

82. *See id.*

83. *See, e.g.*, BUTLER & RIBSTEIN, *supra* note 73, at 33–34.

84. Securities Act of 1933, Pub. L. No. 73-22, sched. A, ¶ 25, 48 Stat. 74, 90 (codified at 15 U.S.C. § 77aa, sched. A, ¶ 25 (2000)).

require *all* stock issuances to be accompanied by audited financials, it did require all issuances to the general public to be so accompanied.<sup>85</sup> As a practical matter, then, this was essentially the same as requiring all stock issuances to have certified financials, at least from the general public's point of view.<sup>86</sup>

The focus of this Article so far has been on the audit provisions of the '33 Act, yet far more important audit provisions would come in the '34 Act. Such focus heretofore on the '33 Act is not misplaced because the '33 Act audit provision set the model for the more far-reaching audit provisions of the '34 Act.<sup>87</sup> At the same time, by 1934 much of the public's furor over the stock market scandals and crash had dissipated, perhaps in part due to the passage of the '33 Act itself; so the '34 Act, including its audit provisions, was arguably not as strong of a reform law as the '33 Act.<sup>88</sup> As discussed in Part I.A above, the '33 Act was only supposed to be the opening volley, on the part of the Roosevelt Administration, of a comprehensive set of laws designed to federalize corporate law. In the meantime, however, corporate and finance groups had a chance to regroup and begin extensive lobbying of their own.<sup>89</sup> Thus, in 1934, the Roosevelt Administration found itself defending the '33 Act as much as promoting new legislation. Accordingly, the '34 Act became a compromise that softened many of the harshest civil liabilities and penalties of the '33 Act, while still providing for regulation of the exchanges, broker-dealers, and the secondary market in stock trading generally.<sup>90</sup>

For purposes of this Article, the most salient part of the '34 Act is the establishment of ongoing periodic disclosure—or “reporting”—of

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85. Because Sections 3 and 4 of the '33 Act provide exemptions to Section 5's registration requirements for certain classes of securities or transactions in securities, not all stock issuances would need to comply with the audit requirements for registered offerings. *See* Securities Act of 1933, Pub. L. No. 73-22, §§ 3-5, 48 Stat. 74, 90 (codified at 15 U.S.C. §§ 77c-77e (2000)).

86. I am only making a definitional claim here: because general or public offerings need to follow the provisions of the '33 Act, investors seeking to buy stock in such an offering now would necessarily receive audited financials as part of the offering prospectus. Of course, members of the public can buy stock in private placements and other non-public, limited offerings, but, without rehashing the general principles of the federal securities laws here, suffice it to say that there are important limitations seeking to ensure adequate control and/or access to information for investors in such private/limited offerings.

87. O'Connor, *supra* note 1, at 817-20.

88. *Id.*

89. *Id.* at 819.

90. *Id.* at 817-19.



publicly traded companies listed on a national exchange.<sup>91</sup> But perhaps owing to the compromise nature of the '34 Act, or to the nascent trend to establish principles and guidelines in federal legislation rather than detailed rules, the disclosure provisions beyond the annual report requirement are grants of rulemaking authority to the new SEC.<sup>92</sup> In particular, the decision whether to require auditor certification of any of these reports was delegated to the SEC.<sup>93</sup> Instead of the "independent public or certified accountant" language of the '33 Act,<sup>94</sup> however, the '34 Act instead prescribed "independent public accountants"—if an audit was to be required at all (yet, like the '33 Act, it did not define the term).<sup>95</sup> The SEC, of course, did choose to require that annual reports be certified, and also prescribed quarterly and material event reporting.<sup>96</sup>

From hereon in, I will refer to the certification under the '33 Act as the "offering audit"<sup>97</sup> and the ongoing certification of annual reports as the "statutory audit." Note that neither of these is identical to the internal audit or external investigative audit. Note further that reporting companies are a subset of "issuers" under the '34 Act—the latter includes any companies that have issued securities in any form or venue regardless of whether the company has also sought to be listed on a national exchange and thus come under the reporting requirements of the '34 Act.<sup>98</sup>

When, in Schedule A of the '33 Act, Congress borrowed the prospectus audit from the Companies Act, 1929, this was appropriate at least at the functional level, despite the other flaws I have discussed above in Part I.A. This is so because both were aimed at delivering economic information to potential investors. But when the SEC issued

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91. See Securities Exchange Act of 1934, 73 Pub. L. 291, §§ 12–13, 48 Stat. 881, 894–95 (codified at 15 U.S.C. §§ 78l–78m (2000)).

92. O'Connor, *supra* note 1, at 819.

93. See Securities Exchange Act of 1934, 73 Pub. L. 291, § 13(a)(2), 48 Stat. 881, 894 (codified at 15 U.S.C. § 78m(a)(2) (2000)) (stating that "[s]uch annual reports certified if required by the rules and regulations of the [SEC] by independent public accountants" (emphasis added)).

94. Securities Act of 1933, Pub. L. No. 73-22, sched. A, ¶ 25, 48 Stat. 74, 90 (codified at 15 U.S.C. § 77aa, sched. A, ¶ 25 (2000)).

95. *Id.*; Securities Exchange Act of 1934, 73 Pub. L. 291, § 13(a)(2), 48 Stat. 881, 894 (codified at 15 U.S.C. § 78m(a)(2) (2000)).

96. See Regulation 13A, 17 C.F.R. §§ 240.13a-1, -13 (2004).

97. It could also be referred to as the "prospectus audit" as in the British tradition. See, e.g., Turnbull, *supra* note 36, at 4, 7; Bush, *supra* note 36, at 7–9.

98. See 15 U.S.C. § 78c(8) (2000) (defining the term "issuers"); see, e.g., 17 C.F.R. § 228.10(b)(3) (2005) (defining the term "reporting company").

regulations requiring the statutory audit it seems to have failed to grasp the distinction between the Companies Act, 1929's prospectus audits and statutory annual audits. Thus, the statutory audit promulgated under the '34 Act differed critically in both form and function from the Companies Act, 1929's statutory annual audit: as a matter of form, it failed to put the statutory audit exclusively in the hands of the shareholders; as a matter of function, it mandated only an economic information role for both existing and prospective investors. Of course, as discussed above, both the SEC and Congress believed they were constrained in what they could do as far as overriding state corporations law governance provisions.

By default, under the '34 Act the SEC got to define who or what constituted an "independent public accountant" just as the FTC had given some guidance as to "independent public or certified accountants" in 1933 after the '33 Act was passed.<sup>99</sup> The FTC deemed that accountants were not independent if they served as officers or directors of the company to be audited, or had a "substantial financial interest" in that company.<sup>100</sup> The following year, the SEC added on to these early auditor independence rules by defining "substantial financial interest" as the equivalent of more than one percent of the *auditor's* personal worth.<sup>101</sup> The SEC later deleted the word "substantial" and prohibited any financial interest in the audit client.<sup>102</sup>

Once the SEC exercised its authority regarding audits under the '34 Act, the potential business impact for accountants was realized: by law, every publicly traded company had to retain an outside audit firm to certify its annual reports. Congress and the accounting profession were clearly aware of the potential economic value to accountants—and expense to issuers—of even the offering audit established by the '33 Act.<sup>103</sup> But the ongoing annual statutory audit established by the SEC under the '34 Act was like the gift of an annuity to the profession.<sup>104</sup>

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99. See PANEL ON AUDIT EFFECTIVENESS, REPORTS AND RECOMMENDATIONS ¶ 5.3 (Aug. 31, 2000).

100. See *id.*

101. See *id.* at ¶ 5.3 n.4.

102. *Id.* The further development of the SEC's auditor independence rules is treated below. See *infra* Part II.

103. O'Connor, *supra* note 1, at 800–07.

104. The term "statutory audit" is a misnomer: technically it should be called the "regulatory audit." But the term "statutory audit" has become the accepted one.

While it is trite to say that there is no free lunch, it is true that the statutory audit franchise given to the accounting profession did not come unencumbered. In particular, under both the offering audit and the statutory audit, the auditor took on legal liability for the opinions she gave as part of the certification.<sup>105</sup> In fact, under the '33 Act as originally passed, this liability was so strict that it incensed leaders of the accounting profession.<sup>106</sup> While the amendments to the '33 Act contained in the '34 Act, together with the relevant substantive portions of the '34 Act, reduced the full bite of this liability, it was not removed entirely.<sup>107</sup> Nonetheless, the offering audit and statutory audit still provided the platform for an unforeseen dramatic expansion in the size and scope of accounting firms, as discussed in Part II below.

Perhaps less obvious at the time, this coveted franchise turned the formerly voluntary public audit into a fungible or staple commodity.<sup>108</sup> For purposes of this Article, I will use the term "commodity" similar to the narrow manner that it is defined in the Commodities Exchange Act to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."<sup>109</sup> This captures the operative essence of commodities in that they are fungible within their class such that none are individually valued other than by coarse metrics such as size or weight—e.g., one bushel of wheat is as good as another for commodities futures trading purposes. Once that objective, coarse metric is determined, sellers of commodities compete primarily on price.

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105. Securities Act of 1933, Pub. L. No. 73-22, § 11, 48 Stat. 74 (codified at 15 U.S.C. § 77a (2000)).

106. O'Connor, *supra* note 1, at 817–19.

107. *Id.*

108. "Commodity" has different meanings in different contexts. In a broad legal definition, it simply denotes "movable articles of value." BLACK'S LAW DICTIONARY 274 (6th ed., West Publishing 1991). In business law contexts it is defined as "[a]n article of trade or commerce" or "a raw material or an agricultural product." A HANDBOOK OF BUSINESS LAW TERMS 123 (Bryan A. Garner, ed., West Group 1999). In the Commodities Exchange Act, "commodity" is defined as a specific list of enumerated items:

The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13–1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.

7 U.S.C. § 1a(4) (2000).

109. 7 U.S.C. § 1a(4) (2000).

The commodities trading markets, particularly the futures market, are dependent upon this being the case.<sup>110</sup> I can commit to paying a certain price for a bushel of wheat in the future just based upon expectations of supply and demand in the markets, *not* upon whether a particular bushel will turn out to have special properties. Thus, the whole range of option puts, calls, swaps, and even short selling (where allowed) becomes available to traders. Shorting depends necessarily on fungibility: I expect that the price of wheat will decrease in the next month, so I borrow several bushels from someone else, promising to return them a month from now; I then sell the bushels tomorrow at the going market rate and pocket the money; finally, if all goes as planned, when it is time to return the bushels to my lender, I buy new bushels on the market at the lower prices a month from now and profit from the difference in what I sold his bushels for and what I had to pay to replace those bushels. Obviously, shorting does not work where lenders expect their actual bushels back (and can identify them as such). Shorting in securities follows the same story.<sup>111</sup>

The interesting situations to watch are where a type of good or service becomes “commodified.” In other words, the good or service either had, or was perceived to have, enough variability from unit to unit that it had to be priced according to the unique value of any particular unit, but then over time either the actual variability among the units, or the perception of that variability, changed and the market began treating the pricing as category wide rather than unit by unit. Services can be tougher candidates for commodification because custom variation almost seems to be part of the nature of services (as opposed to goods). At the same time, many services have become so routinized, or even outright automated, that one can see them as fungible commodity-type purchases. Quick oil change services, for example, come to mind, but it could be that those are still value or premium sales.

From the other end of the spectrum, it is possible for items in a commodities category to move their way “up” in the world and be “decommodified.” I recently spoke at a conference on food security issues and noticed that many speakers were decrying the “commodification of food.” When it was my turn, I pointed out that this

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110. See ROBERT W. HAMILTON AND RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS: ESSENTIAL CONCEPTS AND APPLICATIONS* § 15.4 (Aspen Publishers 4th ed. 2006).

111. At the same time, of course, securities futures can be traded in commodities markets as well as securities markets. See 17 C.F.R. pt. 41 (2006).

was truly odd as many food categories formed the original or archetypal commodities (grains, pork bellies, etc.).<sup>112</sup> Further, I pointed out that the real story is how many food producers have found ways to *decommodify* their products.<sup>113</sup>

But the foregoing suggests another interesting thing about “commodification”: it is apparently a pejorative term to many. In one way this makes sense: when something is, or has become, a commodity, this means it has no individual value. This plays into Kafka-esque and Orwellian fears of people being reduced to numbers or mere “cogs in the machine.” And indeed, when Professor Margaret Jane Radin published her famous book, *Contested Commodities*, much of what she was concerned about was the commodification of babies, body parts, and other essentially human objects.<sup>114</sup> But how much should this type of fear transfer over to the commodification of non-human objects? Animal rights activists may well feel that buying and selling farm animals as commodities debases the dignity of these creatures. And clearly many individuals in the organic and other “natural” food movements feel that treating plant foodstuffs as commodities is somehow undignified as well,<sup>115</sup> although it is less clear who or what is being debased in this scenario.

Nonetheless, while in private practice in the late 1990s and working on a high profile matter for one of the then Big Five accounting firms, I quickly discovered the open secret in the accounting profession that the statutory audit was essentially a commodity sold on price and often used as a loss leader to bring in the more lucrative consulting services. It was also clear that this had not always been the case. My curiosity as to how the statutory audit had become commodified was thus the genesis of this and my earlier publications on the topic.<sup>116</sup> In an earlier piece I posted to

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112. And, of course, these archetypal food types are contained in the definition of “commodities” in the Commodities Exchange Act. 7 U.S.C. § 1a(4) (2000).

113. See, e.g., MICHAEL POLLAN, *THE OMNIVORE’S DILEMMA: A NATURAL HISTORY OF FOUR MEALS* 239–61 (2006).

114. MARGARET JANE RADIN, *CONTESTED COMMODITIES* 1–15 (Harvard University Press, 1996); see also ARJUN APPADURAI, *RETHINKING COMMODIFICATION* 1–29 (Martha M. Ertman and Joan C. Williams eds., N.Y.U. Press 2005). Note that Radin was using “commodification” in its broader sense of having market value generally, not necessarily in the narrower way that I am using it to designate fully interchangeable fungible units.

115. See POLLAN, *supra* note 113, at 239–61.

116. While most of the themes of this article were firmly in place for me by the time I left private practice in 2001, I had a hard time getting earlier drafts placed, in part because there were few public sources available for me to cite to support my central themes, and in part because few people seemed to understand what I meant by “commodification of the audit.” Fortunately, I finally posted

Social Science Research Network (SSRN), I began exploring what accountants were doing for revenue sources before the statutory audit came along.<sup>117</sup> From there it became clear that the real story to follow was how revenue from statutory audits came to dominate the accounting firms' overall income stream. After that, the narrative could shift to how that core service line and revenue stream wound up being a low margin albatross for the firms—with low, to no, to sometimes even negative margins, but indispensable because it employed so many people and provided a golden entry point for audit partners to cross-sell the highly lucrative consulting services offered by other parts of the firm. The details of this transformation occupy Part II.A below.

In the end, the story behind the commodification of the statutory audit is a simple one, but it is wrapped within a second, fairly complex story. The simple story is that once the statutory audit was locked into place, it changed the dynamics for the audit market so profoundly that, arguably, few parties grasped the full impact of the change for a number of years. In essence, an audit that companies took on voluntarily could operate as a quality-signaling mechanism to the markets. Showing that one could get a clean certification from a respected accounting firm, or that one could get listed on the NYSE, should arguably have increased the number of prospective investors and lowered the price of capital for the company because investors could be given evidence that the company was sound and not run with excessively risky business or accounting practices.<sup>118</sup> But once the audit was regulated and required of each and every publicly traded company, there was no longer any signal to be sent, other than that one had complied with the law.<sup>119</sup> Presumably, one could still choose high-reputation accounting firms in an attempt to signal quality to the marketplace, and this practice seemed to hold for

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a version on SSRN in early 2002. O'Connor, *supra* note 77. I continue to be grateful to Jack Coffee, Bill Bratton, and Larry Cunningham who were all willing to give me a much needed boost by citing the SSRN working paper in articles that appeared shortly thereafter. Interestingly enough, about a year or so after the SSRN piece had been circulated and widely cited, the idea of a commodified audit began appearing in other articles and finally appears to have gained currency. *See, e.g.*, Macey & Sale, *supra* note 77, at 1177–78.

117. O'Connor, *supra* note 77, at 3–6.

118. I have found no hard evidence that voluntary audits did reduce the cost of capital for companies who undertook them however. By the same token, I do not know of any definitive evidence that the mandatory statutory audit has reduced the cost of capital to publicly traded companies either.

119. A similar point is made by Professors Butler and Ribstein. *See* BUTLER & RIBSTEIN, *supra* note 73, at 29.

the first years after the implementation of the statutory audit. Yet, over time, awareness appeared to sink into the marketplace that the SEC essentially regulated the accountants who wanted to perform statutory audits, and that thus so long as one chose an SEC “approved” accounting firm for the statutory audit, then this was as much signaling as one needed in the marketplace. This then meant that the statutory audit shifted to the realm of mere legal compliance for many companies and the downward slide to commodification was set in place. The more complex, second story is about the inextricably entwined strands of the statutory audit, growth of the size and scope of the largest American businesses, and growth and consolidation of first the Big Eight and then the Big Four firms in the accounting profession. This more complex story will be considered in the next Part.

In sum, this Part has reviewed the origins of the problem of auditor independence and set the stage for the causes behind the commodification of the statutory audit. In the next Part, I consider the growth and consolidation of the accounting profession that stemmed from the initial windfall of the statutory audit franchise. But this very growth and consolidation also exacerbated the trend towards commodification. It also led to a veritable bramble bush of auditor independence rules and, ultimately, an environment in which meaningful auditor independence is simply impossible.

## II. CAPTURED AUDITORS AND A BRAMBLE BUSH OF INDEPENDENCE RULES

In Part A of this Section, I begin by following the intertwined themes of the growth in size and scope of both the major accounting firms and large American businesses. I then summarize the effects of the statutory audit on the former’s services and practice. To illustrate such growth and the resulting effects of the statutory audit, I use Arthur Andersen as a case study. In Part B, I provide a historical survey of auditor independence rules issued under a number of different sources. I conclude this Part by examining the current state of auditor regulation after the implementation of SOX. In sum, this Part sets the stage for how auditors were effectively captured by management, despite increasingly complicated independence rules.

### A. Growth and Consolidation of the Accounting Profession

Because the former Arthur Andersen accounting firm was often at the forefront as the profession developed after World War II, and then imploded in the most dramatic set of circumstances of any of the then Big Five, it serves as an excellent case study to illuminate key changes in the profession. Arthur Andersen, the founder, took over an existing audit practice in 1913 even as he remained as head of the accounting department at Northwestern University.<sup>120</sup> Purportedly from the beginning, he exhorted both his students and employees to “look beyond the numbers” in performing accounting work because he believed that many valuable insights could be gleaned by the business-savvy accountant reviewing the detailed financial transactions of a company.<sup>121</sup> Andersen also is claimed to have had an interest in systems consulting and advisory services from the very beginning.<sup>122</sup> The new firm, like many others of the time, profited from the passage of the new federal income tax law in 1913<sup>123</sup> and began creating a tax practice to complement the core accounting/audit practice.<sup>124</sup> But perhaps distinct from other accounting firms, it began an “industrial engineering” practice in 1918 specifically to focus on this idea of “looking beyond the numbers” to assist client management in effectively running the business.<sup>125</sup> “Our investigations seek to show the strong or weak points in company position or management, and our installations seek to . . . correct such weak spots.”<sup>126</sup> That same year, the firm changed its name to Arthur Andersen & Co.<sup>127</sup>

During the 1920s, the firm grew steadily, opening offices in New York, Kansas City, Los Angeles, and San Francisco.<sup>128</sup> Throughout the

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120. VISION OF GRANDEUR, *supra* note 68, at 6. Andersen is claimed to be the first university professor to move from teaching to the practice of public accounting. *Id.*

121. *Id.*

122. *Id.*

123. Tariff of 1913 (Underwood Tariff Act), Pub. L. No. 63-16, 38 Stat. 114 (codified as amended in scattered sections of 26 U.S.C. (2000)); see also O'Connor, *supra* note 1, at 778, 783–85; GARY JOHN PREVITS AND BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 254–56 (Ohio State University Press 1998).

124. See VISION OF GRANDEUR, *supra* note 68, at 17.

125. See *id.* at 18.

126. *Id.*

127. *Id.* at 19.

128. *Id.* at 24.



twenties, the firm also began developing a reputation for advising businesses in mergers and acquisitions.<sup>129</sup> Not surprisingly, the firm's revenues declined somewhat in the early years of the 1930s. But, because of the multiple practice areas that it had developed, Arthur Andersen & Co. was able to focus resources on service lines like tax and public utility rate investigations and thus soften the decline of audits and merger related services.<sup>130</sup> Subsequently, the firm accelerated its move into its emerging industrial engineering service line once the economy picked up again during and after World War II.<sup>131</sup> During the 1930s, the firm also managed to open more offices in the United States and begin international affiliations with foreign accounting firms.<sup>132</sup>

When the war effort of the early 1940s dramatically reinvigorated industry and the economy, accounting firms such as Arthur Andersen & Co. benefited as well.<sup>133</sup> Major American businesses grew larger in the size and scope of their activities, so accounting firms had to grow in size and complexity with their clients just to be able to continue providing the statutory audit.<sup>134</sup> In the 1950s, Arthur Andersen & Co. capitalized on the substantial developments in logistics, personnel, and management technologies that originated in the war effort to grow the industrial engineering program, now called the "systems practice."<sup>135</sup> Yet this initiative was not cheap and the returns on the budding systems practice were minimal in the early years. Further, the firm was engaged in aggressive growth and expansion geographically and in other service areas. All of this required the partners to forego significant amounts of income that could otherwise have been paid as partner profits.<sup>136</sup>

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129. *See id.* at 27.

130. *Id.* at 40.

131. *Id.* at 91–99.

132. *Id.* at 42–44, 48.

133. *See id.* at 67–73.

134. *See id.* at 84–86.

135. *Id.* at 84–91. The systems practice became known first as "administrative accounting" and then "administrative services" in 1951, a name it kept until eventually changing to "management information consulting" in 1980. *Id.* at 93. It had its first major computer installation project for General Electric around 1953. *Id.* at 95–96. Following this successful project, the administrative services practice finally began realizing the potential its supporters had long argued for, although in fact the service line was still not a big revenue source. *Id.* at 94–99.

136. *Id.* at 91. This history of reinvestment would later crop up as one of the sorest points for audit and tax practice partners when the systems practice—later renamed again to "Andersen Consulting"—sought and won their essentially cost-free walkout from the Arthur Andersen Worldwide Organization in 2000. *See infra* notes 153–160, 170–172 and accompanying text.

Nonetheless, throughout the 1960s, the yet again renamed “administrative services practice” would expand dramatically through major corporate and government systems installations and even into software creation and sales to smaller businesses.<sup>137</sup> Tax services also experienced a powerful upswing throughout the decade.<sup>138</sup>

But already in the 1960s, signs of the commodification of the audit were appearing:

Price competition between auditors can be intense—though price cutting in order to get an account is officially deplored in the profession . . . Al Jennings, the senior partner of Lybrand, Ross Bros. and Montgomery, recalled recently that his firm had lost a big account to another of the Big Eight, which put in a ‘loss-leader’ bid—after it had managed to wangle an invitation to make a presentation. Firms often submit such bids . . . in the hope that after they get a foot in the door, they can gradually expand the volume of their work and their fees.<sup>139</sup>

By the 1970s, the large accounting firm structure that dominated until the early 2000s—an international, multi-disciplinary organization with audit/accounting, tax, and consulting divisions—was firmly in place in Arthur Andersen as well as the rest of the Big Eight firms.<sup>140</sup> Arthur Andersen also entered the world of true multinational partnerships with the establishment of Arthur Andersen & Co., Société Coopérative (AASC) in Geneva, Switzerland.<sup>141</sup>

137. See VISION OF GRANDEUR, *supra* note 68, at 125–28.

138. PREVITS & MERINO, *supra* note 123, at 328–30.

139. T.A. Wise, *The Auditors Have Arrived*, FORTUNE, Nov. 1960, as cited in A VISION OF GRANDEUR, *supra* note 68, at 119.

140. See U.S. GEN. ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 8 (July 2003), available at <http://www.gao.gov/new.items/d03864.pdf> [hereinafter GAO STUDY]. The Big Eight consisted of Arthur Andersen, Peat Marwick Mitchell, Coopers & Lybrand, Ernst & Whinney, Price Waterhouse, Arthur Young, Deloitte Haskins & Sells, and Touche Ross. *Id.* at 11. I have not found a good account of when the major accounting firms coalesced into the official Big Eight.

141. VISION OF GRANDEUR, *supra* note 68, at 138–39; Andersen Consulting Bus. Unit Member Firms v. Arthur Andersen Bus. Unit Member Firms and Andersen Worldwide Société Coopérative, Int’l Comm. Arb., Case No. 9797/CK/AER/ACS, at 10–14 (July 28, 2000) [hereinafter Arbitration Award]. This capped a firm restructuring that focused on how to allow offices in various countries to fully comply with national laws, and be viewed as national or native firms, while still retaining the “one firm” culture that Andersen had long cultivated. *Id.* The solution was based around establishing legal partnerships in each country where the firm offered its services, while having all of those partnerships sign a member firm inter-firm agreement (MFIFA) with AASC. *Id.* The collection of all of the national member firms, known as the Arthur Andersen Worldwide Organization (AAWO), was administered by AASC, which alone “sets policy, establishes and

Across the profession, meanwhile, the management consulting divisions of the Big Eight grew rapidly, and by 1975 they accounted for eleven percent of the firms' total revenues on average, with a range of five to sixteen percent for specific firms.<sup>142</sup> At the same time, audits of the increasingly complex and large publicly traded companies required increasingly sophisticated audit techniques.<sup>143</sup> The number of accountants skyrocketed from 9,500 in 1945 to nearly 104,000 in 1973.<sup>144</sup> The floodgates of competition were also opened when the FTC, Department of Justice (DOJ), and individuals threatened legal actions against the professional services organizations, including accounting, alleging that the traditional restraint on advertising self-imposed by most of these organizations was actually improper restraint of trade.<sup>145</sup> This new ability to advertise and openly compete likely broke down the last bulwark against complete commodification of the audit.

By the 1980s, "[t]he age of 'auditing as king' was passing, as other attest,<sup>146</sup> tax, and advisory services were offered to assist businesses facing an increasingly complex legal, international, and technological environment."<sup>147</sup> Solidification of the trend started at least as early as the 1960s—accountants, however, did not begin to talk openly about commodification until the Reagan era. At that time, Duane Kullberg,

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monitors worldwide quality standards and coordinates training for all Arthur Andersen personnel." VISION OF GRANDEUR, *supra* note 68, at 139. Further, "[e]ach partner in a national member firm also is a partner in the [AA]SC." *Id.*; see also Arbitration Award at 11–12. Essentially, a hub and spoke network was formed with AASC as the hub, connected to each and every national member firm by a MFIFA.

142. GAO STUDY, *supra* note 140, at 8–9. For comparison, in 1975, audit/attest services accounted for approximately 70 percent of revenues on average, and tax services filled out the roughly 19 percent of remaining revenues on average. *Id.* See also Press Release, Securities and Exchange Commission, SEC Chairman Levitt Proposes Rulemaking, Other Measures to Maintain Quality of Financial Reporting (May 10, 2000) (on file with author) (giving these figures for 1977 as 12 percent for management consulting services, 70 percent for audit/attest services, and 18 percent for tax services).

143. See PREVITS & MERINO, *supra* note 123, at 332.

144. *Id.*

145. See GAO STUDY, *supra* note 140, at 8; see also VISION OF GRANDEUR, *supra* note 68, at 144–45.

146. Attest services are "engagements . . . in which a certified public accountant in the practice of public accounting . . . is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter . . . , that is the responsibility of another party." AICPA, STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS (SSAEs) 10 § 101.01 (2002), available at <http://www.aicpa.org/download/members/div/auditstd/AT-00101.PDF>.

147. PREVITS & MERINO, *supra* note 123, at 349.

CEO of Arthur Andersen & Co., argued that “[c]ompetition is keener than ever among the major accounting firms, and some of our competitors seem to consider their services as commodities for sale at a price.”<sup>148</sup> In response to this trend toward commodification, and given the new permission to advertise, accounting firms attempted to differentiate their audits: “As the marketplace has become more cutthroat, each of the Big Eight has striven to find ways to distinguish its product to make it seem brighter, shinier and better able to do the job.”<sup>149</sup> Yet “[a]ll have been seemingly unsuccessful in persuading clients or prospective clients that this or that audit technique is superior.”<sup>150</sup> Summing up the net result of the profession’s advertising campaign against the audit-as-commodity, an accounting firm marketer was quoted as saying that:

[t]he downside to all this . . . is that the job the profession as a whole has done best is to convince buyers that the audit is a commodity. The firms certainly didn’t set out to do that, but the overuse of fee-cutting as a sales technique has had exactly that effect. It will take time and some very thoughtful, client-focused marketing to repair the damage we have done to ourselves by treating the audit as a loss-leader.<sup>151</sup>

Yet, given a mandatory statutory audit with the primary requirement being the auditor’s ability to satisfy the SEC that he and/or his firm is “independent,” it seems inevitable that firms found themselves competing on price for commodified audit services.

At the same time, the Big Eight seemed to get caught up in the general merger frenzy of the late 1980s. The first major merger of the period, involving Peat Marwick Mitchell, followed the earlier accounting firm merger model of acquiring offshore firms to extend the firm’s international reach and/or to service specific U.S. based clients.<sup>152</sup> Thus the merger of Peat Marwick Mitchell and Europe’s Klynveld Main Goerdeler in 1987 did not materially change the Big Eight, although it did allow the combined entity, KPMG, to become the largest accounting firm worldwide and the second largest U.S. firm—at least for a couple of

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148. VISION OF GRANDEUR, *supra* note 68, at 119.

149. *Id.* at 145 (quoting Peter W. Bernstein, *Competition Comes to Accounting*, FORTUNE (July 17, 1978)).

150. *Id.*

151. *Id.* at 145.

152. GAO STUDY, *supra* note 140, at 10–11.

years.<sup>153</sup> In 1989, four of the Big Eight were involved in mergers to form the Big Six: Ernst & Whinney and Arthur Young teamed up to form Ernst & Young, while Deloitte Haskins & Sells merged with Touche Ross to create Deloitte & Touche.<sup>154</sup>

Arthur Andersen resisted this merger interest, but underwent a significant restructuring. Based in part on the increasing friction between audit/attest and tax partners, on the one hand, and management consulting partners, on the other, AASC encouraged member firms to split the management of the two sides at the office level.<sup>155</sup> In 1988, AASC even created the new name of “Andersen Consulting” for the new business division.<sup>156</sup> While the Arthur Andersen Worldwide Organization (AAWO) was not the only Big Six organization to experience the increasing accountant/consultant friction, it did ultimately take the growing gap to a more dramatic resolution.<sup>157</sup>

Unable to slow the momentum of the two business divisions growing apart, AASC seems to have decided to at least use the increasingly clear separation of the division to its advantage: in 1990 it created new legal entities in the United States and many other countries and transferred the Andersen Consulting division personnel and assets into them.<sup>158</sup> Around the same time, Arthur Andersen LLP, the U.S. audit/tax member firm, requested (and received) a “no-action” letter from the SEC that it would not consider the accounting firm’s independence to be impaired where the new Andersen Consulting LLP, the U.S. consulting member firm, performed non-audit services for an Arthur Andersen LLP audit

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153. *Id.* Of note, by 1986, Arthur Andersen had become the largest U.S. accounting firm, and it maintained this position even after KPMG was created, although KPMG later displaced Arthur Andersen as the world’s largest accounting firm. *Id.*; VISION OF GRANDEUR, *supra* note 68, at 170–71.

154. GAO STUDY, *supra* note 140, at 11. The Big Six were Arthur Andersen, Price Waterhouse, KPMG Peat Marwick, Ernst & Young, Deloitte Touch, and Coopers & Lybrand. Arthur Andersen and Price Waterhouse reportedly contemplated a merger that same year, but it never came to fruition. *Id.* Nonetheless, Arthur Andersen remained the largest firm in the U.S. after the 1989 mergers. *Id.*

155. VISION OF GRANDEUR, *supra* note 68, at 153, 176–77; Arbitration Award, *supra* note 141, at 12–14. Arguably, this separation was also designed to allow greater freedom for consulting in particular to develop both its practice and its approaches to the market. See VISION OF GRANDEUR, *supra* note 79, at 176–77; Arbitration Award, *supra* note 141, at 12–14.

156. VISION OF GRANDEUR, *supra* note 68, at 176–77; Arbitration Award, *supra* note 141, at 12–14.

157. VISION OF GRANDEUR, *supra* note 68, at 176–77.

158. Arbitration Award, *supra* note 141, at 12–21.

client.<sup>159</sup> The basis of this—at least as argued in the no-action request letter submitted by then-Fried Frank partner Harvey Pitt—was that because there would be no common control or management of the two U.S. member firms, as well as no direct profit or loss sharing, they were in all practical ways separate firms and audit engagement partners' independence would not be impaired.<sup>160</sup> Across all of the Big Six during the 1990s, consulting revenues grew 27% annually on average, while audit revenues grew by only nine percent.<sup>161</sup> By the end of the decade, one estimate pegged audit revenues as comprising only 30% of total revenues on average, while consulting revenues accounted for more than 50% of total revenues.<sup>162</sup> In 1998, two more firms within the Big Six merged to create the Big Five: Price Waterhouse and Coopers & Lybrand combined to form Pricewaterhouse Coopers (PwC).<sup>163</sup> A recent General Accounting Office study (GAO Study)<sup>164</sup> estimates that management consulting revenues comprised 45 percent of the Big Five's total revenues on average in 1998, with a range of 34 to 70 percent for specific firms.<sup>165</sup> Audit/attest revenues were then approximately 35 percent of total revenues on average, and tax revenues rounded out the remaining approximately 20 percent of total revenues on average.<sup>166</sup> But note that whichever firm or firms recorded 70 percent of total revenues from consulting revenues then had only 30 percent of revenues coming from the combination of both tax and audit/attest revenues. This represented a tremendous shift from only a couple of decades earlier when management consulting services generated a negligible percentage of revenues for any of the big firms.

At this time, out of the Big Five, only Arthur Andersen was able to successfully separate out its consulting practice. Thus, while the other organizations increasingly found themselves mired in independence

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159. See Arthur Andersen & Co., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 79,484 (June 20, 1990) [hereinafter AA No-Action Letter].

160. *Id.*

161. See Press Release, Securities and Exchange Commission, SEC Chairman Levitt Proposes Rulemaking, Other Measures to Maintain Quality of Financial Reporting (May 10, 2000) (on file with author).

162. See *id.*

163. See GAO STUDY, *supra* note 140, at 12. The Big Five consisted of Arthur Andersen, PricewaterhouseCoopers, Ernst & Young, Deloitte & Touche, and KPMG.

164. See *id.* at 1–3; see also Pub. L. 107-204 § 701 (2002) (requiring the GAO to study the consolidation of the accounting profession and its effects on the market for audit services).

165. GAO STUDY, *supra* note 140, at 8–9.

166. See *id.* at 9 fig.1.

violations by non-audit services that forced them to choose clients for *either* audit/tax *or* consulting, the Andersen twins sailed ahead delivering both sides of the practice division to the same clients. Just as a matter of the universe of potential clients for a firm, this state of affairs essentially doubled that universe for the Andersens over that of their competitors. The post-merger PwC, in particular, found itself the unhappy subject of an SEC-commissioned report that found an alarming number of independence violations—many stemming from the difficulty of ferreting out all the independence related conflicts latent in the merger of two Big Six firms.<sup>167</sup>

Accordingly, Arthur Andersen LLP's no-action letter should have been phenomenally valuable to both it and Andersen Consulting LLP. This would have been particularly true in 2000 when the SEC revised its independence rules to more directly restrict the provision of non-audit services to audit clients, and yet again more critical after SOX essentially codified those restrictions.<sup>168</sup> But, perhaps as just a classic greed story, or perhaps because of some poorly managed legitimate grievances, the Andersen Consulting member firms around the world collectively filed an arbitration under the binding arbitration clauses of their member firm agreements with AASC in 1997.<sup>169</sup> Their main complaint was that they were unfairly "subsidizing" the audit/tax member firms under the cost sharing provisions in the member firm agreements even as the audit/tax firms were building a competing service line under the name of "Arthur Andersen Business Consulting."<sup>170</sup> To summarize, in 2000, a sole arbitrator from Colombia named Guillermo Gamba Posada allowed the Andersen Consulting member firms from around the world to walk away from the AAWO without paying back any of the decades of substantial investments made by generations of Arthur Andersen partners along the long road to the systems consulting practice at the expense of their own personal income<sup>171</sup>—monies that with the interest that would have accrued over

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167. SECURITIES AND EXCHANGE COMM'N, REPORT OF THE INTERNAL INVESTIGATION OF INDEPENDENCE ISSUES AT PRICEWATERHOUSECOOPERS LLP (AP File No. 3-9809) (Jan. 6, 2000) (report prepared by independent consultant Jess Fardella, Esq. *et. al* of the New York law firm Lankler, Siffert & Wohl LLP). *See also* Press Release, Securities and Exchange Commission, Independent Consultant Finds Widespread Independence Violations at PricewaterhouseCoopers, 2000-4 (Jan. 6, 2000) (on file with author).

168. *See infra* Part II.B.

169. Arbitration Award, *supra* note 141, at 2-4.

170. *See, e.g., id.* at 32, 50.

171. *See id.* at 116-18; *see also* O'Connor, *supra* note 1, at 826-27; O'Connor, *supra* note 77, at

the decades I assume would have dwarfed the monies that the Andersen Consulting firms only started sending back into the AAWO beginning in the 1990s. Thus, in the end, Arthur Andersen LLP received only a fraction of the benefit that the no-action letter should have afforded it.

AAWO's loss of Andersen Consulting should have been a gain for the other Big Five organizations because they at least still had consulting practices. Yet in retrospect it turns out that 1997 was the high water mark for revenues from consulting services as a percentage of total revenues on average.<sup>172</sup> In 1998, there was a modest decrease in this percentage, but also a modest decrease in the revenues from audit/attest services as a percentage of total revenue.<sup>173</sup> However, in 1999, roles reversed and the percentage of revenues from audit/attest was roughly equal to that from consulting as audit/attest services began a sharp up-tick inversely related to the beginning of consulting's precipitous drop.<sup>174</sup> By 2002, audit/attest revenues were nearly 60 percent of total revenues on average, while consulting revenues were below their 1975 levels at 10 percent of total revenues on average.<sup>175</sup>

Of course, the arbitration debacle was not the end of the indignities for the once-mighty AAWO. Arthur Andersen LLP was Enron's auditor; and as the latter imploded in a spectacular and almost completely unexpected bankruptcy, the SEC began an investigation of the accounting firm as well.<sup>176</sup> After the SEC discovered that documents related to the audit of Enron had been shredded—allegedly simply in conformance with Arthur Andersen LLP's general document retention policy<sup>177</sup>—the firm was indicted in March 2002 on one count of criminal

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57–58; Nathan Koppel, *Going For Broke*, THE AMERICAN LAWYER 117–18 (November 2000).

172. GAO STUDY, *supra* note 140, at 9 fig.1.

173. *Id.*

174. *Id.*

175. *Id.*

176. Arthur Andersen LLP v. United States (*Andersen II*), 544 U.S. 696, 698–702 (2005).

177. Although it might seem odd at first blush that a document retention policy would call for the destruction of documents, it is not at all unusual. Companies and firms today find themselves overwhelmed by an enormous number of documents. It is entirely reasonable for them to not retain every document, but rather only those that are required to be retained by specific laws or professional duties. Thus, once a document is no longer necessary to retain, it may be disposed of. Document retention policies should clearly set forth which documents must be retained and for how long, as well as how and when to purge documents that are no longer necessary to retain. See Christopher R. Chase, *To Shred Or Not To Shred: Document Retention Policies and Federal Obstruction of Justice Statutes*, 8 FORDHAM J. CORP. & FIN. L. 721, 724–25 (2003). But even beyond this, professional services firms such as those in accounting and law that deal with confidential client information need to also focus on the disposal of documents containing such



obstruction of justice in the federal District Court for the Southern District of Texas.<sup>178</sup> Once the firm was indicted, a “mass exodus of Andersen partners and staff as well as clients” commenced.<sup>179</sup> This apparently was true for the other national member firms of the AAWO, even though it did not necessarily have to happen that way. Nonetheless, when, on June 15, the jury returned a guilty verdict, Arthur Andersen LLP and the rest of the AAWO began winding down their affairs.<sup>180</sup> The Court of Appeals for the Fifth Circuit affirmed the verdict, including a controversial jury instruction, in 2004.<sup>181</sup> However, in a maddening turn of events for former AAWO employees, the U.S. Supreme Court overturned the conviction in a unanimous opinion holding that the trial court’s jury instruction on the definition of the obstruction of justice statute at issue was fundamentally flawed.<sup>182</sup> None of this did any good for the firm, however, which for all intents and purposes went out of business in 2002.<sup>183</sup>

Among the now Big Four firms remaining after Andersen’s demise, the precipitous drop in consulting revenues as a percentage of total revenues was due to the divestiture of all but one of their consulting practices. In 2002, PwC sold its consulting practice to IBM.<sup>184</sup> Ernst & Young sold its consulting arm to Cap Gemini in 2000<sup>185</sup> and KPMG spun off its consulting division as BearingPoint, a company which then went public in 2001.<sup>186</sup> Thus, Deloitte Touche Tohmatsu has remained the only hold-out, shelving plans in 2003 to spin off its consulting arm,

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information. Disposal by means of the trash or recycling could potentially compromise those confidences, and so a specific mandate to shred or otherwise destroy such documents after they are no longer necessary to retain is the best course of action.

178. *Andersen II*, 544 U.S. at 702.

179. GAO STUDY, *supra* note 140, at 12.

180. *United States v. Arthur Andersen LLP (Andersen I)*, 374 F.3d 281, 284 (5th Cir. 2004); Jonathan D. Glater, *Last Task at Andersen: Turning Out the Lights*, N.Y. TIMES, Aug. 30, 2002, at C3.

181. *Andersen I*, 374 F.3d at 284.

182. *Andersen II*, 544 U.S. at 708.

183. Jonathan D. Glater, *supra* note 180.

184. Barney Jopson, *E&Y Poaches Capgemini Staff*, FIN. TIMES, Dec. 24, 2005, at 15; William M. Bulkeley and Kember Dunham, *IBM Speeds Move to Consulting With \$3.5 Billion Acquisition*, WALL ST. J., July 31, 2002, at A1.

185. Jopson, *supra* note 184, at 15.

186. Ellen McCarthy, *BearingPoint Posts Results For 2004, Details Troubles*, THE WASH. POST, Feb. 1, 2006, at D01.

Deloitte Consulting, which was to have been called “Braxton” post-spin-off.<sup>187</sup>

The audit marketplace for large publicly traded companies has been described as a “tight oligopoly” by the GAO.<sup>188</sup> In fact, the Big Four audit more than 97 percent of all publicly traded companies with sales over \$250 million.<sup>189</sup> Further, the gap in size between any of the Big Four—measured on the basis of either employees or revenues—and the next largest, second tier accounting firms is dramatic.<sup>190</sup> For example, KPMG had the lowest of the annual revenues of the Big Four for 2002 at \$3.2 billion, but the fifth largest firm in the United States, Grant Thornton, had annual revenues of only \$400 million for the same year.<sup>191</sup> Similarly, KPMG employed the lowest number of employees of the Big Four, with a total of 12,502 partners and professional staff combined in 2002, while Grant Thornton employed 2,380 partners and professional staff combined in that year.<sup>192</sup> Additionally, and critical in a globalized professional services marketplace, the Big Four dominate internationally as well.<sup>193</sup>

Based on the Hirschman-Herfindahl Index (HHI) employed by the DOJ and the FTC to determine market concentration and potential market power, the GAO determined that the market for big public company audits (i.e., audits of companies with annual sales over \$100 million) is highly concentrated.<sup>194</sup> In this segment, the HHI was 2,566 for 2002 (after Andersen’s collapse), far above the 1,800 threshold used to indicate significant potential for market power among the firms in a market segment.<sup>195</sup> However, even in 1998, after the merger that created PwC, the HHI had jumped from below the potential market power

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187. *Deloitte Consulting LLP*, HOOVER’S IN-DEPTH COMPANY RECORDS, 2006 WLNR 5445788 (Apr. 1, 2006).

188. GAO STUDY, *supra* note 140, at 16. The GAO defines the term “oligopoly” as representing any market in which the top four firms control more than 60 percent of the market and there are significant barriers to entry for other firms. *Id.*

189. *Id.*

190. *Id.* at 17 tbl.1.

191. *Id.*

192. *Id.*

193. *Id.* at 18. For example, in 2002, the Big Four audited over 80 percent of all public companies in Japan, at least 90 percent of all listed companies in the Netherlands, and virtually all of the major listed companies in the U.K. *Id.* For 2001, the Big Five audited over 80 percent of listed companies in Italy. *Id.*

194. *Id.* at 18–19.

195. *Id.*

threshold of 1800 to well above 2,000.<sup>196</sup> By a different measure, the four-firm concentration ratio,<sup>197</sup> the public company audit marketplace looks equally locked down. Whereas the top four of the Big Eight in 1988<sup>198</sup> collectively controlled 63 percent of total sales audited, in 1997 the top four of the Big Six<sup>199</sup> controlled 71 percent of that metric, and by 2002, post-Andersen, the Big Four controlled 99 percent of total sales audited.<sup>200</sup>

Yet, despite this market concentration, the GAO Study concluded that consolidation in the profession has not yet impaired price competition.<sup>201</sup> In fact, the GAO Study found that the model of a marketplace driven solely by pure price competition—essentially a commodity market—accurately predicted the actual audit marketplace, even though market participants believe that other factors such as quality, reputation, and global reach play a role.<sup>202</sup> The GAO’s model simulation further suggested that, even in a pure price competition market, a high degree of concentration could result.<sup>203</sup> The big question is whether any of the national accounting firms outside of the Big Four—such as Grant Thornton, BDO Seidman, or McGladrey & Pullen—could either through organic growth, or through merger or acquisition, begin to offer viable alternatives to the Big Four for large public company audits. Unfortunately, the answer to this seems to be no.<sup>204</sup>

Finally, the GAO Study could not reach a conclusion on whether the consolidation of the audit marketplace had negatively impacted either audit quality or auditor independence.<sup>205</sup> But this was primarily because audit quality and auditor independence are difficult to measure.<sup>206</sup> Thus,

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196. *Id.*

197. “The four-firm concentration ratio is the aggregate sales audited by the top four firms as a percentage of total sales audited.” *Id.* at 20 n.14.

198. Price Waterhouse, Coopers & Lybrand, Arthur Andersen, and KPMG.

199. Ernst & Young, Price Waterhouse, Deloitte & Touche, and Arthur Andersen.

200. GAO STUDY, *supra* note 140, at 21 fig.5.

201. *Id.* at 25–26.

202. *See id.* at 25.

203. *Id.* at 25.

204. *See id.* at 26–30, 45–52. At the same time, these smaller firms have not been without their own independence-related scandals—for example, Grant Thornton’s Italian affiliate was the external auditor for the parts of the Parmalat empire that seemed most involved in that company’s financial scandal. *See* Alessandra Galloni, David Reilly, and Carrick Mollenkamp, *Skimmed Off: Parmalat Inquiry Finds Basic Ruses At Heart of Scandal*, WALL ST. J., Dec. 31, 2003, at A1.

205. GAO STUDY, *supra* note 140, at 35.

206. *See id.* at 35–40.

without being able to objectively determine that audit quality or auditor independence have decreased over the period of accounting firm consolidation, it is difficult to assert that consolidation had any impact on either issue.<sup>207</sup> That said, the GAO Study confirmed that the behavior of the market for statutory audits is in fact consistent with a model of the market based on pure price competition.<sup>208</sup> In other words, the statutory audit is not a premium service, but rather, a commodity service.

The retrenchment of the accounting firms into audit/attest and tax practices, now nearly all devoid of serious consulting arms, presents a new environment in which the firms will have to create new business models. Only time will tell whether the Big Four will: (i) attempt to use their potential market power to increase audit fees in a bid to elevate the audit marketplace above a low (or no) margin service; (ii) begin to regrow some non-audit consulting services that allow them to still comply with the new auditor independence regime under SOX; (iii) simply accept that they are commodity service providers and compete on price; or (iv) some combination of the foregoing. But, before fully considering the implications of all of the developments in the profession since the imposition of the statutory audit under the '34 Act, it is important to trace the auditor independence rules that attempted to track these developments.

### *B. The Bramble Bush of Auditor Independence Rules*

The accounting profession in the United States operates under a mix of external and self-regulation. On the external side, state accountancy boards act as gatekeepers of the basic "CPA" designation, as discussed above, by administering certification exams and setting basic rules for the practice and conduct of CPAs certified in that state.<sup>209</sup> The SEC, and now the Public Company Accounting Oversight Board (PCAOB) created under SOX,<sup>210</sup> provide the remainder of this external regulation. Internal self-regulation comes from organizations such as the American Institute of Certified Public Accountants, (AICPA) and, until recently, the Public Oversight Board (POB)<sup>211</sup> and the Independence Standards

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207. See *id.* at 35–40.

208. See *id.* at 25–26.

209. See, e.g., National Association of State Boards of Accountancy, Licensure and Practice, [http://www.nasbatools.com/display\\_page](http://www.nasbatools.com/display_page) (last visited Aug. 6, 2006).

210. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, tit. I, 116 Stat. 745.

211. See *infra* text accompanying notes 233–240.

Board (ISB).<sup>212</sup> This Section outlines the auditor independence rules developed by each oversight body. It begins with the profession's self-regulatory mechanisms, then turns to the SEC's auditor independence rules in existence prior to SOX, and concludes with the SEC and PCAOB auditor independence rules in place after SOX.

### *1. Independence Rules Under the Accounting Profession's Self-Regulatory Mechanisms*

In response to corporate accounting scandals in the 1990s, the AICPA revised its independence rules, which are codified in its Code of Professional Conduct (Code).<sup>213</sup> Independence, as set out in Rule 101 of the Code, is a general matter for all members in public practice and not restricted to performance of statutory audits.<sup>214</sup> Rule 101 simply states that the accountant "shall be independent in the performance of professional services as required by standards promulgated by bodies designated by [the AICPA]."<sup>215</sup> Closely allied with Rule 101 is Rule 102 covering integrity and objectivity: "In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."<sup>216</sup> The standards alluded to in Rule 101 are then largely set out in a series of "Interpretations" included as part of the Code.<sup>217</sup>

The primary Interpretation (Interpretation of Rule 101) contains three sets of broad prohibitions analogous to the SEC auditor independence rules. First, independence is impaired if the accountant<sup>218</sup> has a direct or

212. See *infra* text accompanying notes 241–247.

213. AICPA CODE OF PROFESSIONAL CONDUCT (2006), available at <http://www.aicpa.org/about/code/index.htm> (last visited June 15, 2002) [hereinafter CODE]. One of the AICPA's progenitors, the American Association of Public Accountants (AAPA), established the precursor to the Code as part of its Bylaws in 1905. See RICHARD G. SCHROEDER AND MYRTLE W. CLARK, ACCOUNTING THEORY: TEXTS AND READINGS 797 (1998). This precursor simply prohibited members from allowing nonmembers to practice in the member's name and prohibited the payment of referral fees. See *id.* After the AAPA became the IPA in 1916, and then the AIA in 1917, it amended the precursor to the Code to include prohibitions on contingency fees, competitive bidding, advertising, forecasts, and substantial financial interests in clients. See *id.* Only in 1934, in response to the passage of the Securities Laws, did the AIA adopt a rule on independence. See *id.*

214. See CODE, *supra* note 213, § 101.01 (Rule 101).

215. *Id.*

216. *Id.* § 102.01 (Rule 102).

217. See *id.* § 101.02–.17.

218. Also analogous to the SEC rules, independence can be affected by a number of people

material indirect financial interest in the client, is a trustee or executor of a trust or estate that has a direct or material indirect financial interest in the client, has a co-investment with the client that is material to the accountant, or has a loan to or from the client.<sup>219</sup> Second, independence is impaired if the accountant, any partners or professional employees of his firm, his immediate family, or any combination thereof, own more than five percent of a client.<sup>220</sup> Third, independence is impaired if a partner or professional employee of the accountant's firm was contemporaneously associated with the client as a (i) director, officer, employee, or other member of management, (ii) promoter, underwriter, or voting trustee, or (iii) trustee for any pension or profit-sharing trust of the client.<sup>221</sup>

Further Interpretations discuss the effects on independence where: (a) former partners of the accounting firm go to work for the audit client,<sup>222</sup> (b) the accountant performs management functions for audit clients,<sup>223</sup> (c) accountants accept honorary directorships or trusteeships of not-for-profit organizations;<sup>224</sup> (d) accountants accept loans from financial

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besides the accountant(s) actually performing the audit engagement for the client including:

*a.* An individual on the attest engagement team; *b.* An individual in a position to influence the attest engagement; *c.* A partner or manager who provides nonattest services to the attest client beginning once he or she provides ten hours of nonattest services to the client within any fiscal year and ending on the later of the date (i) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (ii) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis; *d.* A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement; *e.* The firm, including the firm's employee benefit plans; or *f.* An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in (a) through (e) or by two or more such individuals or entities if they act together.

CODE, *supra* note 213, § 92.06.

219. *See id.* § 101.02(A).

220. *See id.* § 101.02(B).

221. *See id.* § 101.02(C).

222. *Id.* § 101.04.

223. *Id.* § 101.05. Examples of prohibited functions include: (i) authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so; (ii) preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction; (iii) having custody of client assets; (iv) supervising client employees on the performance of their normal activities; (v) determining which recommendations of the accountant should be implemented; (vi) reporting to the board of directors on behalf of management; and (vii) serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent. *Id.*

224. *Id.* § 101.06.

institution audit clients;<sup>225</sup> (e) accountants or their firms are involved in actual or threatened litigation with clients, security holders of clients, or other third party litigation;<sup>226</sup> (f) accountants invest together with an audit client in a third party (commonly called co-investments);<sup>227</sup> (g) accountants have relationships with third parties entities involved in the governance of an audit client;<sup>228</sup> (h) the accountants engage in the provision of restricted-use reports (what I have been calling private audits) for audit clients;<sup>229</sup> (i) accountants or their firm have cooperative arrangements with audit clients;<sup>230</sup> and (j) accountants and/or their firms participate in or utilize “alternative practice structures.”<sup>231</sup>

The POB oversaw the AICPA’s SEC Practice Section (SECPS)<sup>232</sup> from 1977 until the termination of POB operations in March of 2002.<sup>233</sup> While funded by the AICPA, the POB appointed its own members, set its own budget, and established its own operating procedures.<sup>234</sup> The

225. *Id.* § 101.07.

226. *Id.* § 101.08.

227. *Id.* § 101.10 (Section 101.09 is deleted in the current version of the Code).

228. *Id.* § 101.12 (Section 101.11 is deleted in the current version of the Code).

229. *Id.* § 101.13.

230. *Id.* § 101.14.

231. *Id.* § 101.16. Pursuant to many state accounting authority rules, public accounting firms may not be wholly or majority owned by non-CPAs, and in some cases, a non-CPA may not even be a partner in such a firm. *See, e.g.*, FLA. STAT. ANN. § 473.302(5) (West 2006); N.Y. EDUC. LAW § 7408 (McKinney 2006); OHIO REV. CODE ANN. § 4701.14 (LexisNexis 2006); TEX. OCC. CODE ANN. § 901.354 (Vernon 2005). A substantial portion of the rationale for CPA ownership and/or control of public accounting firms may be based on concerns over fraudulent use and misrepresentation of CPA credentials by non-CPAs. Accordingly, the AICPA’s direct prohibitions on non-CPA ownership and/or control reside in Rule 505, “Form of Organization and Name,” rather than in Rule 101, “Independence.” *See* CODE, *supra* note 211, § 505.

232. This practice section of the AICPA counts as its members essentially all AICPA members that audit publicly held companies, because such members must be part of an SECPS member firm. SEC Practice Section (SECPS), <http://www.aicpa.org/members/div/secps/index1.htm> (last visited July 9th, 2006). There are currently 1,300 SECPS member firms. *Id.* Member firms are required to submit to peer review of their practices by other accountants as well as quality control inquiry to review audit failures alleged in litigation by SEC registrants against member firms. Questions and Answers About SECPS Peer Review <http://www.aicpa.org/members/div/secps/faq/faq.htm> (last visited July 9th, 2006); Requirements of Members, <http://www.aicpa.org/members/div/secps/require.htm> (last visited July 9th, 2006). Additional membership requirements focus on improvements in the quality of audits and enhancement of auditor independence. *Id.*

233. About the POB, <http://www.publicoversightboard.org/about.htm> (last visited July 9th, 2006).

234. *See id.* The POB’s five members were primarily non-accountants, making it perhaps the most “independent” of the profession’s self-regulatory bodies, and it was primarily concerned with other aspects of statutory audits besides independence. *See* PUB. OVERSIGHT BD. ANN. REP., at 6 (1996–1997).

POB became a focus of attention in the pre-Enron debates over auditor independence when, in 2000, the AICPA threatened to cut off funding for the POB's planned special review of large SECPS member audit firms for compliance with SEC and professional auditor independence rules.<sup>235</sup> The review had been requested in 1998 by then SEC Chairman Arthur Levitt,<sup>236</sup> just as many observers were calling for a strengthened, more independent POB—with real authority over the SECPS and its members—as a central part of the solution for auditor independence problems.<sup>237</sup> In response, the POB appointed an eight member Panel on Audit Effectiveness (Panel) to thoroughly examine the current statutory independent audit system.<sup>238</sup> Despite surviving the funding scare of 2000, the POB announced in January 2002 that it would terminate its existence no later than March 31 of that year in response to a proposal by the SEC, in consultation with the AICPA and the SECPS Executive Committee, to substantially revise the accounting profession's self-regulatory system—without input from the POB.<sup>239</sup> Despite a request by then SEC Chairman Harvey Pitt for the POB to reconsider, the members of the POB asserted that continuing “would be against the interests of the public,” and that “it would mislead the public” for the POB to appear to still play a role in accountants' regulation.<sup>240</sup>

Even as the POB's Panel on Audit Effectiveness was considering independence issues as part of its overall mandate, the SEC and AICPA also jointly created the ISB as a separate entity “to establish a conceptual framework to serve as the foundation for principles-based independence standards.”<sup>241</sup> Eight members, serving on a part-time basis, comprised

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235. See Arthur Levitt, Chairman, U.S. Sec. & Exch. Comm'n, Speech at the New York University Center for Law and Business: Renewing the Covenant with Investors (May 10, 2000).

236. See Press Release, Pub. Oversight Bd., Panel on Audit Effectiveness Releases Exposure Draft (June 6, 2000).

237. Editorial, *When Financial Cops Turn Bad*, L.A. TIMES, Jan. 14, 2000, at 6, available at 2000 WLNR 8184565.

238. See Press Release, Pub. Oversight Bd., Panel on Audit Effectiveness Releases Exposure Draft (June 6, 2000). While the Chair of the Panel was Shaun F. O'Malley, former Chairman of Price Waterhouse LLP, the members were a mix of accountants and non-accountants. See *id.* The Panel issued a final report in 2000 which focused on non-audit services but offered no formal opinion as to whether any restrictions should be imposed. PUB. OVERSIGHT BD., REPORT AND RECOMMENDATIONS (2000).

239. Press Release, Pub. Oversight Bd., Panel on Audit Effectiveness Releases Exposure Draft (Jan. 20, 2002).

240. See Letter from Charles A. Bowsher, Chair of the Pub. Oversight Bd., to the Honorable Harvey L. Pitt, Chair of the U.S. Sec. and Exch. Comm'n (Jan. 31, 2002).

241. See Press Release, Independence Standards Bd., SEC Recognizes Authority of ISB to



the ISB: four were members of the public; three were senior partners of SECPS member firms; and one was to be either the President of the AICPA or his or her designee.<sup>242</sup> William T. Allen, renowned former Chancellor of Delaware's Court of Chancery, acted as the ISB's Chairman, asserting that "systematic re-consideration" of auditor independence is "essential."<sup>243</sup> However, despite this and some other promising remarks by Allen which suggested that the ISB would start with a clean slate in considering new conceptual independence frameworks,<sup>244</sup> the ISB immersed itself in the minutiae and paradigm of the current rules.<sup>245</sup> The end result was that the ISB failed to provide a sorely needed fresh look at auditor independence.<sup>246</sup> In any event, the ISB disbanded in 2001, ostensibly because it had "largely fulfilled its mission."<sup>247</sup>

## 2. SEC Independence Rules Before SOX

Over time, the SEC's default authority to define who is an "independent public accountant" allowed it to effectively regulate CPAs who wished to perform offering audits and/or the steady cash cow statutory audits—essentially all major accounting firms. But, as described in Part II.A. above, as statutory audits became a core service line for the major accounting firms, increasingly the latter found themselves providing substantial non-audit services to audit clients. This, coupled with the dramatic increase in the size and scope of non-

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Address Auditor Independence Questions (Feb. 19, 1998); see also SECURITIES AND EXCHANGE COMMISSION, COMMISSION STATEMENT OF POLICY ON THE ESTABLISHMENT AND IMPROVEMENT OF STANDARDS RELATED TO AUDITOR INDEPENDENCE § I, available at <http://www.sec.gov/rules/policy/33-7507.htm>. Neither the SEC nor the AICPA delegated any official rulemaking or other administrative capacity to the ISB, and the SEC was careful to establish that it retained all of its administrative powers with regard to definition and enforcement of regulations pertaining to auditor independence. See *id.* § II.

242. See Independence Standards Bd., Operating Policies, art. 2.

243. Press Release, Independence Standards Bd., SEC Recognizes Authority of ISB to Address Auditor Independence Questions (Feb. 19, 1998).

244. See O'Connor, *supra* note 77, at 40–50.

245. This might not be surprising, though, given that the ISB chose to "adopt[] as its guidance existing published SEC rules and interpretations." Press Release, Independence Standards Bd., SEC Recognizes Authority of ISB to Address Auditor Independence Questions (Feb. 19, 1998). Further, the ISB may have felt such a stance was necessary to ensure SEC support of its endeavors.

246. See O'Connor, *supra* note 77, at 40–50.

247. Press Release, Independence Standards Bd., Independence Standards Board to Cease Operations After Making Major Contributions To The Resolution Of Difficult And Longstanding Auditor Independence Issues (July 17, 2001).

audit services and the ongoing periodic corporate accounting scandals cited in Section II.B.1, led the SEC to develop a complex set of rules codified in Regulation S-X with which CPA firms must comply if they want to be considered “independent” (SEC Independence Rules).<sup>248</sup>

The SEC Independence Rules were substantially revised in late 2000 after an extensive and controversial debate,<sup>249</sup> but then modified again in 2003 under the requirements of SOX.<sup>250</sup> Even though SOX has much to say about auditor independence in the text of the statute itself, while also delegating significant auditor independence rulemaking authority to PCAOB,<sup>251</sup> the SEC Independence Rules remain in effect. The term “independent public accountant” is still defined through an explanation based on the peculiar nature in which the SEC originally obtained its power to define the term:

The [SEC] 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. In determining whether an accountant is independent, the [SEC] will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the [SEC].<sup>252</sup>

Thus an accountant will not qualify as independent where he either (i) will in fact be biased in conducting the audit engagement or (ii) will be deemed to be biased by a “reasonable” informed investor. The latter reflects the sharp debate over inclusion of an “appearance”

248. The codification of these rules is at Regulation S-X, 17 C.F.R. § 210.2-01(b)–(c) (2004) and Codification of Financial Reporting Policies §§ 601–02, *reprinted in* SEC Accounting Rules (CCH) ¶3872, at 3796. The Codification of Financial Reporting Policies is not intended to supplant the rules set forth in Regulation S-X, but is instead intended only to supplement those rules.

249. One of the most contentious issues was the SEC’s initial proposal to drastically curtail the type and amount of non-audit services that could be provided to audit clients. *See* SEC Revision of the Commission’s Auditor Independence Requirements, Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56; File No. S7-13-00, 65 Fed. Reg. 76,008 (Dec. 5th, 2000) [hereinafter Final Rule] (amending 17 C.F.R. §§ 210, 240 (2000)).

250. 17 C.F.R. § 210.2-01(e) (2006); *see also* SEC Strengthening the Commission’s Requirements Regarding Auditor Independence, Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68, File No. S7-49-02, 68 Fed. Reg. 6006 (Feb. 5th, 2003) (amending 17 CFR §§ 210, 240, 249, 274 (2002)).

251. *See infra* Part II.B.3.

252. 17 C.F.R. § 210.2-01(b) (2006).

independence standard along with the accepted “factual” independence standard: is it enough that auditors in fact be independent even where they might appear otherwise?<sup>253</sup> The SEC tried to introduce an “objective” appearance standard, based on the “reasonable investor” standard, because

an auditor’s independence is impaired either when there is direct evidence of subjective bias, such as through a confession or some way of recording the auditor’s thoughts, or when, as in the ordinary case, the facts and circumstances as externally observed demonstrate, under an objective standard, that an auditor would not be capable of acting without bias.<sup>254</sup>

Because this general definition of independence admits much interpretation, the SEC promulgated four guiding principles of interpretation as well as a non-exclusive compendium of actual applications of the general definition to specific circumstances<sup>255</sup>—an approach similar to the AICPA guidance on auditor independence. The four principles focus on whether an auditor’s relationship or provision of service:

creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.<sup>256</sup>

The non-exclusive compendium of specific examples or interpretations includes guidance on whether independence is impaired where: (i) the accountant<sup>257</sup> has a “direct” or “material indirect” financial

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253. See Final Rule, *supra* note 249, at IV.C.

254. *Id.*

255. See 17 C.F.R. § 210.2-01, Preliminary Note.

256. *Id.*

257. For simplification, the term “accountant” is used in this paragraph to include “immediate family members,” 17 C.F.R. § 210.2-01(f)(13) (spouse, spousal equivalent, and dependents), and “covered persons,” 17 C.F.R. §§ 210.2-01(f)(11) (partners, principals, shareholders, and employees of the accountant’s firm who: (i) are on the audit engagement team; (ii) are in the chain of command over the accountant, the audit, or will exercise quality control or oversight over the audit; (iii) have performed ten or more hours of non-audit services to the audit client during the period covered by the audit engagement (up to the date when the accountant certifies the financial statements) or will perform ten or more hours of non-audit services to the audit client on a recurring basis; or (iv) are located in the firm’s office where the accountant primarily practices for purposes of the audit).

interest in the audit client;<sup>258</sup> (ii) there is an employment relationship between the accountant and the audit client;<sup>259</sup> (iii) the accountant has any direct or material indirect business relationships with the audit client or persons associated with the audit client in a decision-making capacity;<sup>260</sup> (iv) the accountant or firm provides non-audit services to audit clients;<sup>261</sup> (v) the accountant uses a contingent fee or commission payment structure such that the accountant's financial interests are now linked with those of the audit client;<sup>262</sup> (vi) the audit engagement partner is not rotated off from the audit client engagement at regular periodic intervals;<sup>263</sup> (vii) audit or non-audit services for an audit client have not been pre-approved by the client's audit committee;<sup>264</sup> and (viii) individual auditors are compensated based on procuring non-audit services for the firm from an audit client.<sup>265</sup> The SEC also included a safe harbor under the title of "quality controls." Independence will not be deemed impaired where: (a) the accountant or related person did not know of the circumstances giving rise to the lack of independence; (b) the accountant's or related person's lack of independence was corrected as promptly as possible under the relevant circumstances upon awareness of the impaired independence; and (c) the accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the firm's practice, that the firm and its employees do not lack independence.<sup>266</sup>

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258. 17 C.F.R. § 210.2-01(c)(1).

259. 17 C.F.R. § 210.2-01(c)(2).

260. 17 C.F.R. § 210.2-01(c)(3).

261. 17 C.F.R. § 210.2-01(c)(4). The SEC contemplated a near complete ban on such services, but then backed off this position for the final version of the current auditor independence rules. See Final Rule, *supra* note 249. Nonetheless, the following services will impair independence: (i) bookkeeping or other services related to the audit client's accounting records or financial statements; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions; (vii) human resources; (viii) broker-dealer, investment adviser, or investment banking services; (ix) legal services; and (x) expert services unrelated to the audit. 17 C.F.R. § 210.2-01(c)(4)(i)–(x).

262. See 17 C.F.R. § 210.2-01(c)(5).

263. See 17 C.F.R. § 210.2-01(c)(6).

264. See 17 C.F.R. § 210.2-01(c)(7).

265. See 17 C.F.R. § 210.2-01(c)(8).

266. 17 C.F.R. § 210.2-01(d). However, where the accounting firm provides audit, review, or attest services to more than 500 companies with a class of securities registered under the '34 Act, a quality control system will not fit within the safe harbor unless it includes the following: (i) written independence policies and procedures; (ii) an automated system with respect to partners and

### 3. Regulation of Auditors After SOX

In the wake of Enron and the other corporate accounting disasters of the first few years of the 2000s, Congress hastily passed SOX.<sup>267</sup> The legislation was widely touted by its proponents as “sweeping reform,” but some commentators were far more sanguine about it.<sup>268</sup> Among many different sections of the law, a new regulatory mechanism for auditors was placed front and center. First, SOX created a new entity, PCAOB, that seems to have been modeled after the now defunct POB.<sup>269</sup> But PCAOB, as a statutory creation, arguably will have more clout and staying power than the POB.<sup>270</sup> In particular, PCAOB is empowered to: (i) register public accounting firms that prepare audit reports for issuers;<sup>271</sup> (ii) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;<sup>272</sup> (iii) conduct inspections of registered public accounting firms;<sup>273</sup> and (iv) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms.<sup>274</sup> SOX also gives express oversight and enforcement authority over PCAOB to the SEC.<sup>275</sup>

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managerial employees that identifies their investments in potentially independence impairing securities; (iii) a system that provides timely information, for all professionals, about entities from which accountants must maintain independence; (iv) an annual or ongoing, firm-wide training program about independence; (v) an annual internal inspection and testing program to monitor adherence to independence requirements; (vi) notification to all firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with independence requirements; (vii) written policies and procedures requiring that all partners and relevant persons report promptly to the firm when they become engaged in employment negotiations with an audit client, as well as that the firm immediately remove any such professional from that audit client’s audit engagement and promptly review all the work which the professional performed related to that engagement; and (viii) a disciplinary mechanism to ensure compliance with the independence rules outlined in the section. *See id.*

267. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

268. *See, e.g., generally* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915 (2003).

269. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, tit. I, 116 Stat. 745.

270. *See id.* § 101(a).

271. *Id.* §§ 101(c), 102.

272. *Id.* §§ 101(c), 103.

273. *Id.* §§ 101(c), 104.

274. *Id.* §§ 101(c), 105.

275. *Id.* § 107.

Second, SOX amends both the '33 Act and the '34 Act. Pursuant to the former, it enhances the SEC's authority to establish, authorize, or adopt generally accepted accounting principles (GAAP) for reporting under that Act.<sup>276</sup> Pursuant to the latter, it specifically prohibits certain services that registered public accounting firms can provide to audit clients.<sup>277</sup> In particular, SOX added subsection (g) to § 10A of the '34 Act, which prohibits the provision to the audit client of: (i) bookkeeping or accounting services; (ii) financial information systems design; (iii) appraisal or valuation services, including fairness opinions; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser, or investment banking services; (viii) legal services and expert services not related to the audit; or (ix) any other service that PCAOB determines, by regulation, to be impermissible.<sup>278</sup> This list looks suspiciously like the list of prohibited independence-impairing activities in the SEC Independence Rules, but not because the SEC's rules arose in the wake of the passage of SOX. Instead, these restrictions were largely in place by the 2000 revision of the SEC Independence Rules.<sup>279</sup> Thus, this is one reason why I believe that SOX delivered a little less than meets the eye.

But was there any substantive purpose behind elevating restrictions already largely existing in the 2000 version of the SEC Independence Rules to the level of statutory law? Some might argue that it increases the enforcement potential of the rules—indeed probably the main reason to make this move. When the list was only part of rules regarding independence impairing activities, it meant only that if an auditor was found to have provided those services, then the auditor would not be accepted as independent for purposes of certifying the client's annual report as part of the statutory audit.<sup>280</sup> This was bad, but did not necessarily bring any penalties and no law had been violated. But with the new statutory codification of the list, any provision of the prohibited activities to an audit client would be a violation of the '34 Act, as amended.<sup>281</sup> Plus, SOX brought audit firms that perform statutory audits

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276. *Id.* § 108.

277. *Id.* tit. II.

278. *Id.* § 201(a) (codified at 15 U.S.C.A. § 78j-1 (West Supp. 2006)).

279. The 2000 SEC Auditor Independence Rules includes everything in this list except: the "expert services not related to the audit" part of (viii). See Final Rule, *supra* note 249.

280. See Final Rule, *supra* note 249, at 1–3; see also O'Connor, *supra* note 77, at 10.

281. 15 U.S.C. § 78j-1.

directly under the government's regulatory authority (through PCAOB and registration requirements),<sup>282</sup> rather than the indirect regulation available before SOX through the SEC's power to define "independent public accountants."

SOX did add some truly new provisions to the offering and statutory audit relationship, in addition to the existing SEC Independence Rules that it elevated to the level of statutory law. First, as the impetus for one of the newly added independence impairing activities in the 2003 version of the SEC Independence Rules, auditors must receive pre-approval by the client's audit committee for any audit or non-audit services.<sup>283</sup> Second, and corresponding to another addition in the 2003 version of the SEC Independence Rules, audit partners must rotate off the audit engagement every five years.<sup>284</sup> Third, but this time not corresponding directly to anything currently in the SEC Independence Rules, auditors must prepare reports regarding execution of the offering and/or statutory audit and submit them directly to the client's audit committee.<sup>285</sup> And fourth, corresponding in part to an item in the SEC Independence Rules, an auditor may not perform a statutory audit for a client where any C-level executive or controller of the client was an employee of the auditor prior to the audit engagement and participated in any capacity in a statutory audit of that client occurring within the preceding year.<sup>286</sup>

A final relevant change imposed by SOX is codification of mandatory listing requirements to be implemented by national securities exchanges and associations, especially around the rules for audit committees of listed companies.<sup>287</sup> The main thrust here seems to be that a proper audit committee, including "independent" directors/committee members, is required to link up with the other new SOX requirement that auditors report directly to such committees.

All in all, there is a certain admirable quality to SOX's drafters' attempt to nail down auditor independence rules once and for all, make them truly enforceable, and mandate that properly constituted audit committees of the issuer control the statutory audit relationship with the

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282. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 202–206, 116 Stat. 745 (codified at 15 U.S.C. § 78j-1).

283. *Id.* § 202 (codified at 15 U.S.C. § 78j-1).

284. *Id.* § 203 (codified at 15 U.S.C. § 78j-1).

285. *Id.* § 204 (codified at 15 U.S.C. § 78j-1).

286. *Id.* § 206 (codified at 15 U.S.C. § 78j-1).

287. *Id.* § 301 (codified at 15 U.S.C. § 78j-1).

auditor. But, at the same time, this just seems to be the latest incredibly complicated mechanism to force agents such as auditors to live up to the impossible task of serving many masters and essentially acting against their interest in serving the company as client rather than shareholders and an investing public that they have no contact with.

In sum, this Part has documented the dramatic changes in the accounting profession following the passage of the federal securities laws in the 1930s and the concomitant ever-growing bramble bush of auditor independence rules and interpretations promulgated by different regulatory bodies to keep pace. Of course, this Article argues that this tangled nest of rules exists primarily because the mistaken creation of the statutory audit, in particular, put auditors in an untenable position serving many masters, while being controlled (e.g., hired, fired, and paid) by the party that is in fact the agent to be audited. The next Part, then, outlines a proposal to remedy the problem by three interdependent changes that in tandem would dramatically strengthen auditor independence by reducing or even possibly eliminating the need for it.

### III. REDUCING THE NEED FOR INDEPENDENCE: REALIGNING AUDITORS AND THEIR CLIENTS

This Article has thus far laid out a number of different events over time that, taken together, have made meaningful auditor independence impossible. Section A of this last Part of the Article brings all of these strands together to establish why auditor independence under the current system is impossible. Section B then proposes a tripartite solution whose components necessarily need to work in tandem to reestablish audits as the effective control and premium signaling mechanisms that they were intended to be.

#### *A. The Impossibility of Auditor Independence Under the Current System*

In *United States v. Arthur Young & Co.*,<sup>288</sup> the Supreme Court outlined the bind auditors find themselves in as a result of the statutory audit system:

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288. 465 U.S. 805 (1984). The issue in this case was whether auditor work-product related to assessment of the adequacy of a corporation's financial reserves set aside for contingent tax liabilities was immune to a disclosure request by the IRS during an investigation of the corporation. See *id.* at 807–08. The Court held that no such immunity—which it considered tantamount to an accountant-client privilege, itself already denied by the Court in *Couch v. United States*, 409 U.S. 322 (1973)—existed. See *Arthur Young*, 465 U.S. at 817–21.



By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>289</sup>

In essence, the Court is noting that the auditor stands in a quasi-fiduciary relationship with the public. Such a heightened sense of duty on the part of the auditor may be beneficial, but the question remains, who *is* the client? Further, are stockholders' and creditors' interests regarding a certain company always aligned? If not, who gets the greater allegiance of the auditor? Agents cannot serve two masters, at least not faithfully.<sup>290</sup> And, finally, does it even make sense to talk of the interest of the "investing public" as if it were of single mind and unitary interest? There may be times when the interests of current shareholders—say, to maintain the value of their shares in the secondary market—are contrary to the interests of potential shareholders—say, to have the most accurate information about the company to determine whether to buy its shares in the secondary market.<sup>291</sup> Regardless, the questions raised by the responsibility of the auditor to the public remain.

When courts have focused on questions of auditor liability to third parties, outside of the regulatory context of the statutory audit under federal law, most have rejected open-ended negligence liability to ill-defined sets of third party beneficiaries such as prospective investors or the "investing public."<sup>292</sup> But this exact kind of open-ended liability to

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289. *Id.* at 817–18.

290. *See, e.g.,* Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 449 (2002) (quoting Justice Harlan Stone, "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'").

291. *See generally* Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2004–2005); *see also* William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 452–62 (2003–2004); O'Connor, *supra* note 77, at 66–68.

292. *See generally* *Ultramares Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931); *Bily v. Arthur Young & Co.*, 834 P.2d 745, 746–47 (Cal. 1992). Besides New York and California, eleven other states appear to have adopted the privity approach: Alabama, Idaho, Nebraska, Pennsylvania, Arkansas, Illinois, Kansas, Utah, Delaware, Colorado, and Indiana. *Bily*, 834 P.2d at 755. Three

an ill-defined “investing public” is essentially what the statutory audit imposes on auditors. As I have written elsewhere, Congress and the SEC needed to deputize someone to help them monitor the stock offerings and financial disclosures of new and existing reporting companies—accountants more or less applied for the job and got it.<sup>293</sup> Yet, as one commentator has colorfully entitled an article on the subject, “Accountants Make Miserable Policemen,”<sup>294</sup> and they seem to have vastly underestimated the dimensions of what they took on, especially in regard to the statutory audit.<sup>295</sup>

In exchange for this new public trust, the accounting profession received a franchise of mandatory annual audit work that was nearly as good as an annuity. But what few, if any, focused on at the time was that the statutory audit was now a commodity. Where even their clients did not fully internalize this new state of affairs, it slowly became clear to both auditors and the management of their clients that the only things that really mattered were price and the ability of the auditor to handle the size and complexity of the audit.<sup>296</sup> The size issue was not negligible, and seems to have provided a counterweight that slowed—but did not stop—the slide into commodification of the audit.<sup>297</sup> Arguably, the statutory audit, combined with the remarkable growth of larger U.S. companies in the middle of the twentieth century, set up a competition where only those accounting firms that could grow quickly enough, and do so without losing all quality controls in the process, survived to audit those companies. This may be part of the story of the emergence of the Big Eight. It certainly seems to be a big part of the story in the continued consolidation of the profession in the 1980s and 1990s which resulted in

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states—New Jersey, Wisconsin, and Mississippi—appear to have adopted a foreseeability rule that would find negligence liability for essentially an unlimited class of plaintiffs, so long as those plaintiffs’ use of the audit report, whether directly or derivatively, was foreseeable by the auditor. *Id.* at 755–57. A third, compromise approach follows Section 552 of the Restatement Second of Torts by allowing for negligence liability to third parties who were clearly intended to benefit from the audit report. *Id.* at 757–59. Under the Restatement approach, general public annual audits do not create negligence liability to third parties. *Id.* at 758. Seventeen states are claimed to follow this approach: Tennessee, Florida, Georgia, Iowa, Michigan, Minnesota, Missouri, Montana, New Hampshire, Ohio, Texas, Washington, West Virginia, Louisiana, Kentucky, North Dakota, and Rhode Island. *Id.* at 758–59.

293. O’Connor, *supra* note 77, at 8.

294. Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C. J. INT’L L. & COM. REG. 725 (2003).

295. *Id.*; see also O’Connor, *supra* note 1, at 822–27.

296. See *supra* Parts I.B, II.A; see also Macey & Sale, *supra* note 77, at 1167–70.

297. See *supra* Parts I.B, II.A; see also Macey & Sale, *supra* note 77, at 1167–70.

the Big Five.<sup>298</sup> The open question is whether the current situation—in which only four firms have the capacity to audit large companies, and in which traditional economic metrics indicate a strong potential for market power—will finally tip the scales against the commodifying tendency of the statutory audit franchise. After all, government franchises can be extremely valuable if given exclusively to only one or two parties.

Further complicating matters, the Big Four seem to have significant “feed the beast” issues with regard to demanding high work and revenue flow just to maintain the enormous payrolls and overhead needed to perform audits for the largest companies. Coupled with the problem that large issuers may also wind up being one of a few, or even the only, clients for any particular audit engagement partner, the deal flow issue makes “auditor capture”—where the auditor treats management rather than shareholders or the investing public as the true client/beneficiary/principal—a very real threat.<sup>299</sup> Of course, under the current regulatory system, issuers do not have an entirely free hand to fire, or even threaten to fire, their auditors. As Professor Coffee has pointed out, changes or even just disputes with auditors must be reported by issuers in their mandatory periodic disclosure documents to the SEC, which are then made publicly available in the EDGAR system.<sup>300</sup> Thus, one could infer that any such events become public information which can tend to spook the markets for the issuer’s securities.<sup>301</sup>

But Coffee’s real insight in this area was that issuers could use the promise of granting (or alternatively the threat of withholding) lucrative non-audit services to influence the auditor without ever disagreeing with him over the statutory audit or threatening to fire him from the audit.<sup>302</sup> Thus, one might argue that the recent spin-offs and restructurings of Big Four consulting divisions are a win for the auditor and independence. However, a large number of non-audit advisory and consulting services remain within the accounting, audit, and tax divisions of these firms. For example, this was true of the Arthur Andersen Business Consulting group within the former Arthur Andersen LLP—post Andersen-

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298. See GAO STUDY, *supra* note 140, at 12–15.

299. O’Connor, *supra* note 77, at 50–52; Macey & Sale, *supra* note 77, at 1167–70.

300. Coffee, *supra* note 74, at 1411.

301. *Id.*

302. *Id.*

Consulting divorce. Given the profitability and panache of consulting services it may be hard for the Big Four to stay away from them.<sup>303</sup>

Additionally, the Big Four very much operate in an international arena.<sup>304</sup> Accordingly, much of the Big Four's growth in non-audit services before 2000 was driven by different regulatory and client expectation environments overseas. Thus, while the United States is undoubtedly one of the largest markets for the Big Four, these firms cannot exclusively focus on either the legal/regulatory system or the professional services marketplace here. Indeed some of the regulatory problems that the major firms have faced over the past decade or so may stem from focusing too much on the practice environments in other countries, or perhaps on the sort of hubris that sometimes develops within those who consider themselves "transnational" and thus largely above any particular jurisdiction's rules.

All of the foregoing suggest that the commodified audit may be with us for a while. But a commodified statutory audit—as a high volume, pure price competition business—seems a poor choice for an investor protection device. In short, the problem is that there is neither an incentive towards costly quality control measures, nor an appropriate level of focus on serving the interests of the intended third party beneficiaries such as shareholders and the investing public at large. Therefore, "independence" appears to be a countervailing rhetorical and regulatory device to try to enforce the profession's side of the bargain in which they received the statutory audit franchise. The more challenges it faces, though, the more band-aids rather than real solutions seem to be applied in response.

While at the ISB,<sup>305</sup> Professor Allen noted the instrumental value of independence. Prior to the introduction of the concept of independence in the '33 Act, its constituent components of objectivity and integrity were valued primarily for their role in the fiduciary obligations that accountants were expected to fulfill to their paying clients.<sup>306</sup> These profession-imposed duties can be illuminated by hypothetical examples from professional relationships in other fields. Objectivity would exist

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303. Jopson, *supra* note 184, at 15. Deloitte, of course, still has its consulting division intact within the firm. See Deloitte Consulting Home Page, [http://www.deloitte.com/dtt/section\\_node/0,1042,sid%253D26551,00.html](http://www.deloitte.com/dtt/section_node/0,1042,sid%253D26551,00.html) (last visited July 9, 2006); *Deloitte Consulting LLP*, HOOVER'S IN-DEPTH COMPANY RECORDS, 2006 WLNR 5445788 (Apr. 1, 2006).

304. GAO STUDY, *supra* note 140, at 13–15.

305. See *supra* note 243 and accompanying text.

306. See *supra* Part I.

for doctors and lawyers where the professional does not have interests adverse to accurately assessing the patient/client's actual medical or legal situation. Integrity would exist for doctors and lawyers where the professional resists the pressures of these conflicting interests where they do exist. "Independence" *per se* is unnecessary or irrelevant in these examples for two reasons. First, a client/patient is unlikely to hire a professional whom he believes to have a strong alliance with an individual or organization whose interests are adverse to his own.<sup>307</sup> Second, in the traditional professional services environment where doctors are simply doctors, lawyers simply lawyers, and accountants simply accountants, the "reputational capital" of the professional should be based on the public's belief that the professional acts with objectivity and integrity. Professionals who engage in reputation-depleting activities will likely find themselves with few clients over time, regardless of their "independence."

Thus it is telling that a theory of "independence" had to be introduced by the drafters of the federal securities laws in the first place. This suggests that the normal reputational capital market was somehow inadequate for the statutory audit system. The risks that reputational intermediaries incur through their activities include diminishment of their established reputations and lawsuits brought by third parties who relied on their assurances about a particular client.<sup>308</sup> The liability of the reputational intermediary for the client's acts gives credibility to the client, because the market believes that the reputational intermediary would only take on this risk if it was assured of its client's credibility.<sup>309</sup>

In light of perceived failures of this theory, however, a number of commentators have advanced criticisms.<sup>310</sup> First, as discussed above,

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307. This is underscored in the concerns over managed care where patients fear that their doctors are constrained by the HMO's rules in care decisions.

308. See Choi, *supra* note 74, at 916–17; Gilson, *supra* note 74, at 289–90; Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, *supra* note 74, at 53–54; Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, *supra* note 74, at 292–99.

309. See Choi, *supra* note 74, at 916–17; Gilson, *supra* note 74, at 289–90; Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, *supra* note 74, at 53–54; Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, *supra* note 74, at 292–99.

310. See Coffee, *supra* note 74, at 1405; John C. Coffee, *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* 10–14 (The Ctr. for Law and Econ. Studies, Columbia Law Sch., Working Paper No. 191, 2001), available at <http://ssrn.com/abstract=270944>; Brian W. Mayhew, Jeffrey W. Schatzberg & Galen R. Sevcik, *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, AUDITING J. PRAC.

accountants appear to have engaged in reputation-depleting activities to a degree not predicted by the theory.<sup>311</sup> One study notes that in a world of unambiguous accounting rules, accountants may in fact remain objective to enhance their reputation with managers and investors; yet in the world that we inhabit, ambiguous accounting rules lead accountants away from objectivity despite the damage to their reputations.<sup>312</sup> Second, the effect of ambiguous accounting rules may be compounded by: (i) the opaque nature of accounting and the audit process; (ii) collusion among auditors, management, and even the audit committee; and (iii) the divergence of audit firm interests and individual audit partner interests (e.g., the firm holds the reputational capital in the marketplace while the engagement partner's compensation and advancement rely on big fees and cross-selling services).<sup>313</sup> Thus, the engagement partner—who controls audit quality—may perceive relatively little risk in reputation-depleting activities because the firm will bear most of the reputation costs in the marketplace.<sup>314</sup> Further, the incentives to please the audit client are magnified by firm reward structures which may outweigh whatever individual reputation risk the auditor may perceive.<sup>315</sup> Third, the increased difficulty in obtaining judgments against individual audit partners or their firms<sup>316</sup> has reduced further the perceived risk to auditors for lapses of objectivity and integrity.<sup>317</sup>

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THEORY, Sept. 2001, at 49; O'Connor, *supra* note 1, at 788; O'Connor, *supra* note 77, at 65–67; see generally Partnoy, *supra* note 74; Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 219 (2000); Choi, *supra* note 74, at 916–17.

311. See generally Mayhew, Schatzberg & Sevcik, *supra* note 310.

312. See *id.*

313. See Coffee, *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting*, *supra* note 310, at 10–14.

314. See *id.*; see also Macey & Sale, *supra* note 77, at 1169–72; Partnoy, *supra* note 74, at 528–35.

315. See Macey & Sale, *supra* note 77, at 1169–72. Of course, an audit partner cannot act so egregiously that the firm is forced to fire him regardless of the fees and services he brings in, as in the case of David Duncan as the audit engagement partner at Arthur Andersen for Enron.

316. The increased difficulty to obtain judgments against auditors stems from legislation such as the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. But of course, such judgments are not impossible. Consider the case of Duncan and Arthur Andersen. See *supra*, note 315.

317. See Coffee, *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting*, *supra* note 310, at 11; see also Partnoy, *supra* note 74, at 528–35.

Reputational capital may, figuratively speaking, be like other capital. That is, properly invested it can generate interest on the principal. If so, one could imagine that firms with sufficient reputational capital could afford to engage in reputation depleting activities without suffering harm in the market. So long as these activities only deplete “interest,” the principal is not diminished.<sup>318</sup> To stretch this simile even further, one could envision this “interest” as the extra goodwill that comes with market dominance: simply being at the top enhances a firm’s reputation regardless of its current activities.<sup>319</sup>

Perhaps most important, the *Young* court’s interpretation of the statutory audit system is at odds with the reputational intermediary theory because the intended beneficiaries of the statutory audit—existing shareholders, creditors, and potential investors—do not have a role in choosing the auditor. The auditor has to be primarily concerned with his reputation among those who directly hire and fire him. This led to the traditional conflict between the interests of management and shareholders in hiring auditors. Generally speaking, management tends to seek auditors who will approve the financial statements prepared by it,<sup>320</sup> while shareholders would like to know what is really going on.<sup>321</sup> Attempts to bridge this gap, such as shifting control of the audit relationship to audit committees and introducing shareholder ratification of outside auditors, may be helping. But, as evidenced by ongoing corporate accounting crises such as the recent meltdown at Refco in which auditors seem complicit,<sup>322</sup> these reforms have not cured the problems. First, while shifting control of the audit to an audit committee comprised of outside directors, as required under SOX,<sup>323</sup> seems like a

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318. This theory seems supported by the story of Arthur Andersen in that even after a number of SEC enforcement actions and fines, together with the negative publicity that these generated, the firm still maintained its prestigious reputation. It finally took a federal criminal indictment to burn through the substantial amounts of “interest” that Andersen had accrued over its decades as a major accounting firm. But once this happened, the “principal” was spent down quickly as well and the firm collapsed as clients finally began fleeing in droves.

319. This is similar to the intuition that Federal Express, for example, generates substantial goodwill and customers just from being so visible and dominant in the overnight delivery market.

320. Coffee, *supra* note 74, at 1413–14.

321. Although, as noted above, sometimes shareholders may have as much interest as management in presenting a favorable but inaccurate picture of the company to the public to maintain share value in the secondary market.

322. See Riva D. Atlas & Jonathan D. Glater, *Mystery at Refco: How Could Such a Huge Debt Stay Hidden?*, N.Y. TIMES, Oct. 24, 2005, at C1.

323. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 202, 116 Stat. 745.

good way to take control of the audit away from the corporate insiders being monitored by the audit, there are serious problems with the model of outside directors as both good directors and proxies for shareholders.<sup>324</sup> Second, auditor ratification is a limited reform both because the shareholders are still restricted to withholding votes for the audit committee's choice of auditors and because the audit relationship will still be managed by the audit committee.

In the end, the misalignment of interests and the commodified statutory audit place too much of a burden on the dubious construct of "independence." Paradoxically, this construct could be incrementally helpful in a better aligned premium service audit system, because "independence" can be a useful proxy for the normal agent attributes we seek of objectivity and integrity. Or, at the very least, as mentioned at the outset of this Article, one certainly does not want an agent/auditor who is *dependent* on the very individuals or entities that she has been hired to audit. Thus, at the margins, one is always looking to ensure that one's agent/auditor is *independent* of the individuals and entities that she is supposed to audit. But it is wholly inadequate in the current audit system where in so many ways the auditors have been captured by the parties they are supposed to be auditing and are therefore clearly dependent on those parties. Accordingly, auditor independence is simply impossible under the current system.

### *B. A Tripartite Solution*

The review I have undertaken thus far sets the stage for a fresh approach that could finally take us out of this morass once and for all. By tracing key developments in the history of auditing and its regulation, some interesting turning points were revealed which suggest that the road not taken might have been better. Because we cannot turn back the clock and undo these decisions, we must instead consider second-best ways of remedying the problems resulting from these missteps. This Article concludes by arguing for three interrelated changes to statutory and regulatory law that, if implemented together, could effect such a remedy. Namely, the SEC should rescind the statutory audit, shareholders should be given control of an audit primarily for their benefit, and the regulation of accountants should be unified or harmonized.

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324. See, e.g., BUTLER & RIBSTEIN, *supra* note 73, at 13–15.



### 1. Dismantling the Statutory Audit

Public annual audits have not prevented any of the rashes of corporate scandals over the decades—whether those of the 1920s, when audits were a voluntary best practice, or those occurring even after the passage of SOX.<sup>325</sup> On the other hand, private audit rights and related information and control rights such as those negotiated by venture capital funds appear to work to the reasonable satisfaction of those kinds of shareholders.<sup>326</sup> At the same time, companies are tending to remain either privately held, or to return actively to privately held status because of the increasing burdens and liabilities placed on publicly held companies by the securities laws.<sup>327</sup> Thus, the benefits of the statutory audit may be largely illusory—even as the cost of compliance, both in dollars spent and the moral hazard presented to “captured” independent auditors, is substantial.

As established above, the statutory audit requirement was somewhat of a historical accident based on a hopeful, yet uncompleted, federalization of corporation law. The Roosevelt Administration wanted to replace the crazy quilt of state corporations law with a uniform federal system—modeled after the Companies Act, 1929—that might better support a rapidly mobilizing nation with increasing interstate commerce and ties.<sup>328</sup> The ‘33 Act, and to a lesser extent the ‘34 Act, were considered to be the opening salvos in the necessary barrage of legislation to achieve this goal. Thus, it was perhaps seen as little matter that a great many provisions of the Companies Act, 1929, including their audit provisions, were to be lifted out of their comprehensive and

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325. See Markham, *supra* note 294, at 794–99; *supra* Part I. Note that non-audit services still permitted after SOX continue to land some of the Big Four firms in hot water, such as KPMG’s recent brush-up with the Justice Department over its seriously flawed tax shelter practice. Floyd Norris, *When Auditors Go Astray, What Director Dares Say So?*, N.Y. TIMES, Sept. 6, 2005.

326. See, e.g., Richard J. Testa, *Venture Capital Financing*, in 1 MASSACHUSETTS BUSINESS LAWYERING 13-1, 13-15–16, 13-18–20 (Stanley Keller, ed., 1991); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1081–83 (2003). Some commentators argue, however, that these private audits have higher transaction costs for the very reason that they do have to be individually negotiated. See Hepp & Mayhew, *supra* note 39, at 12–22.

327. See generally Ehud Kamar, Pinar Karacha-Mandic & Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (Law and Econ. Workshop, U. Cal., Berkeley, Paper No. 12, 2005), available at [http://repositories.cdlib.org/berkeley\\_law\\_econ/fall2005/12](http://repositories.cdlib.org/berkeley_law_econ/fall2005/12) (finding that predicted exit of firms from capital markets due to increased costs of compliance with SOX held true for small firms but not for large firms).

328. See *supra* Part I.A.

coherent original context and dumped into narrow legislation taking on only the securities issuing part of companies and their regulation.

Further, it is interesting to note that when the federal tax laws were passed, some accountants considered whether to petition the Treasury Department to require attestation of income tax returns by accountants on behalf of filers.<sup>329</sup> However, nothing ultimately came of this.<sup>330</sup> Today, it seems quite natural that neither individuals nor companies need hire an accountant to certify their tax return. In fact, the developed practice is quite different in that accountants, when hired to do taxes, are very much seen as the taxpayer's advocate, trying to find her the best tax profile resulting in a lower tax bill (or higher refund). We could have set up our securities system this same way, with accountants simply assisting their clients to prepare and submit annual reports on Form 10-K to the SEC. The SEC could then have been given the power to initiate investigative or forensic audits where it had suspicions about a filer's report.

The underlying theme is that auditors cannot faithfully act on behalf of "many masters" any more than any other agents can.<sup>331</sup> This is acutely true where the interests of the different masters are contrary to one another. For example, compare the prospective investor who likely wants to know the most pessimistic outlook for the company before investing with the existing investor who instead likely wants the most optimistic outlook so as to inflate the company's stock price to its loftiest levels.<sup>332</sup> The end result is an auditor with seriously conflicted agency issues. Likewise, different investors might have different risk profiles, investment time horizons, and status regarding the company (e.g., manager, employee, creditor, director, shareholder).<sup>333</sup> For Professor Bratton, this means that perhaps an agency framework is simply the wrong way to go about fixing the audit system.<sup>334</sup> He argues that any sort of relational framework jeopardizes independence, and he may be right on that score. But he may also have the wrong end of the

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329. O'Connor, *supra* note 1, at 784–85 (citing JOHN L. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL 1896–1936*, at 215–16 (1969)).

330. *Id.*

331. *See generally* Seligman, *supra* note 290.

332. *See generally* Schwarcz, *supra* note 291.

333. *See* Bratton, *supra* note 291, at 452–62.

334. *Id.* at 485–89.

stick in that he often sounds as if he believes that independence is an end in itself.<sup>335</sup>

I tend to side with Professor Allen's instrumentalist view of independence.<sup>336</sup> As such, I would rather chuck independence than try to shore it up by tossing an agency approach overboard. Like Bob Dylan sang, you "gotta serve somebody,"<sup>337</sup> and so long as audits are provided on any other basis than as a gift, agency issues will arise as the auditor will be serving *someone*. Even Consumer Reports serves its constituency, as do government agencies (hence the name). Accordingly, the audit must be conceived of as an agency relationship.<sup>338</sup> Thus, the primary question is how best to align the parties' interests to maximize their benefit while, at the same time, acknowledging that this account of the audit relationship does not have to be a *pure* agency story: other interests can be taken into account to some degree.

Dismantling the statutory audit and replacing it with an audit right directly controlled by the shareholders<sup>339</sup> provides the best option for addressing the inherent conflicts presented by the independent audit. The rationale for doing so is multi-faceted. First, removing the annual statutory audit makes sense because it eliminates serious conflict of interest issues on the part of the auditor. Such a conflict exists, in part, because of the possibly diverging interests of potential and current shareholders, and in part, because of the close relationship that develops over the years between auditor and client—including the independence impairing substantial (yet low margin) annual revenues from such an audit.<sup>340</sup>

Second, the general purpose audit, such as that required by the statutory audit, is simply not a very effective device. By design, it is most emphatically *not* a forensic or investigative audit, but rather primarily ensures that the audited company's financial statements are

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335. Although I do not think that is what he really means.

336. For a fuller discussion of Professor Allen's views after he left the ISB, see generally William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L.Q. 519 (2002).

337. BOB DYLAN, *Gotta Serve Somebody*, on SLOW TRAIN COMING (Columbia Records 1979).

338. Placement of auditors into a theoretical agency framework goes back to at least the 1980s. See generally Rick Antle, *Auditor Independence*, 22 J. ACCT. RES. 1 (1984); Rick Antle, *The Auditor as an Economic Agent*, 20 J. ACCT. RES. 503 (1982).

339. See *infra* Part III.B.2.

340. See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 418–19 (2004); Macey & Sale, *supra* note 77, at 1169, 1177–78.

internally consistent and that they seem to correspond to actual fiscal health, as determined by statistical analysis based on limited investigations of corporate records.<sup>341</sup> Auditors use statistical sampling of actual records of corporate transactions to essentially “spot check” the financial statements prepared by management against the original records of underlying transactions or perhaps actual assets or inventory on hand.<sup>342</sup> Auditors do not examine each and every underlying record or asset.<sup>343</sup> Accordingly, employees or management who are intent on defrauding creditors or shareholders have the opportunity to take steps to minimize the chance that the auditor will detect the fraud. That being said, there seems to be a bit of the information technology world’s maxim of “garbage in, garbage out” to the audit process as well: the quality of answer that one gets from an audit may well depend on the kind and quality of the question asked.<sup>344</sup> Thus, in true investigative or forensic audits, the auditor is seeking evidence to answer a specific question. For example, did a particular manager improperly record certain transactions? In the end, auditors are put into a position where they may look less competent than they are because they are restricted to a relatively superficial audit in the statutory audit process despite possessing the capability to perform much more hard hitting audits such as those used in investigative or forensic audit engagements.

Third, removing the audit could help reduce the widespread misperception that registered issuers and their securities have been given some kind of government seal of approval. Obviously, this is not the case given our disclosure-based, rather than merits review-based, federal securities system.<sup>345</sup> Yet, even where investors understand that the issuer’s securities have not been approved for the soundness of the investment by the SEC, there is still a concern that the statutory audit, combined with the overall disclosure via the SEC, somehow puts the government’s imprimatur on at least the disclosure and audit.<sup>346</sup> Going back to the second reason for dismantling the statutory audit given in the preceding paragraph, the SEC’s requirement of the statutory audit may

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341. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 31 (2002); Markham, *supra* note 294, at 795–99; Bily v. Arthur Young & Co., 834 P.2d 745, 749–50 (Cal. 1992).

342. Bily, 834 P.2d at 749–50.

343. *Id.*

344. See Hepp & Mayhew, *supra* note 39, at 5–7; Markham, *supra* note 294, at 796–98.

345. O’Connor, *supra* note 1, at 797–98.

346. Markham, *supra* note 294, at 771–72, 798–99, 808.

signal to some that the audit is more effective than it really is in assuring that a company's financial statements accurately portray the fiscal state of the issuer.<sup>347</sup> In an era where even mandatory disclosure is a topic for debate,<sup>348</sup> the certification requirement for that disclosure seems even more ripe for reconsideration.

Fourth, and perhaps most importantly, the dismantling of the statutory audit would realign the normal agency incentives and relationships in private audits. Such removal would also allow the chance for the experiment in a true reputational intermediary marketplace to unfold. If the theories about reputational intermediaries are correct, then why would we not want to free those markets from the unnatural restraints of the current commodified statutory audit? As an added bonus, such a move would likely save countless amounts of money heretofore spent on counterproductive audits which do not clearly benefit anyone—that is, audits with effectively no limited target audience. Either a real market for premium signaling audits would develop, or their inability to expose serious accounting issues would become known and we would be commenting, along with Senator Gore, that, “[w]e have had all this debacle here in spite of that.”<sup>349</sup>

Finally, on a technical implementation note, this part of the solution may be the easiest to achieve. Congress has never codified the statutory audit (as opposed to the offering audit which is right in the text of the ‘33 Act). Thus, the SEC could simply rescind its regulation that annual reports under the ‘34 Act be certified by a registered public accountant. This could make heads explode, because the entire edifice of Regulation S-X and SOX have been erected in large part on the foundation of the statutory audit. But note that I am *not* arguing for removal of the offering audit—which would require an act of Congress given its codification in the ‘33 Act. Thus, Regulation S-X and SOX’s audit reforms would still apply to the offering audit. The reason why I am not advocating the removal of the offering audit is twofold. First, in the IPO context, the public often has very little intelligence about the company going public. Second, recent empirical work has shown that the offering audit has not been commodified—perhaps because it is a one-time engagement.<sup>350</sup>

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347. *Id.*

348. *See, e.g., id.* at 800–12.

349. Carter Statement, *supra* note 16, at 59–60.

350. *See generally* Ramgopal Venkataraman et al., *What if Auditing Was Not A 'Low-Margin Business'? Auditors and Their IPO Clients as a Natural Experiment* (MIT Sloan, Working Paper No. 4508-04, July 30, 2004), available at <http://papers.ssm.com/sol3/papers.cfm?>

Thus the offering audit may still retain its signaling power for companies.

In sum, the first part of the proposal discontinues the mandatory statutory audit as a transparency audit,<sup>351</sup> on the expectation that a shareholder right to a stewardship audit<sup>352</sup> will be created under state or federal law as described in the second part of the proposal.<sup>353</sup> Both public and private companies would be encouraged to voluntarily undergo a transparency audit as a premium signaling device to the market.<sup>354</sup> Ideally, these new voluntary transparency audits would conform to a set of best practices (e.g., Generally Accepted Auditing Standards (GAAS)),<sup>355</sup> but such guidelines should not be mandatory. Use of best practices rather than mandatory audit performance rules would allow for accounting firms themselves to signal their quality to the marketplace. To be clear, there are *two* levels of premium signaling to the marketplace in my proposal. First, a voluntary transparency audit allows companies to signal their quality to either the public or private markets, as appropriate. Second, the development of best practices for this transparency audit itself would allow auditors to develop a reputation for quality in the market as well as allow companies to choose what level of quality signal they want to send (as indicated by their choice of auditor and/or audit quality level).<sup>356</sup> This would put us back

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351. Using the term as defined by Hepp and Mayhew—and discussed above—to signify an audit done for benefit of third party prospective investors in the public markets (Turnbull refers to these as economic oriented, or prospectus, audits). See *supra* Part I; Hepp & Mayhew, *supra* note 39, at 3–4; Turnbull, *supra* note 36, at 2.

352. Again, using the term as defined by Hepp and Mayhew—and discussed above—to signify an audit done solely or primarily for the benefit of a principal who hires the auditor as his direct agent (Turnbull refers to these as governance oriented audits such as the statutory annual audit in the U.K.). See *supra* Part I; Hepp & Mayhew, *supra* note 39, at 3–4; Turnbull, *supra* note 36, at 2.

353. *Infra* Part III.B.2.

354. Private companies who have not registered their securities or offerings under either the '33 Act or '34 Act would of course have to take care not to appear to be offering securities for sale in violation of the '33 Act. See Securities Act of 1933, Pub. L. No. 73-22, § 5, 48 Stat. 74 (codified at 15 U.S.C. § 77e (2000)).

355. “Generally accepted audit standards” had been issued by the AICPA, but will now be under the control of the PCAOB. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 103, 116 Stat. 745.

356. The proposal’s effect on company level signaling comports well with Butler and Ribstein’s observations set out in their recent book. See BUTLER & RIBSTEIN, *supra* note 73, at 25–30. It could also strengthen beneficial competition and quality signaling efforts by stock exchanges and other capital markets in that they could require certain kinds and quality of transparency audits in their listing requirements, similar to the NYSE position in the 1920s. See *supra* Part I; BUTLER &

on the path of a real reputational marketplace for auditors that was lost over seventy years ago.

## 2. Giving Shareholders Control of the Audit

Even as one hand seems to take away in this proposal, the other gives back. States would be strongly encouraged to amend their corporations laws to give shareholders an explicit right to administer an annual audit for the shareholders' benefit, with costs charged to the company. In the alternative, and acknowledging the difficulty of amending the laws of fifty states,<sup>357</sup> the proposal could accommodate a change in the '34 Act or SEC regulations thereunder that requires a representative shareholder or shareholders, elected directly by the shareholders at large, to manage the audit relationship. This would transfer control of the audit relationship from the board's audit committee, where it sits now per SOX (as discussed above), to the shareholders themselves. Regardless of whether this shareholder audit right is located in state or federal law, it would be constructed as a stewardship audit, such that its sole purpose would be to inform the existing shareholders as they exercised their voting and ownership rights in the company.<sup>358</sup>

In my 2004 article, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*,<sup>359</sup> I concluded by suggesting that the U.S. attempt to emulate the British system on which it was ostensibly based.<sup>360</sup> Thus, this second part of my

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RIBSTEIN, *supra* note 73, at 33–34. On the other hand, Hepp and Mayhew argue that the elimination of a mandatory transparency audit might increase transaction costs for information in the marketplace. See Hepp & Mayhew, *supra* note 39, at 12–22. However, the flawed commodified statutory audits currently employed as transparency audits must bring their own heightened transaction costs which Hepp and Mayhew do not appear to address. Thus, in a world where the statutory audit is in fact a reliable, trustworthy certification and/or source of information, Hepp and Mayhew would likely be correct that such a device would reduce other information-based transaction costs in the marketplace. I am arguing that that world is impossible.

357. Although arguably not all states' laws would need to conform to this part of the proposal for it to have the desired effect. Adoption by key incorporation states such as Delaware would effectively cover a large number of corporations. Further, even as state corporations law is often characterized as a race to the bottom as each state tries to attract more corporation charters with business friendly provisions, activist and institutional shareholders could theoretically drive this the other way by choosing to invest in companies chartered in states with the proposed shareholder stewardship audit. Butler and Ribstein make similar observations about shareholder desires and state competition for shareholder protections. See BUTLER & RIBSTEIN, *supra* note 73, at 30–33.

358. See *supra* Part I.

359. O'Connor, *supra* note 1.

360. *Id.* at 825.

proposal must work together with the discontinuation of the statutory audit as a transparency audit to instead establish a stewardship audit right for shareholders. But I acknowledged in my earlier article that the British audit system might not be demonstrably better than the U.S. system.<sup>361</sup> In fact, commentators in England, Canada, and Australia have noted a problem with their respective British shareholder audit based systems—while the shareholder audit is still included in statutory corporations law in these countries, it has been co-opted such that management effectively controls the audit relationship.<sup>362</sup> Because this paradoxically put shareholders in those countries in a *worse* position with regard to the auditor than U.S. shareholders in the post-SOX system (which requires independent audit committee control of the audit relationship), jurisdictions such as Canada have moved to an audit committee system partly modeled after the U.S. system.<sup>363</sup> But, as commentators have noted, this still ignores the original strength of the British based shareholder stewardship audit right.<sup>364</sup>

Accordingly, a number of commentators in those countries are calling for a return to a true shareholder stewardship audit right, meaningfully controlled by the shareholders.<sup>365</sup> One commentator further notes that in an era of strong, motivated institutional investors, the collective action problem existing in a model based on a view of the shareholder population for a given company consisting of hundreds or even thousands of small individual shareholders is no longer as problematic.<sup>366</sup> While large institutional investors may not have the same interests as other kinds of investors,<sup>367</sup> they could still work as a useful coordinating mechanism for other investors and interests, similar to lead plaintiffs/counsel for class action law suits.<sup>368</sup> In the alternative, my

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361. *Id.*

362. See Turnbull, *supra* note 36, at 5–9; Bush, *supra* note 36, at 37–40; Anita I. Anand & Niamh Moloney, *Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives*, 5 EUR. BUS. ORG. L. REV. 223, 240–44 (2004); Anita I. Anand, *Shareholder Isolation and the Regulation of Auditors*, 54 U. TORONTO L.J. 1, 9–14 (2004).

363. See Anand & Moloney, *supra* note 362, at 226 n.5, 230–31 nn.21 & 22; Anand, *supra* note 362, at 29.

364. See Anand & Moloney, *supra* note 362, at 230–31 n.21; Anand, *supra* note 362, at 33–35.

365. See Turnbull, *supra* note 36, at 11–12; Bush, *supra* note 36, at 45–46; Anand & Moloney, *supra* note 362, at 292; Anand, *supra* note 362, at 44.

366. See Anand & Moloney, *supra* note 362, at 292; Anand, *supra* note 362, at 7–9.

367. See *supra* Part III.A.

368. See, e.g., BUTLER & RIBSTEIN, *supra* note 73, at 30. The analogy to lead plaintiffs/counsel is the author's own, not that of Butler and Ribstein.



proposal could accommodate, and benefit from, the financial statement insurance (FSI) proposals of Professors Cunningham, Ronen, and Cherny,<sup>369</sup> in that the insurance entities providing FSI could play the coordinating role for shareholders instead. Another commentator has in fact suggested that FSI could be used to realign auditors' incentives in the agency theoretic framework.<sup>370</sup> Because my proposal neither relies on, nor requires, implementation of an FSI model, I will not discuss the perceived merits and flaws of the model here.

The second part of my proposal is bolstered by the British, Australian, and Canadian commentators as they explain the current deficiencies of nominally shareholder stewardship audits in countries that followed the original British audit system. These commentators assert that such deficiencies are largely attributable to the kind of management and/or board committee capture of the audit relationship as happened in the United States. Coupled with the apparent satisfaction of venture capital and private equity investors in the direct contractual information and control systems upon which they condition their investments in portfolio companies,<sup>371</sup> it is clear that the time for a shareholder stewardship audit right has arrived.

In an alternate, counterfactual world from the one in which we actually live, the Roosevelt Administration would have been able to shepherd a more complete U.S. version of the Companies Act, 1929 through Congress.<sup>372</sup> However, just because Roosevelt was unable to complete his vision of federalizing corporate law, we should not be stuck with the historical accident of a discordant corporate/securities laws regime separated between the federal and state governments. At the same time, debates over federalizing corporate law are extensive and will not be restated here. In part, this is because I do not see my proposal as necessarily part of the federalization initiative. The shareholder stewardship audit right that I am looking for could likely be promulgated

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369. See generally Cunningham, *supra* note 340; Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39 (2002); Joshua Ronen & Julius Cherny, *Is Insurance a Solution to the Auditing Dilemma?*, NAT'L UNDERWRITER, LIFE & HEALTH/FIN. SERVICES EDITION, Aug. 12, 2002. In the FSI model, insurers would directly hire auditors to perform the statutory audit, thus removing the auditors from the management capture problems discussed in this article. See Cunningham, *supra* note 340, at 415. The FSI policies would then cover damages to shareholders arising from audit failure, thus incentivizing the insurer to closely monitor the auditors' performance. *Id.*

370. Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989, 1010-12 (2003).

371. See *supra* note 327 and accompanying text.

372. See *supra* Part I.

by the SEC as part of its power to regulate some of the governance of issuers under the '34 Act, especially after passage of SOX.<sup>373</sup> In the alternative, it could be legislated by Congress as an amendment to the '34 Act, even though some commentators argue that Congress may have already overstepped its constitutional bounds in partially pre-empting state corporate governance laws.<sup>374</sup> Thus, my proposal neither relies on nor requires a full blown federalization of corporate law.

My preference is for this shareholder stewardship audit right to be added into state corporations law with other shareholder rights. But that will only work if the right can be made meaningful and effective in a critical mass of states.<sup>375</sup> Effective state law shareholder rights are themselves the subject of an intense debate that is closely intertwined with the debate over "shareholder primacy"—a collection of positions arguing for the primacy of shareholders interests over those of other stakeholders in a corporation.<sup>376</sup> Accordingly, the challenge of amending corporations law in a number of states and making sure that such amendments are meaningful for shareholders,<sup>377</sup> may make implementation of the second part of my proposal at the state level somewhat unlikely.

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373. In fact, some commentators have argued that the full federalization of corporate governance by the SEC acting under the federal securities laws is already underway. *See, e.g.*, Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005).

374. *See generally id.*; Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003.

375. Not necessarily a majority, but rather at least major incorporation states such as Delaware, California, New York, New Jersey, and now, from what I hear anecdotally, Nevada.

376. For support of increased shareholder rights and some form of shareholder primacy, see, for example, Lucian A. Bebchuck, *Letting Shareholders Set the Rules* (Harvard John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper No. 548, March 2006), available at <http://papers.ssrn.com/abstract=891823>; Lucian A. Bebchuck, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835 (2005); and Julian Velasco, *The Fundamental Rights of the Shareholder* (Notre Dame Law Sch., Legal Studies Research Paper No. 05-16, 2006), available at <http://papers.ssrn.com/abstract=761904>. For opposition to shareholder primacy models, see, for example, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) and Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power* (UCLA Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 05-16, Aug. 2005), available at <http://ssrn.com/abstract=783044>. For arguments supporting limited shareholder voting rights, see, for example, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006).

377. For example, the amended laws do not allow recapture of the auditor similar to the experience in a number of British audit system countries. *See, e.g., supra* text accompanying notes 360–364.

In sum, the second part of my proposal essentially takes what was the transparency statutory audit (removed under the first part of the proposal) and refashions it into a shareholder stewardship audit right. This is especially true if the shareholder stewardship audit is implemented at the federal legislative or regulatory level because the two parts could be done as more or less a single act of legislation or rulemaking. Implementation at the federal level also seems to be the more plausible path at the moment as well. But making the change at the federal level seems to play into constitutional concerns over the increasing federalization of corporate governance laws. Thus, a conceptually neater, and constitutionally sounder, implementation would be at the state level. However, this path has its own challenges due to achieving reform in multiple states and some opposition to increased shareholder rights and/or primacy. Nonetheless, given the flexibility in implementation paths available for the second part of the proposal, I am confident that this reform could be achieved as well.

### *3. Unifying or Harmonizing the Licensing and Regulation of CPAs*

The final strand of the solution focuses on the hybrid federal/state/non-governmental organization regulation and association of the accounting profession. Certainly other professions, including the legal profession, have operated more or less successfully with bifurcated licensing and association functions. But most other professions, including the legal profession, have not had the same extent of simultaneous multi-party obligations foisted upon their performance of a core service line. For example, lawyers are supposed to uphold the legal system as officers of the court as they go about their client services, but this is not even close to the “public trust” that CPAs are supposed to be working on behalf of—even if it means acting against their paying client’s interests—when they perform the current statutory audits. At the same time, state boards of accountancy have been lax in monitoring CPA behavior and imposing appropriate sanctions for misbehavior.<sup>378</sup> Finally, outside of some controversial provisions in SOX itself,<sup>379</sup> lawyers are generally not subjected to the same hybrid state-federal system to which accountants are—at least CPAs who wish to perform statutory audit work.

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378. See McCoy, *supra* note 370, at 1000–02.

379. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745.

Currently, the discordance of federal-state corporate and securities laws exists in an enhanced manner for CPA regulation: not only are there separate state and federal systems regulating CPAs, but there are also important self-regulatory aspects to the CPA system—such as the AICPA—that are not part of federal, state or local governments.<sup>380</sup> As indicated above, the unified system of licensing and regulating the prestigious chartered accountants in the United Kingdom—through the royally chartered accounting societies—already existed when the drafters of the 1930s U.S. securities laws were copying selective parts of the Companies Act, 1929 to create the new U.S. laws.<sup>381</sup> But the audit provisions of the Companies Acts, 1929 arguably rested in part on the very existence of this effective, unitary regulatory mechanism for the accountants who would be hired by shareholders to actually perform the audit. Combined with the error in not taking the exact Companies Act, 1929 provision of exclusive shareholder control of auditors, this failure on the part of the drafters of the securities laws to consider fully the effects of the very different accountant regulatory systems of the two countries arguably led to the intractable problems surrounding the issue of auditor independence in the United States.<sup>382</sup>

Thus, the final part of my proposed solution calls for a unified licensing, regulation, and association body for accountants. Such a modification could still take place on the state level, and even through the existing state boards of accountancy, but the theme would be to emulate more fully the British chartered accountant model that still seems to command more respect and prestige than any of its U.S. counterparts.

#### IV. CONCLUSION

The current audit system simply does not work. The root cause of why it does not work is the misalignment of incentives in the inescapable agency model of auditing. Despite debates over shareholder primacy, federalization of corporate law, and even the mandatory disclosure system, the protection of shareholder interests must at least be on the same level as protection of other stakeholders. Otherwise, we may well see a sharp reduction in the availability of investor capital in the

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380. O'Connor, *supra* note 1, at 751–56, 822–24.

381. *Id.*

382. *Id.*

markets. Because the corporate structure is still largely a means to create a vehicle to aggregate capital for socially beneficial and desirable undertakings, the incentives for such capital aggregation need to be protected.

One of the key protections that must be afforded to those who make an investment of capital is a meaningful mechanism to monitor one's investment, not just to wait and hope for a decent, but unexplained, return on that investment. Going back to its roots in the British system, the single purpose audit can be one of the most powerful tools to monitor one's investments. In fact, private audit rights are often negotiated into everything from a venture capital financing to a copyright license (to monitor the accrual and payment of royalties). Yet, the U.S. audit system took some wrong turns as it developed and, as a result, exists currently in a state of confusion and inefficiency. A massive bramble bush of independence rules has not helped the system, nor prevented—nor perhaps even substantially limited—any of the corporate accounting scandals of the past century. Thus it is time to reconsider the system from first principles, as advocated by Professor Allen in his original work with the ISB. The position of this Article is that the players and their interests—especially the accountants—need to be realigned along basic, understandable, and enforceable agency principles.

There exist three means to achieve this, each having a different combination of the options I presented under each part of my proposal above. The first combination is perhaps conceptually neater and, I would argue, ideal: federalize corporations law, add a shareholder stewardship audit right, remove the statutory audit from federal securities law, and unify the licensing, regulation, and association of accountants in one national body (endorsed by Congress, but not necessarily a federal agency). However, this path seems to present the greatest political and constitutional challenges, making it unlikely to be adopted in full.

The other two combinations are far from perfect, yet they do a decent job of remedying the most severe shortcomings of the current system. The second combination is a mixed federal-state plan that presents challenges because it requires the passage of legislation across multiple states. Given that the UCC seems to be the only major model law widely adopted across the country, then it would appear that this second approach would risk partial adoption across the country. This is not necessarily fatal, so long as the primary charter states such as Delaware adopt the change. Further, it could be that influential shareholders such

as institutional investors push this change once it starts by choosing to invest only in companies chartered in states that have adopted the new audit right. At the same time, given the state of crisis that the audit system is in, and the spiraling costs of corporate compliance with it and other aspects of SOX, it would seem that even an uphill battle in state legislatures across the country would be better than staying with the status quo.

The third combination focuses exclusively on federal legislation and rulemaking. Congress could amend SOX and/or the '34 Act to create a shareholder stewardship audit right, while either Congress or the SEC could concurrently rescind the statutory audit through legislative or regulatory action as appropriate. This would avoid the challenge of amending state corporations law across the country. But it would leave the fairly large number of shareholders of privately held, non-registered companies without an audit right. This flaw might be ameliorated by the fact that some number of these shareholders (e.g., professional investors such as venture capitalists and hedge fund managers) have in fact already negotiated the rights they want to control their investment, often including some form of express private audit right. For the remaining shareholders, we may have to rely on the state corporations law protections for minority shareholders, or other mechanisms that tend to assist shareholders with relatively illiquid holdings in non-publicly traded companies with thin markets for those companies' securities.

Any of these combinations would go a long way to getting us out of the quagmire of auditor independence in the current audit system. On an abstract level, this proposal seeks to strengthen auditor independence—or at least the auditor integrity and objectivity that we really seek under the rubric of “independence”—by effectively reducing the need for it. “De-commodifying” the audit under my proposal would re-establish and distinguish audits as the control (stewardship) or premium signaling (transparency) mechanisms that they were intended to be. The only remaining question, then, is whether to try to complete Roosevelt's agenda from seventy years ago or continue our great experiment in corporate federalism.

