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2003]

OBSERVATIONS ON THE ROLE OF COMMODIFICATION,
INDEPENDENCE, AND GOVERNANCE IN THE
ACCOUNTING INDUSTRY

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I. INTRODUCTION

THE modern accounting industry operates more like a business than a profession. The decline in professionalism is a problem that goes beyond Enron, Worldcom, and other recent corporate scandals. The problem is deeper than the concerns about the simultaneous provision of audit services and consulting. Accountants serve a gate-keeping function. Market participants need to rely with confidence on accountants so that they can have confidence that public company financial statements accurately reflect the financial condition of the companies that issue them. Unfortunately, along with other gatekeepers, the accounting industry failed investors during the 1990s. Earnings restatements by public companies increased and investors were left wondering how so many financial documents, certified by audit firms, could be so inaccurate.

In this Article, we argue the internal corporate governance structure of the big accounting firm is fundamentally flawed, and that this flaw contributed to the current crisis of confidence in the integrity of public reporting.¹ The incentive structure within accounting firms makes it virtually impossible for auditors to be independent of significant clients like Enron.² This flaw has led to a gradual, but fundamental, change in the basic balance of economic power between accounting firms and their audit clients. In combination with the lack of accountability created by the limited liability partnership (LLP) and the regulatory commodification of audits, this flaw has led to a market in which audits are bought and sold. As a consequence, audits no longer serve the economic purpose—providing information that protects investors and leads to efficient pricing of securities—that they once served.

In well-governed businesses, accurate information reaches the relevant people within the company in a timely way. The top management of

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1. With the demise of Arthur Andersen, the remaining national accounting firms are Deloitte & Touche, Ernst & Young, Price Waterhouse Coopers, and KPMG.

2. For discussion of the detrimental incentive structure within accounting firms, see *infra* Part II.

accounting firms, however, depends almost entirely on the “lead audit partners” that they put in charge of big accounts, like Enron, for information about what their clients are doing. Often, partners in big accounting firms have only one client. Their professional success depends on the quality of the relationship they form with the top managers of the client they are auditing. In this environment, audit partners inevitably become captured by their client and are unwilling to report anything negative about those clients back to their firms.

The Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act” or the “Act”)³ reflects this concern with auditor capture by requiring auditor rotation. Section 203 of the Act prohibits audit firms from providing audit services to a public company if the lead or coordinating audit partner or the partner responsible for reviewing the audit has performed audit services for that company in each of the five previous fiscal years. It is not, however, clear that this provision will decrease the problem of auditor capture. To the extent that auditors are rotated regularly, auditor capture might be reduced. On the other hand, to the extent that partners in major accounting firms compete against one another for promotion and bonuses, and to the extent that client satisfaction is taken into account in comparing partner performance, the new auditor rotation provisions of the Act could actually exacerbate the problem of auditor capture. However, to the extent that the auditor rotation provisions in section 203 provide incentives for auditors to compete against internal rivals in order to be viewed as more flexible and “client-friendly,” the provisions could lead to more, rather than less, auditor capture.⁴ Thus, whether the provision will be efficacious will depend on the audit firms’ internal governance structures.

There was a time when the audit function was carried out in a market environment that induced high quality financial reporting. In that era, accounting firms were willing to put their seal of approval on the financial records of a client company only if the company agreed to conform to the high standards imposed by the accounting profession. Investors trusted accountants because investors knew that any accounting firm that was sloppy or corrupt could not stay in business for long. Auditors had significant incentives to do “superior audit work” because “auditors with strong reputations could command a fee premium, and high fees ‘signaled’ quality in the auditing market.”⁵

The long-term loss to an accounting firm’s reputation from doing slipshod or fraudulent work was much greater than any possible short-term gains the accounting firm might get by cutting corners. Companies that refused to comply with the auditors’ demands for transparency and

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

4. See *id.* § 203, 116 Stat. 745, 773 (codified in 15 U.S.C. § 78j-1(j)).

5. *Financial Reporting Quality: Implications of Accounting Research: Submission to the (Canadian) S. Standing Comm. on Banking, Trade and Commerce* (2002) (statement of Daniel B. Thornton) (on file with authors).

simplicity in reporting risked being dismissed by their auditors. Being fired by an accounting firm sent a negative signal to investors that often would both devastate a company and lead to the dismissal of top management. Companies wanted good audits, and were willing to incur the substantial costs necessary to obtain such audits, because they lowered the costs of capital. Outside audits sent a strong signal to investors that the company's financial house was in order. Investors would pay more for securities issued by companies that had subjected themselves to high-quality audits.⁶

Unfortunately, the balance of power between accounting firms and their clients has shifted dangerously away from the equilibrium imbedded in the market model and back in the direction of the companies the accounting firms are supposed to monitor. This change threatens to undermine the investing public's basic faith in the quality of financial reporting. If investors think that there is a risk the books do not reflect the nature of the companies' businesses and the risks associated with the investment, they will not invest in companies.

Client capture is only part of the problem. Although traditional partnership governance structures did not include an explicit duty to monitor one's peers, the fact that partners were vicariously liable for each other's professional negligence created strong incentives to monitor one another. The introduction of the LLP eliminated that incentive, leaving us to question why Arthur Andersen's top management applauded itself when it fired David Duncan, the lead partner on the Enron audit, and placed three other partners involved with the firm on administrative leave. Andersen justified firing Duncan by saying that he violated the firm's policies requiring "reasonable good judgment." But reasonable good judgment also would have required better oversight over the decisions being made by the people in charge of the Enron account by other Andersen partners. Better systems of internal monitoring and control are necessary to ensure that more Enron-type situations will not occur. Those systems, however, are compromised by the limited liability structure of Andersen and the other auditing companies.

The Securities and Exchange Commission's (SEC) long-standing notion about what constitutes "auditor independence" also has contributed significantly to the decline in the quality of the auditor-client relationship. For regulatory purposes, Arthur Andersen was said to be independent of

6. See George Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515, 517 (1969) (indicating that financial disclosure requirements of Securities Exchange Act of 1933 were unnecessary); Ross Watts & Jerold Zimmerman, *Agency Problems Auditing and the Theory of the Firm: Some Evidence*, 26 J.L. & ECON. 613, 622 (1983) (concluding that important incentive to report impropriety was effect that failure to report would have on auditors' reputation); see also Norman Macintosh et al., *Financial Accounting as Simulacrum and Hyper-reality: Perspectives on Income and Capital*, 25 ACCT., ORG. & SOC'Y 13, 29-30 (2000) (chronicling decrease in transparency of financial statements with introduction of "simulation era" accounting).

Enron because Enron accounted for less than one percent of Arthur Andersen's billings, but Enron appears to have accounted for all of the billings of the lead partner assigned to the Enron audit and for several members of his team. Worse, Arthur Andersen management in Chicago appears to have relied exclusively on its captured audit team not only for its information about the client, but also for how to report the financial information provided by the client.⁷ Unfortunately, although Andersen undoubtedly represented an extreme example of an auditing firm losing its internal controls, the general contours of the auditor-client relationship that existed between Andersen and Enron are common. The nature of this relationship suggests that investors have good reason to worry about the quality of the financial reporting provided by the national accounting firms, even when the SEC considers such firms to be "independent." In this Article, we explore each of these issues in turn.

II. PARTNERSHIPS AND THE DUTY OF CARE

The role of accountants and the nature of accounting firms have changed considerably over time. With size has come increased profits and decreased accountability. Partners in today's accounting firms are not subject to the same incentives to monitor their peers as they used to be. No matter the size of their per partner profit, partners reject the notion that "innocent" partners should have to pay for the wrongdoing of their colleagues.

When accounting firms were organized as "old-fashioned" general partnerships, partners were jointly and severally liable for the professional negligence and malfeasance of their partners. Under this system, partners had serious incentives to monitor one another. The move in organizational form from general partnerships to LLPs has reduced these incentives. Today, the limited liability form protects partners from personal liability. As a result, partners have significantly lower (and perhaps negative) incentives to monitor their peers.

The partnership entity has a long history as a form of organization. In its traditional, but increasingly extinct form, the general partnership operated in a family-like fashion. A small number of partners, who all knew each other's spouses and children, worked together and socialized together. They knew each other's clients and accounts and watched each other's practices grow.

The law governed these traditional partnerships in direct ways. For example, with respect to their peers, partners were subject to fiduciary duties of candor and loyalty. Their failure to adhere to these duties was subject to sanction. Unlike their corporate peers, however, partners were

7. For a discussion of the breakdown in Arthur Andersen's internal governance with regard to Enron, see *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 613-37 (S.D. Tex. 2002) (detailing role of Arthur Andersen in concealing Enron loss through "sham" business entities).

not subject to a fiduciary duty of care. In the corporate structure, this duty exists, in part, to solve the agency problem inherent where shareholders are passive and unable to monitor their investment. Indeed, shareholders are not allowed to make management decisions in corporations. In exchange for their investment and relinquishment of control rights, the law provides shareholders with protection from personal liability. Instead, their liability is limited to the company's assets.

The traditional partnership structure did not suffer from the same agency problem. Ownership is not separate from control in a partnership. The duty of care problem was solved by the presence of vicarious personal liability. Under the traditional structure, partners who failed to monitor their peers would be personally liable for their peers' mistakes. This liability created an incentive for partners to monitor each other. When the partnership's assets were insufficient to meet a malpractice judgment, vicarious liability put the partners' personal assets at stake. In the world of vicarious liability, homes, cars, and swimming pools were all eligible for the judgment pie.

During the 1980s, the savings and loan debacle caused a merger of the theory and the reality of partnership liability. With the savings and loan crisis, lawyers and accountants perceived for the first time significant personal risk associated with their business practices. When this occurred, partners in law firms and accounting firms joined forces to galvanize into an effective political coalition to push for protection. Beginning in Texas, these lawyers and accountants succeeded in pushing through legislation granting them the right to organize as partners and, thereby, to retain the significant tax advantages of the partnership form while eliminating vicarious liability for the professional misdeeds of their partners.

The emergence of the LLP was a major phenomenon that swept through the states. After its introduction in Texas in 1991,⁸ similar legislation was swiftly enacted in the other states. This legislative wave reflected an organized response from powerful special interests—law and accounting firms—that were being pursued in private and government actions for their roles in the savings and loan crisis of the 1980s.⁹

The LLP legislation that swept the country in the 1990s made dramatic changes in the nature of partnership governance. Where “[a] basic principle” of the general partnership requires individual partners to be liable for any partnership obligations that exceed the assets of the partnership, the LLP removes vicarious liability by limiting liability to partnership assets instead.¹⁰ Although the exact form of LLP liability varies with jurisdiction, the basic concept of eliminating personal liability for partners

8. See Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1069 (1995) (discussing origins of LLP statute).

9. See *id.* at 1069-71 (providing impetus for explosion of LLP formations).

10. See *id.* at 1067 (describing “shield of limited liability” provided by LLP statutes).

who do not control or supervise the wrongdoers is consistent across states.¹¹

The mové from general partnership form to the LLP form creates disincentives to monitor. Most LLP statutes impose personal liability on partners engaged in the supervision of the professional activities of others, eliminating the incentive to supervise one's peers. As a result, professionals who might have provided advice and counsel to their colleagues under the general partnership form may resist doing so in an LLP in order "to avoid taking on potential liability for the work."¹² However noble in intent, these provisions undermine partners' incentives to engage in supervisory work. Although the market could develop contractual devices to deal with this perverse incentive problem, there is no evidence that such solutions have been found.¹³

When combined with today's accounting firm reality—with one partner dominating the work of a client and working on an "eat-what-you-kill" basis—the outcome is perhaps even more troubling. No one supervises partners on particular client cases and partners face financial pressure to hold on to their clients. Their clients, aware of the pressure, exert their own pressure on accountants not to monitor too carefully. As a result, audits have become less reliable. This outcome may have been an unintended consequence of the move within the accounting industry from general partnership form to LLP form, but it was a consequence all the same.

III. THE SECURITIES AND EXCHANGE COMMISSION RULES REGARDING AUDITOR INDEPENDENCE

The 1933 Securities Act the "1933 Act", the 1934 Securities Exchange Act the "1934 Act", collectively known as the "Acts" and the accompanying regulations complicate the problem. The securities regulatory system relies on auditors as gatekeepers for the markets in several ways.¹⁴ For ex-

11. See ALAN BROMBERG & LARRY RIBSTEIN, LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT 17 (2001) (noting that most significant characteristic of LLP is limitation of liability provided to members).

12. Jonathan D. Glater, *Fearing Liability, Law Firms Change Partnership Status*, N.Y. TIMES, Jan. 10, 2003, at C2.

13. For example, it has been reported that after the large law firm of Weil, Gotshal & Manges converted to LLP form, the partners decided to indemnify one another when they took on work for their colleagues' clients in order to provide incentives for partners not involved in a transaction to continue to provide advice and guidance. See *id.* (discussing growing concern at several large firms that conversion to LLP would discourage cooperation among partners).

14. For general discussions on the role of gatekeepers, see Stephen Choi, *Market Lessons for Gatekeepers*, 92 Nw. U. L. REV. 916, 946 (1998) (noting intervention techniques of traditional gatekeeping); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1404-05 (2002) (discussing traditional role of gatekeepers); Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 888-96 (1984) (commenting on functioning of gatekeeper liability within corporate governance structure).

ample, the 1933 Act requires that companies selling registered securities provide an independently audited balance sheet and profit and loss statements for the previous three years or period of time for which the company has been in business.¹⁵ Strict liability and negligence-like causes of action enforce the gatekeeping role. Under the 1934 Act, companies must include independent audits in their annual reports.¹⁶ Although auditor liability under this provision is more indirect, it is still possible.¹⁷ Moreover, the reputational loss associated with litigation is, in theory at least, supposed to provide a sufficient incentive for accounting firms to act as auditors.

The role of auditors through securities regulation was, in part, easily explained through the traditional law and economics view of auditors and their reputations. Theoretically, any potential gain to an auditor from participating in a client's fraud was outweighed by the diminution in value to that auditing firm's reputation. Even though companies could audit themselves, they would choose not to do so in order to enhance the credibility of their financial disclosures. Enhanced credibility benefited companies by making it easier for them to attract outside capital. Companies needed independent audits to attract outside capital because it was widely believed that an auditing firm that discovered a problem would insist on a correction or, ultimately, fire the client.

In this environment, being fired by an accounting firm had serious implications for the client. Significantly, the consequences for the client were more serious than for the accounting firm. The accounting firm would lose only a single client and would likely gain others by virtue of the reputation enhancement resulting from manifesting its independence. Arguably, in this environment, the danger was that accounting firms would act strategically vis-à-vis their clients, perhaps by being too strict, in order to advance their own reputational interests at the expense of a client. In sum, the client-auditor balance of power tilted toward the auditor.

This theory of mutual reputation enhancement undergirds the independent audit requirements of the securities laws and regulations. For example, Regulation S-X¹⁸ sets out the parameters for auditor independence and provides that to comply with its provisions, auditors must certify or examine and report on the financial statement with an "opinion."¹⁹

15. See Securities Exchange Act of 1933, 15 U.S.C. § 77aa, Schedule A, ¶ 25 (2000) (requiring independent audit as attachment to Schedule A in registration statement).

16. See Securities Exchange Act of 1934, 15 U.S.C. § 78m(a)(2) (2000) (noting that Commission may require certification of annual books by independent accountants).

17. See, e.g., 15 U.S.C. § 78j (2000) (prohibiting use of instrumentalities of interstate commerce in deceptive sale or purchase of securities).

18. 17 C.F.R. § 210 (2003).

19. See 17 C.F.R. § 210.2-01(f).

According to Regulation S-X, the definition of an independent accountant excludes anyone who:

is not, or [where] 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 Commission 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 Commission.²⁰

Although Rule 2-01 sets out numerous specific circumstances in which the independence of an auditor would be compromised, thereby effectively prohibiting companies from using that auditor to certify their financial statements, the list in Rule 2-01 is non-exclusive. The paragraph quoted above is intended to provide guidance for all non-specified situations.

Obviously, accountants who have employment relationships with audit clients are not independent.²¹ Their independence will be deemed to be impaired both by virtue of the general guiding statement, as well as by an enumerated prohibition. There are three categories of employment relationships that are specifically prohibited. First, the regulations impair direct employment by audit clients as, for example, on a board of directors or other management aspect of the client.²² Second, accountants whose relatives are employed in an accounting role by an audit client are impaired under the independence rules.²³ Third, former employment relationships impair accountant independence.²⁴

Prior to the passage of the Sarbanes-Oxley Act, consulting arrangements did not necessarily impair auditor independence. Under section 201(a) of the Act, however, it became unlawful for an accounting firm that performs an audit for a public company to provide the company with certain types of non-audit services, such as: (a) bookkeeping or other services related to the maintenance of a company's accounting records or financial statements; (b) financial information systems design and implementation; (c) appraisal or evaluation services, fairness opinions or evaluations of contributions in-kind; (d) actuarial services; (e) internal audit out-sourcing services; (f) management functions or human resources functions; (g) investment banking services such as broker-dealer services and investment advisor services; (h) legal services and other expert services unrelated to

20. 17 C.F.R. § 210.2-01(b).

21. *See* 17 C.F.R. § 210.2-01(c)(2).

22. *See id.*

23. *See* 17 C.F.R. § 210.2-01(c)(2)(ii).

24. *See* 17 C.F.R. § 210.2-01(c)(2)(iii).

the audit; (i) other services that the Public Company Accounting Oversight Board determines by regulation to be impermissible.²⁵

Another auditor independence issue that arose in the Enron/Arthur Andersen situation was whether an internal audit relationship impairs independence for the purposes of the outside certified audit. Arthur Andersen not only performed the independent audits for Enron, but its employees prepared internal audits as well. Under Rule 2-01, accountants who performed internal audits impaired their independence only if the time spent on internal audits exceeded forty percent of the total hours that the client spent on all internal audit services in that year.²⁶

Auditor independence is also impaired when an accountant provides internal audit services, or operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements for audit clients, because the provision of such services places the auditor in the position of auditing and verifying its own work. Prior to the passage of the Sarbanes-Oxley Act, however, accounting firms could perform internal auditing services as long as they complied with certain technical conditions. First, the client's management was required to provide a written acknowledgement to the audit firm and its own audit committee or the board of directors that the client understood that it was responsible for establishing and maintaining a system of internal accounting controls to comply with section 13(b)(2) of the 1934 Act.²⁷ Second, the audit client was required to appoint a "competent employee or employees, preferably within senior management, to be responsible for the internal audit function."²⁸ Third, the client's management had to proscribe the "scope, risk, and frequency of internal audit activities . . ."²⁹ Fourth, the client's management was charged with the responsibility of evaluating the accounting firm's internal audit findings and results.³⁰ Fifth, the client's management was required to obtain reports from the accountant as part of a required evaluation of the adequacy of the audit procedures and findings.³¹ Sixth, the accountant's work could not be the primary basis for the client's evaluation of its internal audit controls.³² Assuming that the accountant and the client met the provisions of these exceptions, prior to the Sarbanes-Oxley Act, the accountant could have a role in the client's internal audit, not just the external certified audit.

In retrospect, these auditor independence rules appear deeply flawed. The rules appear to have been premised on the faulty assumption

25. See Sarbanes-Oxley Act of 2002 § 201(a) (2003) (providing unlawful non-auditing services).

26. See 17 C.F.R. § 210.2-01(c)(4)(v)(A).

27. See 17 C.F.R. § 210.2-01(c)(4)(v)(B)(1).

28. 17 C.F.R. § 210.2-01(c)(4)(v)(B)(2).

29. 17 C.F.R. § 210.2-01(c)(4)(v)(B)(3).

30. See 17 C.F.R. § 210.2-01(c)(4)(v)(B)(4).

31. See 17 C.F.R. § 210.2-01(c)(4)(v)(B)(5).

32. See 17 C.F.R. § 210.2-01(c)(4)(v)(B)(6).

that auditors and their clients had a shared incentive to maintain their independence from one another and to perform high quality work. The exceptions just described appear to be more of an historical testament to the lobbying prowess of the accounting industry than to any serious effort by regulators to protect the public from the deterioration of the traditional incentive structure that guided the accounting profession during its halcyon days.

IV. THEORY MEETS REALITY

In our view, the “independence” rules had a perverse effect on the accounting profession. Over time, the demand for audit services became a function of regulation, not reputation. An independent audit was one that was certified to have met the letter of the rigid, highly technical auditor independence rules, regardless of the true economic relationship between the auditor and its clients. Audit firm independence was confused with auditor independence.

For example, the auditor independence rules require that a certifying audit firm receive only a small portion of its revenues from the audit of any particular company. To meet this basic requirement, audit firms had to expand in order to become large enough to be qualified to audit large corporate clients. Audit firms expanded by merger in order to obtain the size and scope necessary to be considered sufficiently “independent” of their corporate clients. An unintended consequence of this aspect of the auditor independence regime has been a well-documented, dramatic increase in the levels of concentration within the accounting profession. An industry that used to be comprised of “the big thirteen” gradually became the “big eight” and is now the “big four.”

It is in this context that Arthur Andersen could claim it was independent of Enron, not because its audit team was independent in any sense, but because it had 2300 other audit clients and could plausibly claim that Enron accounted for about one percent of Andersen’s United States auditing revenue.³³ This type of analysis, of course, increases the motivation of large accounting firms to merge together in order to retain the illusion that they are independent from their clients. Moreover, this metric for independence does not assure anything more than technical firm independence. It says nothing about the independence of the audit team that actually made the relevant decisions regarding the treatment of the financial reports of audit clients. Instead, that relationship went largely unsupervised.

Furthermore, as the choice of firms decreased, public companies in need of SEC-certified audits faced a constantly diminishing set of service providers from which to choose. To meet the requirements of securities regulators, companies needed certified audits. For large companies, only

33. Andersen’s 2001 revenues, according to its now defunct website, were \$9.34 billion, and its anticipated revenue from Enron was \$100 million.

a handful of audit firms were large enough to meet the independence restrictions. As the accounting profession became increasingly cartelized, accounting firms had to rely less on their reputations as a means for attracting new business. At some point, the big eight (now four) accounting firms became indistinguishable from one another in terms of their reputations.

Note that we are not arguing simply that concentration in the accounting industry has led to a cartel that permitted accounting firms to restrict output and raise prices. Accounting firms still must compete with one another for clients just as a monopolist who wants to maximize profits has an incentive to maintain high quality. However, the combined effect of an increasingly concentrated accounting industry and the SEC's auditor independence rules, which effectively prevented companies from utilizing small, independent accounting firms, reduced the accounting firms' incentives to differentiate their products on the basis of quality. The result has been a "commodification" of the audit process.

In sum, over time, the importance of auditors' reputations decreased and, ironically, the independence rules were partially responsible for this decline. As firms merged, partly to meet the regulatory independence limitations, the number of audit firms decreased. As client choice decreased, the auditing firm incentive to protect its reputation to compete for clients also decreased. With the focus shift from the market-oriented benchmark of auditor reputation to the regulatory-oriented benchmark of auditor certification, incentives to protect reputation further decreased. The result has been a shift from the provision of professional audit services to the sale of a commodity, the certified audit.

The change in the nature of vicarious liability in auditing partnerships also contributed to the problem. As auditing partnerships, like their legal counterparts, adopted forms of business organization that included various forms of limited liability for professionals, the incentive to engage in monitoring and to maintain tight systems of corporate governance diminished simultaneously with the diminution in perceived litigation risk. In the post-LLP world, auditors are not personally liable for the negligent acts of their peers. The result has been a decrease in their incentive to monitor their peers, particularly since such monitoring, if construed as supervision, can result in liability for monitoring partners.

Client satisfaction and the concomitant client capture problem exacerbated the limited liability problem. As client satisfaction, rather than maintenance of the reputation of the accounting firm, became the paramount objective for the individual audit partners assigned to particular accounts, the interests of individual audit partners diverged from those of the firm as a whole. Unfortunately, it is those individual audit partners, rather than "the firm," who must be relied upon to make specific accounting decisions for individual clients.

When combined with the commodified nature of an audit, the result was a further decline in the quality of audits. Even though independence could be calculated on a firm-wide basis, the individuals on a particular audit team still had to satisfy their (single) client in order to advance within the firm. The value of the team auditors within their own firm was based on keeping their clients. In an audit-as-commodity world, keeping the client became less about reputation and more about keeping the client happy. Without the internal governance mechanism created by vicarious liability, then, the commodity-selling audit team became further subject to client capture.

The possibility of going in-house with an audit client arguably further exacerbates the conflicted situation. It has been estimated that more than three hundred accounting and finance positions at Enron were filled with former Arthur Andersen auditors and professionals.³⁴ Yet, a possible in-house job creates an additional incentive for auditors to care more about the care-and-feeding of their clients than about the integrity of the audit services being provided.

The growth in audit firm provision of consulting services also contributed to the problems. To the extent that audit firms enjoy higher profit margins from the provision of consulting services than from the provision of audit services, firms will use audit work as a mechanism for “opening the door” with a client for the purpose of pitching their (higher margin) consulting services.

Further, from a game-theoretic perspective, the provision of consulting services provides the opportunity for client firms to manipulate auditors by engaging in “carrot-and-stick” or “tit-for-tat” behavior.³⁵ Dishonest, unscrupulous, or even “merely” overly aggressive audit clients can reward cooperative auditors who yield to client preferences on the accounting treatment of particular matters by rewarding them with more consulting business. Similarly, additional consulting business can be withheld from auditing firms that refuse to go along with the preferences of their clients.

Clients, of course, cannot “ration” the provision of auditing services. Clients need the services and accounting firms either provide them or do not. It is, however, possible for clients to ration the amount of consulting work they allocate to auditors. This ability to ration and the power that accompanied it presumably did affect clients’ incentives. As a result, the provision of consulting services by auditors jeopardizes auditor independence.

In similar vein, Professor Jack Coffee has made some important points about how the introduction of consulting services into audit firms

34. See *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 647 (S.D. Tex. 2002) (detailing Arthur Andersen’s lack of auditor independence).

35. We are grateful to Jeff Gordon of Columbia Law School for this insight and the information in the subsequent paragraph.

contributed to the shift in the balance of power from auditors to clients.³⁶ As Professor Coffee notes, “in the real world” it is difficult for an audit client to fire its auditor because it invites “potential public embarrassment, public disclosure of the reasons for the auditor’s dismissal or resignation, and potential SEC intervention.”³⁷ Where the client is both an audit client and a consulting client, however “the client can then easily terminate the auditor as a consultant, or reduce its use of the firm’s consulting services, in retaliation for the auditor’s intransigence.”³⁸ Professor Coffee observes that this is a “low visibility response” that “requires no disclosure, invites no SEC oversight, and yet disciplines the audit firm so that it would possibly be motivated to replace the intransigent audit partner.”³⁹ The purchase of consulting services becomes leverage over audit outcomes.

Over time, all of these factors combined to make the notion of auditor “independence” a mirage at large accounting firms such as Arthur Andersen. There is no reason to believe that the model of Enron management “capturing” the individual Andersen audit team members assigned to the Enron account is not a more-or-less typical situation. Consider a few of the Enron specifics.⁴⁰

Andersen team members routinely succumbed to demands for certification from Enron management. Where the local auditors did not succumb directly, they were told to do so by their Chicago peers. When they refused, their advice was ignored. Non-Enron auditors at Andersen no longer had an incentive to check on their Enron peers. Additionally, consultants did not value the contribution of their audit peers. Andersen auditors, thus, had pressure from their client and their peers to sell the audit commodity and collect the money. After all, the client could easily purchase the commodity elsewhere.

Testimony at the Andersen criminal trial and in the Enron securities litigation supports these conclusions. For example, David Duncan testi-

36. See Coffee, Jr., *supra* note 14, 1411-12 (outlining client methods for manipulating control over auditors).

37. *Id.* at 1411.

38. *Id.* at 1412.

39. *Id.*

40. Arthur Andersen has been singled out for criticism as an outlier within the accounting profession because it has audited so many companies that have suffered from high-profile accounting frauds. For example, the complaint in *In re Enron Securities Litigation* emphasizes that Arthur Andersen “is a repeat offender with a history of failed audits, conflicts of interest and document destruction in some of the most egregious cases of accounting fraud in history.” *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 675 (S.D. Tex. 2002). The complaint recounted Andersen’s allegedly improper conduct in “Waste Management, Sunbeam Corporation, Baptist Foundation of Arizona, Colonial Realty Company, Lincoln Savings/ACC,” and asserted that Arthur Andersen had a “calous, reckless disregard for its duty to investors and the public trust for decades.” *Id.* at 675-76. An examination of the incidence of public company restatements during the period 1997-2003, however, reveals that the companies that Andersen audited were not forced to undergo more restatements than clients audited by any other accounting firm. See Proprietary Data Set (on file with Jonathan R. Macey).

fied that he rejected or ignored advice to change the accounting treatment of the Enron transactions. He needed the client to maintain his pay and status at Andersen. Other members of the Andersen audit teams testified that their negative views of Enron's accounting techniques were also ignored or mischaracterized. In some cases, advice was simply not provided to the client, presumably, out of fear that the client would hire another auditor.

In the class action civil suit against Enron, the district court found that:

A number of surviving Arthur Andersen documents reveal that Arthur Andersen knew, was concerned about, yet covered up or ignored fraudulent accounting practices by Enron. For instance, Arthur Andersen Professional Standards Group (PSG) partner Carl Bass sent an e-mail on 12/19/99 to Defendants Stewart and Neuhausen expressing opposition to Enron's accounting for LJM2 and urged that Arthur Andersen not support it. Again on 2/4/00 Bass sent another e-mail to Stewart stating that Bass thought that a particular SPE had no real substance and that he was annoyed that Enron would receive appreciation on the Enron stock that had been contributed to that SPE. That information was also sent to Bauer, Cash, and David Duncan. In an e-mail to Stewart and Neuhausen three days before, Bass had described several transactions at a different partnership and commented that "this whole deal looks like there is no substance." Later, on March 4, 2001, just before Bass was removed as PSG advisor for the Enron audit team, Bass sent Stewart another e-mail criticizing Enron's accounting for the Blockbuster and Raptor transactions, which, aggregated, constituted at least \$150 million in improperly recognized income or avoided losses at year-end 2000. The complaint asserts that David Duncan, Cash, Stewart and Neuhausen, with others, were heavily involved in structuring LJM2 and decisions to allow Enron to account improperly for the entity, as well as aware of Bass' disagreement with LJM2 accounting beginning in 2000.⁴¹

It appears that Mr. Bass was removed from the Andersen PSG when he tried to clean up the accounting problems at Enron. It also appears that Andersen suffered an internal corporate governance failure of epic proportions. The clearest manifestations of this failure were the ability of the local audit team to ignore with impunity the advice provided by higher level, more objective experts within the firm and the inability or unwillingness of these higher-level officials to assert their authority by following through to insure that their recommendations were followed.

41. See *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F.Supp. 2d 549, 679 (S.D. Texas, 2002).

Rather than fire the client to protect its reputation, Andersen decided to continue to work with Enron and manage its engagement risks. Rather than listen to Andersen partners critical of Enron's accounting manipulations, Andersen listened to Enron's management who complained about partners critical of the company's accounting choices. Rather than interpret accounting standards in a manner contradicting balance sheets providing a profitable appearance, Andersen partners succumbed to management pressure. In other words, it appears that Arthur Andersen permitted engagement partners who were the least objective to operate without any effective controls. It seems doubtful that this situation would have existed if the firm had been operating under a legal regime in which partners were jointly and severally liable for negligence, audits were tied to reputation and not sold as commodities, and auditors were truly independent.

Of course, not every firm is as fraudulent and manipulative as Enron and its audit team. Most public companies have honest managers who are firmly constrained by an independent moral commitment to obeying the law and to complying with well-established societal norms that dictate honesty and forthrightness. These societal norms manifest themselves in the corporate setting by a strong proclivity to report financial results honestly and completely. Gatekeepers, like accountants, are not needed for all firms because all (or even most) firms cannot be trusted. Rather, they are required to identify the small percentage of firms that engage in crooked conduct and to provide a credible means by which the large majority of honest firms can signal to the investing public that the performance and financial condition of the firm are what the firm's officers and directors say they are.

Thus, our point is not that corporate America is pathologically crooked. Our point is simply that the traditional economic model of the auditor-client relationship no longer fits reality. Accounting firms can no longer be trusted to place their long-term incentives to safeguard their reputations above their short-term incentives to earn audit (and consulting) fees from a particular client. Individual auditors on particular engagements were not independent because they lacked a diversified client base. The colleagues of these auditors were deprived of incentives to monitor by the shift to LLP organizational form.⁴²

42. Despite these concerns, after the collapse of Arthur Andersen, former Andersen accountants appear to have experienced little difficulty finding work at the remaining firms within the industry. This outcome is not surprising. Although the collapse of Arthur Andersen decreased the number of large accounting firms by twenty percent (from five to four), the number of public companies needing audits did not decline appreciably. These firms needed to hire experienced auditors in order to keep up with the increased workload that followed in the wake of Andersen's collapse. In other words, it seems that in today's market environment the risk that an accounting firm's reputation will decline—or even the risk that an entire firm will disappear—does not threaten the net worth of the individual accountants who work in that firm. Arguably, auditors do not even have a strong

The balance of power in the accounting industry gradually shifted from auditors who provided clients with professional services to clients who buy the audit commodity, along with a bundle of other services offered by the accounting firm. Although many factors certainly contributed to this situation, this Article has explored what we regard to be the two most significant: (a) the commodification of audits through the regulatory certification requirement and (b) the governance problems of accounting firms who lack an incentive to monitor peers due to the elimination of vicarious personal liability. Certainly, other factors contributed to the lack of accountability in audits as well, including the elimination of aiding and abetting liability and the enactments of limitations on securities litigation generally.⁴³ But, Andersen's acquiescence in Enron's aggressive accounting practices appears particularly troubling in light of the evidence that distinguished accountants within Arthur Andersen understood the problems within Enron. Stunningly, these people were unable to make themselves heard. Instead, their efforts to correct Enron's reporting deficiencies led to successful professional reprisals. Lack of liability, then, is only a partial explanation for what is a more pervasive governance problem.

V. THE SARBANES-OXLEY ACCOUNTING REFORMS

To date, the most significant set of reforms aimed at dealing with the corporate governance failures that led to Enron and similar disasters are those contained in the Sarbanes-Oxley Act, which was signed into law in July 2002. The Sarbanes-Oxley Act contains many reforms designed to regulate or eliminate conflicts of interest and related problems in the accounting profession. We examine three of these reforms here.

First, the Sarbanes-Oxley Act creates the Public Company Accounting Oversight Board (the Board).⁴⁴ The Board is charged with the task of registering the public accounting firms that audit public companies, setting standards for the reports generated in the course of those audits, inspecting registered public accounting firms, conducting investigations, and imposing sanctions on accounting industry professionals and firms. Board members must be full time. Only two members are permitted to have experience as certified public accountants. Public companies and accounting firms will pay fees that will cover the Board's expenses. Start-up funding will come from the SEC but will be reimbursed. Second, the Act establishes mechanisms that create a duty of care in audit firms and prescribes sanctions for accounting firms that fail properly to supervise their accountants, further establishing care-based duties for audit firms

incentive to monitor their colleagues in order to protect their firms from collapse because their income stream is not necessarily linked to the future of the firm.

43. For a discussion of these issues, see Coffee, Jr., *supra* note 14, at 1409-10 (studying effect of limiting auditor liability on incentive to deter).

44. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 101-109, 116 Stat. 745, 750-71 (2002).

and partners.⁴⁵ And, third, the Act articulates standards for auditor independence and specifically requires the rotation of audit partners on client accounts.⁴⁶

A. *The Accounting Oversight Board*

The Board is an entirely new nonprofit entity given significant power to regulate the role and job of accountants for public companies.⁴⁷ In addition to paying homage to the interests of investors and the public interest in the importance of accurate information in the marketplace, the clause establishing the Board specifically notes the necessity of independent audit information.⁴⁸ To achieve those goals, the legislation delineated that the Board should be composed of five full-time members, only two of which were allowed to be, or have been, certified public accountants.⁴⁹

Among other duties, the Sarbanes-Oxley Act directs the Board to establish a procedure for registering accounting firms who perform public auditing functions,⁵⁰ to adopt rules and standards regulating those firms,⁵¹ to inspect those firms⁵² and to enforce the duties of those firms, including, where appropriate, sanctions.⁵³

Registered firms agree to provide annual reports and to report as frequently as necessary to ensure their registration information is accurate.⁵⁴ In addition, registered firms agree to provide documents and other information in response to Board requests, creating a dramatically different type of review for accounting firms than under the Commission's prior independence requirements.⁵⁵ Finally, the reports are to be publicly available, allowing for some "marketplace" scrutiny of audit firm information.⁵⁶

Taken together, the provisions establishing the Board set-up, and the registration process creates, a new mechanism for accounting practices for accounting firms. The legislation makes clear that auditors are in for a new world of regulation and interference in what have traditionally been private entities organized as partnerships under state law. As this Article points out, the key question is whether the Board can replace the incentive system created by the old system of general liability for professional

45. *See id.* § 105.

46. *See id.* § 203.

47. *See id.* § 101(a).

48. *See id.*

49. *See id.* § 101(d)(1)-(2).

50. *See id.* § 101(c)(1).

51. *See id.* § 101(c)(2).

52. *See id.* § 101(c)(3).

53. *See id.* § 101(c)(4).

54. *See id.* § 101(d).

55. *See id.* § 101(b)(3).

56. *See id.* § 101(e).

negligence for accounting firm partners that was lost with the shift to the LLP organizational form.

B. *New Standards for Auditing Firms*

The second key aspect of the Sarbanes-Oxley Act is the set of requirements that, in effect, establish previously non-existent duties of care within audit firms, including language requiring the Board to establish standards for auditing, quality control, independence, and ethics. These provisions are a significant departure from existing regulations.⁵⁷ Under the legislation, the Board has the power to draft such rules and standards. We have every reason to believe that it will do so. After all, a new set of audit standards will, in part, justify the Board's existence.

Despite the power to draft new rules, the legislation also contains some specific requirements. For example, the Act requires registered audit firms to (1) prepare and maintain work papers and other information sufficient to support the conclusions in their audit reports,⁵⁸ (2) establish partner peer review and approval of such reports,⁵⁹ and (3) describe their efforts to, and corresponding results of, tests of internal company controls.⁶⁰ These provisions prescribe a duty of care previously nonexistent in the partnership form of organization and are clearly designed to address the lack of monitoring of one's peers that was a byproduct of the LLP legislation.

In addition to creating a mandate to regulate and set standards for registered audit firms, the Sarbanes-Oxley Act also provides the Board with the power to inspect those firms and make determinations about firm compliance with Board rules and standards.⁶¹ For firms auditing more than 100 issuers, inspections must occur annually,⁶² for others, inspections must occur at least every three years.⁶³ Although the Board may promulgate its own rules to govern the inspections, the legislation specifically tasks the Board with determining whether registered audit firms are in compliance with the provisions of the legislation, Commission regulations, audit firm standards, and any Board regulations.⁶⁴ Any such compliance problems must be reported to the Commission and state agencies,⁶⁵ and the Board must initiate formal investigations and disciplinary proceedings

57. *See id.* § 103.

58. *See id.* § 103(2)(A)(i).

59. *See id.* § 103(2)(A)(ii).

60. *See id.* § 103(2)(A)(iii). Sarbanes-Oxley also contains some specific reporting requirements for the registered audit firms to provide information about how they monitor professional ethics and independence and how they accept and determine whether to continue audit engagements. *See id.* § 103(2)(B)(i) & (v).

61. *See id.* § 104.

62. *See id.* § 104(a).

63. *See id.* § 104(b).

64. *See id.* § 104(c)(1).

65. *See id.* § 104(c)(2).

when appropriate.⁶⁶ The Sarbanes-Oxley Act also requires the Board to complete inspection reports and to share those reports with the Commission and the public.⁶⁷ Finally, the Act provides the Board with the powers necessary to carry out effective investigations, including the power to require testimony from audit firms and personnel,⁶⁸ demand documents and audit work papers,⁶⁹ and require testimony and documents from audit clients and others.⁷⁰

People and firms who refuse to cooperate can be barred from registered public firm status.⁷¹ If an employee of a registered audit firm is not cooperative, the Act gives the Board power to require that the firm dismiss the employee. And, when the Board determines that a knowing or intentional violation or sustained negligent conduct has in fact occurred, the Act provides a list of sanctions, ranging from a temporary suspension of registered status to civil fines.⁷² The possibility of other sanctions does, however, exist for a failure to supervise persons associated with audit firms, once again creating an enforceable duty of care.⁷³

C. *New Standards for Auditor Independence*

Finally, in Title II of the Sarbanes-Oxley Act, Congress set forth its own prescriptions for auditor independence. In addition to setting limits on the types of services that auditing firms can offer to clients,⁷⁴ the Act makes it unlawful for a registered public accounting firm to provide audit services to any client if the partner with primary responsibility for the audit or the reviewing partner has provided services to the client in each of the last five years.⁷⁵ This rotation requirement is a direct response to the client capture problem discussed in media reports and court testimony in the Enron case. It is also a less invasive solution than early calls for firm rotation. The provision is another attempt by Congress to enforce a duty of care within audit firms.

If it succeeds, it may well improve the quality and integrity of audits and audit services. Whether it will succeed, however, depends in part on firm culture and the importance of client satisfaction. If client satisfaction remains as dominant a factor in evaluating partners, rotating partners may be an insufficient response. Each partner may be willing to accept some pressure from clients in order to protect their own status within the firm, and a “whistle-blowing” partner does not stand to gain much by doing so.

66. *See id.* § 104(c)(3).

67. *See id.* § 104(g)(1)-(2).

68. *See id.* § 105(b)(2)(A).

69. *See id.* § 105(b)(2)(B).

70. *See id.* § 105(b)(2)(C).

71. *See id.* § 105(b)(3)(A).

72. *See id.* § 105(b)(3)(D).

73. *See id.* § 105(b)(6).

74. *See id.* § 201.

75. *See id.* § 203.

Thus, in a world where client satisfaction remains a dominant measure of partner performance, this provision could actually prompt a race to the bottom.⁷⁶ Moreover, clients have generally controlled the choice of audit partner. Like lawyers, clients hire their auditors. Yet, if clients can control the choice of auditor, this provision is less likely to be efficacious in eliminating client capture and the associated problems. In sum, the efficacy of the auditor rotation provision remains to be seen.

VI. CONCLUSION

For decades, the accounting profession flourished because investors demanded that the books of the companies they invested in be scrutinized by an honest, independent, outside entity. Companies used outside audits to gain leverage in capital negotiations. As long as investors believed that auditors would refuse to support inadequate accounting practices, the system continued to function. The belief in the system was so strong that the securities regulators adopted it wholesale, incorporating certification requirements and independence rules for public companies.

Along the way, however, the accounting profession forgot that companies could provide their own accounting services internally at a fraction of the cost of hiring outside auditors. Traditionally, companies hired outside accounting firms not for their technical expertise, but for their reputations for honesty and integrity. Over time, accounting firms began to market professional services beyond the audit and those services became more profitable than the audits. The securities laws and regulations, however, required independent audits, so firms continued to sell them and companies continued to buy them—from audit partners, who in the case of large accounts like Enron, had only one client. Finally, those audit firms, wielding political power and fearing litigation, lobbied successfully for limited liability and other litigation limitations, decreasing the incentive of non-audit partners to supervise the work of their peers. The result was client capture where the partner's career depended on the care and feeding of a single, demanding client who had the power to go elsewhere with few audit-firm mechanisms to balance the capture concerns.

Enron and other less spectacular failures have damaged the public's faith in the integrity of the financial markets in general and the corporate disclosure system in particular. Although the Public Accounting Board and other provisions of the Sarbanes-Oxley Act hold some promise for reforming the audit firm problems contributing to the current market difficulties, we will know that the system is fixed only when a "lead audit partner" for a big accounting firm is confident that he can fire a dishonest

76. To some extent, section 204 of Sarbanes-Oxley will help to mitigate any race to the bottom. Section 204 mandates disclosure of accounting treatment decisions and communications with management to the issuer audit committee. *See id.* § 204 (providing reporting requirements for registered public accounting firms performing audits for issuers as required by Title 15).

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client without fear that the dismissal will tank his career or, better yet, with the hope that it will enhance his career. Until then, the market will continue to feel the effect of client capture and audit firm governance problems.

