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# Gatekeeper Incentive Compensation

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# GATEKEEPER INCENTIVE COMPENSATION

SHARON HANNES\*

"...[E]xecutive compensation abruptly shifted in the United States during the 1990s, moving from a cash-based system to an equity-based system. More importantly, this shift was not accompanied by any compensating change in corporate governance to control the predictably perverse incentives... ." <sup>1</sup>

## Abstract

A massive wave of corporate fraud at the beginning of the twenty first century exposed the failure of corporate gatekeepers. The Sarbanes-Oxley legislation accordingly targeted gatekeepers, primarily auditors, by imposing strict regulation and enhanced independence guidelines. This legislative remedy is of disputable benefit while its costs have been huge. This paper maintains that a certain type of auditor incentive compensation could work better than regulation. Under such an alternative scheme, auditors would defer a portion of the payment they receive from the client firm, which would be used to purchase shares in the client after their tenure as auditor has ended. Instead of making them simply independent, this compensation structure would cause auditors to fend against inflated share prices. This type of auditor compensation could, therefore, serve to counterbalance recent trends in executive compensation that cause managers to overstate earnings. Modern accounting standards that augment management's scope of discretion make the suggested type of auditor compensation even more beneficial. Thus, the paper advocates calls for the Securities and Exchange Commission to promulgate a safe harbor that would facilitate such

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<sup>1</sup> John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REV. ECON. POL'Y 198, 202 (2005).

compensation schemes, which current independence guidelines do not allow.

## I. Introduction

The surge in executive incentive compensation is perhaps the most salient corporate phenomenon of the last fifteen years.<sup>2</sup> The old practice of compensating managers with a fixed salary and bonus has disappeared, and executive pay today consists in large part of stock options and other methods of pay-for-performance.<sup>3</sup> Pay-for-performance has also been the cause for the more than tripling of total compensation for top executives in the last fifteen years.<sup>4</sup> The change in compensation practice was no less than a revolution. While in 1985, the value of the options granted was only 8% of the average CEO total compensation,<sup>5</sup> in the period between 1992 to 1998, their value rose from 15% to 40%,<sup>6</sup> peaking in 2000 at 78% of the average total compensation.<sup>7</sup> Moreover, while in 1980, only 57% of the top executives held options in their firms, this had risen to 87% by 1994;<sup>8</sup> in the year 1999 alone, 94% of the

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<sup>2</sup> Kevin F. Hallock & Kevin J. Murphy, *THE ECONOMICS OF EXECUTIVE COMPENSATION* (K. Hallock & K. Murphy eds., 1999) (reporting a surge in the number of papers that discuss executive compensation in the 1990s).

<sup>3</sup> Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138 (1990) (reviewing U.S. executive compensation in the period from 1969 to 1983 and revealing that executives' pay is hardly keyed to the performance of the corporations they run and concluding, therefore, that U.S. managers are actually paid like bureaucrats); Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 655 (1998) (reviewing compensation practices of the 400 largest public firms and concluding that executives are no longer paid like bureaucrats and that pay is linked to performance).

<sup>4</sup> Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49 (2003) (reporting and discussing executive option grants).

<sup>5</sup> See Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 64 (1992) (an empirical study of 800 public firms).

<sup>6</sup> See Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209 (2002); Todd Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 131 (2000); Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 719 (1995) (an extensive review of executive compensation practices among 1000 large public firms, revealing, among other issues, that options accounted for 23% of total executive compensation, averaging \$1,300,000 per each of the top-five paid executives).

<sup>7</sup> See Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 290 tbl. 4 (2005) (reporting compensation figures for S&P 500 firms); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 848 (2002) (discussing growth in executive compensation).

<sup>8</sup> See Hall & Liebman, *supra* note 3, at 663.

largest companies granted options to their executives.<sup>9</sup>

While the new practice carries certain benefits,<sup>10</sup> it is also easy to see that it produces unfavorable incentives that encourage securities fraud or at least sugarcoating of financial reporting.<sup>11</sup> Stock-based compensation typically amounts to a sizable proportion of executives' assets portfolios, and when the corporation's stock is overvalued by the market, managers can reap a sizable profit.<sup>12</sup> For this reason, the practice of paying managers with stock and stock options has been described as "throwing gasoline" onto the market "fire."<sup>13</sup> Given these circumstances, it was only a matter of time until crises would arise.

It is hardly surprising, therefore, that the twenty-first century has witnessed a series of unprecedented financial debacles involving such American giants as Enron, Global Crossing, WorldCom, and Tyco. This has proved, however, to be only the tip of the iceberg of a huge phenomenon of misreporting by many firms,<sup>14</sup> one of several factors that led to the

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<sup>9</sup> See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. ECON. 3, 4 (2002) (reviewing executive compensation in the largest 500 U.S. firms); see also Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1888 (2000) (reporting that, in 1996, in a sample of 250 large public firms, 90% of the companies used stock-option compensation).

<sup>10</sup> See the discussion below in *infra* note 41 and in the text above.

<sup>11</sup> See, e.g., Shane A. Johnson et al., *Executive Compensation and Corporate Fraud* (2006) (unpublished manuscript), available at <http://ssrn.com/abstract=395960> (showing that firms charged with accounting fraud had more executive stock-based compensation than found for a matching sample of firms unsuspected of securities fraud); Jap Efendi, Anup Srivastava & Edward P. Swanson, *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667 (2007) (showing that firms that restated their financial statements had more executive stock-based compensation than found for a matching sample of firms that did not restate their earnings). Additional evidence discussed below in *infra* Part II. The view that equity-based compensation encourages financial misreporting is also widespread amongst public and within financial circles. See, for example, the statement made by Senator William Gramm linking the accounting misconduct of Enron's managers to their compensation scheme, 148 Cong. Rec. S6628 (daily ed. July 11, 2002).

<sup>12</sup> See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 174-79 (2004) (explaining the common practices of executive stock-option grants, vesting, and exercise).

<sup>13</sup> Michael C. Jensen, *Agency Cost of Overvalued Equity*, 34 FIN. MGMT. 5 (2005).

<sup>14</sup> According to the Corporate Fraud Task Force, since the passage of the Sarbanes-Oxley Act, no less than 214 CEOs, 53 CFOs, and 23 corporate counsels and attorneys have been convicted in the U.S. for corporate fraud. Wrongdoing is, of course, a much larger phenomenon than these conviction cases are directly indicative of. See Kate Plourd, *Quick: How Many CFOs Have Been Convicted?*, CFO.COM, July 19, 2007, at [www.cfo.com/article.cfm/9502734/c\\_9512631?f=home\\_todayinfinance](http://www.cfo.com/article.cfm/9502734/c_9512631?f=home_todayinfinance); see also SECOND YEAR REPORT TO THE PRESIDENT: CORPORATE FRAUD TASK FORCE (July 20, 2004), available at [http://www.usdoj.gov/dag/cftf/2nd\\_yr\\_fraud\\_report.pdf](http://www.usdoj.gov/dag/cftf/2nd_yr_fraud_report.pdf).

securities market bubble and its subsequent bursting at the beginning of the century.<sup>15</sup> As explained above, managers, especially those armed with options and other types of stock-based compensation, simply benefit from misreporting that can artificially inflate the market value of their enterprise, even if the stock prices eventually fall.<sup>16</sup> The Sarbanes-Oxley 2002 corporate reform act targeted this very conflict of interest between managers and shareholders, introducing a variety of mechanisms aimed at improving transparency and accuracy of financial reporting.<sup>17</sup> The legislation also intensively engages in regulation of third parties such as external auditors and legal counsel who serve as gatekeepers and may deflect misreporting.<sup>18</sup> Included amongst the Sarbanes-Oxley Act's measures are more stringent disclosure rules,<sup>19</sup> mandatory managerial certification of periodic reports, greater

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<sup>15</sup> Eric F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393 (2006) (demonstrating with a historical survey that stock market bubbles almost invariably coincide with securities fraud epidemics).

<sup>16</sup> For the robust empirical evidence, see *infra* Part II.b.

<sup>17</sup> Sarbanes-Oxley, Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (codified at U.S.C. §§ 15, 18). Stephen M. BAINBRIDGE, *THE COMPLETE GUIDE TO SARBANES-OXLEY*, UCLA School of Law, Law-Econ Research Paper No. 07-17 (2007), explains that the Sarbanes-Oxley Act has had the biggest impact on American business of any federal securities legislation since the New Deal. Academia and market reactions to the Act were mixed. On the one hand proponents argue that it improved transparency and accuracy of financial reporting. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915 (2003); John C. Coates, IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91 (2007); Stephen Wagner & Lee Dittmar, *The Unexpected Benefits of Sarbanes-Oxley*, HARV. BUS. REV., Apr. 2006, at 133. On the other hands opponents claim that the Act unjustifiably increases the regulatory burden on public firms (see, e.g., Harvey Coustan, Linda M. Leinicke, W. Max Rexford & Joyce A. Ostrosky, *Sarbanes-Oxley: What It Means to the Marketplace*, 197 J. ACCT. 43 (2004); Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003) ("[T]he Act also seems to contemplate 'real time' disclosure of material business developments even in circumstances where premature disclosure may well sacrifice shareholder value for very little gain in capital market efficiency. This I call 'price-perfecting disclosure' and believe that eliminating the board's discretion to this extent may be unwise..."); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) ("SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases.")). For the mixed response to the Act in the marketplace, see, e.g., John S. Lublin & Kara Scannell, *Critics See Some Good From Sarbanes-Oxley*, W.S.J., July 30, 2007, at B1 (citing market participants on the fifth anniversary of the Act and recognizing some of its benefits although viewing it largely as excessively costly).

<sup>18</sup> Reinier Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1983).

<sup>19</sup> For instance, increased disclosure of off-balance sheet transactions. Sarbanes-Oxley Act § 401(j), 2002 U.S.C.C.A.N. (116 Stat.) at 786 (codified at 15 U.S.C. § 78m(j)).

board independence with enhanced financial understanding,<sup>20</sup> and, perhaps most importantly, improved auditor oversight and independence requirements.<sup>21</sup>

This paper takes a different approach to the problem of managerial bias and suggests a radical transformation in current methods of compensating gatekeepers, particularly external auditors.<sup>22</sup> One scholar has described the prevailing practices of executive stock-based compensation as a major development that corporate governance practices have failed to respond to thus far.<sup>23</sup> The transformation of gatekeeper compensation practices proposed here can constitute just such a needed response for the new practices of executive compensation. The gist of this proposed compensation scheme is to combat the noted conflict of interest between managers and shareholders by creating incentives for auditors to fend off any misleading reporting by the corporation. Accordingly, in order to counter managers' incentives to inflate share prices, a properly designed stock-based compensation plan for gatekeepers would create incentives for the latter to deflate share prices.<sup>24</sup>

An old and well-sustained principle of corporate governance precludes

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<sup>20</sup> Perhaps the most salient requirement in this area is that all listed companies create audit committees comprised solely of independent directors. Sarbanes-Oxley Act § 301, 2002 U.S.C.C.A.N. (116 Stat.) at 775-77 (codified at 15 U.S.C. § 78j-1(m)).

<sup>21</sup> Among the steps taken is the creation of a public board to oversee auditors. Sarbanes-Oxley Act § 101, 2002 U.S.C.C.A.N. (116 Stat.) at 750-53 (codified at 15 U.S.C. § 7211). See also discussion on the auditor independence requirements at Part III c. *infra*.

<sup>22</sup> There have been discussions in the recent literature of the proposition of offering rewards to gatekeepers that would encourage them to fight fraud. The present paper diverges from these discussions in its proposal to use a novel equity-based system to the same end. For other discussions on this issue, see, e.g., Assaf Hamdani & Reiner Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677 (2007); LAWRENCE A. CUNNINGHAM, BEYOND LIABILITY: REWARDING EFFECTIVE GATEKEEPERS (GWU Legal Studies Research Paper No. 359, 2007), available at <http://ssrn.com/abstract=1022360> (suggesting rewards to promote effective capital market gatekeeping in lieu of penalties).

<sup>23</sup> See Coffee, *supra* note 1, at 202 ("when one pays the CEO with stock options, one creates incentives for short-term financial manipulation and accounting gamesmanship").

<sup>24</sup> There is some similarity to the wide-spread usage of short sales in the markets today. Short sales make markets more efficient by allowing every trader with negative expectations about the market or a certain stock to manifest their expectation by selling shares. The importance of this practice is now well-recognized and most recently led to the relaxation of previous restrictions on short sales. Thus, on July 6, 2007, the SEC revoked Rule 10a-1 of the Securities Exchange Act of 1934, commonly known as the uptick rule, which prevented short sales in a declining market. See the SEC concept release, Short Sales, Release No. 34-42037, File No. S7-24-99, at [http://www.sec.gov/rules/concept/34-42037.htm#P49\\_9887](http://www.sec.gov/rules/concept/34-42037.htm#P49_9887).

compensating auditors with shares in the corporation they work for.<sup>25</sup> This principle emanates from the ideal of auditor independence. However, independence may not be sufficient to ensure that auditors counter and thwart corporate fraud. So-called independent auditors receive their compensation from the corporations they are supposed to scrutinize. While I do believe that reputation concerns as well as professional ethics and legal liability underlie the crucial gatekeeper role played by these auditors, the infamous Arthur Anderson case demonstrated the potential inadequacy of these constraints.<sup>26</sup> More generally, since accounting and auditing standards involve many uncertainties and a fair amount of unpublicized information, the quality of much of the auditor's work is often unverifiable and unobservable and, consequently, also protected from legal penalty and even reputation backfire. This paper argues, however, that there is a way to induce auditors to perform their task well, even when their efforts are unobservable to outsiders. This would entail stock-based compensation but not the type that originally led to the legal prohibition on compensating auditors with stock or any type of contingent fee arrangement. Whereas stock-based compensation for managers may lead them to pursue and back artificially inflated stock prices, my proposed scheme for auditors would have the opposite effect, as this paper explains. Negotiations between the auditor and client firm are conducted behind closed doors, and both sides have a significant extent of private knowledge regarding the firm, as auditors conduct an intensive auditing procedure. The private and sophisticated nature of this interaction and the imprecise nature of the accounting profession to a great degree shield the

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<sup>25</sup> Regulation S-X, Rule 2-01, 17 C.F.R. 210.2-01 (2006). See also Ronald A. Dye et al., *Contingent Fees for Audit Firms*, 28 J. ACCT. RES. 239 (1990) (developing the moral hazard argument against contingent auditor fees). See also Sankar De & Pradyot K. Sen, *Is Auditor Moral Hazard the Only Reason to Ban Contingent Fees for Audit Services?*, 1 INT. J. AUDIT. 175 (1997) (discussing reasons for the legal prohibition on auditor contingent fees).

<sup>26</sup> See Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1188-89 (2007); Eric L. Talley, *Symposium: Litigation Reform Since the PSLRA: A Ten-Year Retrospective: Panel Two: Sarbanes-Oxley Accounting Issues: Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1663-64 (2006).

auditor from reputation effects and legal liability. This reality makes the need for adequate structuring of auditor incentives even more acute, something that has only intensified since executives began to receive compensation in the form of stock options and the like. Indeed, the idea is not only to make auditors independent of management but to also make them dependent on the fate of future shareholders who may be harmed by earnings manipulation and bad-faith disclosure. The resulting recommendation is that the regulator (the Securities and Exchange Commission) creates a safe harbor for a novel stock-based compensation scheme for auditors.

There are a few ways to craft a stock-based compensation plan for auditors that would create incentives to fight inflated share prices.<sup>27</sup> In this paper, I introduce one possible type of plan that would cause auditors to share the fate of future shareholders who are at the risk of buying overpriced shares. To illustrate, suppose that a corporation announces that it has hired a new auditor with a compensation agreement under which the latter (or, alternatively, the lead audit partner) agrees to work for the corporation for a maximum specified period (say, 3 years),<sup>28</sup> during which the auditor (or the lead audit partner) will defer a certain fraction of its compensation (say, 50%) until it signs and issues the last audit report for the client. The deferred compensation will be held throughout the period by a trustee who will use the money to buy for the auditor (or the lead audit partner) shares in the firm on the

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<sup>27</sup> Besides the type of plan discussed in this paper, one could also consider other schemes including granting put options to auditors or placing them in a short position on the client's stock. Each type of plan has a different payout structure but they all create incentives to counter inflated share prices (and favor deflated prices). Similar to the market decision to grant executives certain types of stock-based compensation (including options, restricted stock, SARs, RSUs etc), the market should also make a decision on the certain type or mixture of auditor stock-based compensation. However, since stock-based compensation for auditors is currently illegal, the SEC must craft a safe harbor to allow the usage of such plans. Given this challenge I consider it advantageous from a political economy perspective to pursue the type of plan I highlight in the text which hopefully does not create the image of turning auditors into speculators.

<sup>28</sup> Audit partner rotation is in any case an existing legal requirement. Section 203 of the Sarbanes-Oxley Act mandates this practice, providing, "It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."



market following the signing of the last audit report.<sup>29</sup> For example, if the market value of one share on the day following the release of the last audited report by the issuer is \$30, and the amount of the deferred compensation is \$30 million,<sup>30</sup> then the auditor (or the relevant audit partner) will receive one million shares. Moreover, under this compensation scheme, the auditor agrees to the restriction that it will not sell the stock for a period ranging between 18 to 24 months following its purchase (and thus the shares are left in the hands of the trustee during that period). Note that if the auditor sells its entire holdings of the firm's stock, under the existing regulation (which I do not suggest modifying), the auditor becomes eligible to be reappointed as the firm's auditor.

There are unique benefits to this compensation scheme. The auditor fees are contingent on its success at preventing financial misreporting. The scheme requires that the auditor invest a good portion of its compensation (\$30 million in our example) in the stock of the corporation it audits. If the auditor does not adequately perform its duties, the resulting financial misreporting may drive the price of the firm's stock above its bona fide value, and consequently, the auditor will overpay for the stock it is compelled to purchase under the compensation scheme (paid for with the auditor's deferred compensation). And since the shares are restricted and the auditor cannot divest of its holdings upon receipt, information regarding the true state of the company may be revealed over time and the stock that the

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<sup>29</sup> Alternatively, the deferred compensation would be transferred and held by a trustee who would transfer the money back to the issuer in exchange for shares issued to the auditor based on the market price of those shares *at the time of issuance*. In either case, the trustee's instructions would be that if the issuer collapses prior to the date of the stock purchase, then the accrued amount will be released to the auditor in cash. This safety measure would prevent harm to the auditor in extreme scenarios as well as, consequently, a perverse incentive to conceal such Enron-like cases from the public.

<sup>30</sup> The above example sets the annual audit fee at \$20 million dollars. In reality, the audit fee varies tremendously amongst firms due to several factors such as firm size and complexity. At the largest and most complex U.S. corporations, audit fees and audit-related fees paid to the firm's certified auditor can exceed \$100 million dollar per year. *See, e.g.,* AIG Proxy Statement of 2007, at 54 (Form DEF 14A), *available at* [http://www.ezonlinedocuments.com/aig/2007/proxy/images/AIG\\_Proxy2007.pdf](http://www.ezonlinedocuments.com/aig/2007/proxy/images/AIG_Proxy2007.pdf) (fees paid by AIG in 2006 were \$91.9 million); *see also* the Audit Fees Section in the GE Proxy Statement of 2007 (Form DEF 14A), *available at* <http://www.sec.gov/Archives/edgar/data/40545/000119312507040510/ddef14a.htm> (fees paid by GE in 2006 were \$106 million).

auditor received in lieu of cash compensation may drop in value. This effect would be augmented by the auditor's exclusion from working for the corporation for as long as the auditor does not sell its shares. The auditor who is no longer actively involved in the firm cannot help to maintain the artificial elevation of the stock prices, while, at the same time, the new auditor will seek to call its predecessor's bluff as soon as possible so as not to eventually suffer from the inflated prices.

It should be noted that during the entire period that an auditor works for a corporation, the market value of the shares could fluctuate for reasons unrelated to financial misreporting. Thus, the value of the shares in the above example could vary during the auditor's three-year appointment due to firm performance, for better or for worse, as well as due to macro-economic factors and frictions that affect the entire market. However, it is important to understand that, under the proposed compensation scheme, the auditor does not bear risks that stem from such market-value fluctuations, whatever their cause may be. Because the auditor receives its deferred compensation in shares based on their market price following its period of service for the corporation, previous stock price variations do not influence the value of its compensation package in its entirety (\$30 million in the above example). The amount of shares issued to the auditor will be set with this goal in mind; the auditor will receive fewer shares if the price per share increases and vice versa if it drops. This means that the auditor bears no investment risk during the period it works for the firm, but must still be alert to any misreporting that could inflate the value of the shares and possibly hurt its compensation when it eventually does sell its shares. The proposed scheme does, however, involve some risk-related costs for the auditor, which arise during the period in which it is required to retain its stock. Since the auditor is compelled to invest a large sum of money in the stock of a single corporation, it will likely demand compensation for this risk,

leading to higher overall auditor compensation levels than what auditors currently receive in cash.

The larger the auditor and the more firms it works for with a similar compensation scheme,<sup>31</sup> the lower the premium that it would require for accepting this method of compensation.<sup>32</sup> Yet, even a substantial premium may be a justified cost when we consider the multibillion-dollar price of financial misrepresentation as documented in the literature. If the incentive scheme described in this paper is beneficial, the ensuing ample efficiency gains would compensate all parties involved. Moreover, I do not argue that this compensation proposal would suit all companies and all gatekeepers. Rather, my point is that there is no justification for the existing legal prohibition on all types of stock compensation for auditors and that the market should be aware of the possible benefits that may evolve once such compensation is allowed.

Finally, some of the triggers of fraud and misreporting may, in fact, also prevent firms from adopting the proposed mechanism. Misreporting may harm the corporation's future shareholders and creditors while enriching its existing shareholders. This proposal should, therefore, be advanced by institutional shareholders and banks, which have large stakes of equity and debt that are vulnerable to misreporting and therefore should be driven to search for ways to ameliorate the problem. As we shall see below, it is also important and appropriate for the Securities and Exchange Commission to encourage the use of the proposed plan by instituting certain exemptions from the provisions of the Sarbanes-Oxley legislation.

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<sup>31</sup> Audit firms, and particularly the so-called "Big Four Firms" (KPMG, Deloitte, Ernst & Young, and PricewaterhouseCoopers), are giants with many clients and revenues in the multi-billions. In 2007, each of the Big Four had revenues of at least \$20 billion. See *Big Four Firms Report Tremendous Results* (Dec. 4, 2007), available at <http://bigfouralumni.blogspot.com/2007/12/big-four-firms-report-tremendous-2007.html>.

<sup>32</sup> Diversification takes away risks related to the single firms but one cannot diversify away the market risk unless the compensation is indexed to some market measure. For a discussion on market (systematic) risk and diversification, see RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *CORPORATE FINANCE* 154-72 (8th ed. 2006). Still, an auditor could replace its existing portfolio of stock, assuming it holds such

The paper progresses as follows. Part II starts out by briefly discussing the proliferation of executive stock option plans (and other equity-based compensation) in the U.S., the ongoing debate regarding such incentive pay schemes, and how they exacerbate the misreporting and overvalued equity problems. Part III then considers the notion of gatekeepers and gatekeeper regulation and, in particular, the Sarbanes-Oxley Act provisions and the auditor independence requirements. Part IV proceeds to set out the proposed auditor compensation method, explaining why this scheme would respond to the ongoing trends in executive compensation practices and how it is compatible with existing gatekeeper regulation. The discussion is wrapped up in Part V.

## **II. Executive Compensation and Securities Misreporting**

This Part begins with an examination of the surge in executive compensation and the revolution in equity-based compensation that caused this leap in executive pay. It then presents the recent and growing body of empirical evidence that links stock-based compensation to earnings management and financial scandals.<sup>33</sup> This conclusive evidence constitutes only a small part of a much larger phenomenon of perverse outcomes produced by equity compensation, as much of the paltering, whitewashing, and selective reporting is hard to detect and verify. These outcomes may occur in perfectly rational markets but intensify in irrational markets that put too much emphasis on accounting presentation. This Part looks at some of the enormous body of evidence indicating that our capital markets suffer from such irrational episodes and shows that even an optimal compensation scheme would leave a wide

portfolio as an investment, with the stock generated by the proposed type of compensation and hence bear similar risks to the ones it faces without the new compensation scheme.

<sup>33</sup> The literature is also quite clear about the huge social cost that inflated or inaccurate stock prices bring about. See, e.g., Jensen, *supra* note 13 (discussing how inflated stock prices bring about increased managerial agency costs); Andrei Shleifer & Robert W. Vishny, Stock Market Driven Acquisitions, 70 J. Fin. Econ. 295 (2003) (arguing that inflated stock prices bring about inferior acquisitions); Marcel Kahan, Securities Laws and

opening for misreporting. In particular, even if managers' incentives are perfectly aligned with the incentives of existing shareholders, they may still opt for financial misrepresentation at the expense of future shareholders and creditors. This discussion will lead us to Part III, which first considers the role and limits of gatekeepers in ameliorating the problem of securities misreporting and then turns to the paper's proposed reform of gatekeeper compensation practices.

#### **a. The Growth in Executive Pay and Equity-Based Compensation**

Much has changed since Jensen & Murphy first made their claim in 1990 that American CEOs are "paid like bureaucrats."<sup>34</sup> Since the early 1990s, total compensation of top executives has more than tripled.<sup>35</sup> Between the years 1980 and 1994, the average executive compensation rose by 209%,<sup>36</sup> and between the years 1992 and 1998, it grew by almost threefold, with average compensation to the top five executives in the largest 500 U.S. companies climbing from \$2,335,000 to \$6,549,000.<sup>37</sup> The increase in average CEO total compensation was even more stunning between 1993 and 2000, going from \$3,700,000 to \$17,400,000, respectively.<sup>38</sup>

This striking rise in executive compensation can be attributed in large part to the

Social Costs of "Inaccurate" Stock Prices, 41 *Duke L. J.* 977 (1992)(discussing the harm that inaccurate share prices cause the allocative efficiency of the market).

<sup>34</sup> Jensen & Murphy, *supra* note 3 (reviewing U.S. executive compensation in the period between 1969 and 1983); Hall & Liebman, *supra* note 3, at 655 (reviewing compensation practices of the 400 largest public firms and concluding that executives are no longer paid like bureaucrats and that pay is linked to performance).

<sup>35</sup> Hall & Murphy, *supra* note 4 (reporting and discussing executive option grants).

<sup>36</sup> Hall & Liebman, *supra* note 3 at 655 (reviewing compensation practices of the 400 largest public firms and concluding that executives are no longer paid like bureaucrats and that pay is linked to performance).

<sup>37</sup> Murphy, *supra* note 7, at 848 (discussing growth in executive compensation); Susan J. Stabile, *One For A, Two For B, and Four Hundred For C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 *U. MICH. J.L. REFORM* 115 (2003) (discussing and criticizing growth in executive compensation); Todd Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 *WAKE FOREST L. REV.* 123, 124 (2000) (same).

parallel dramatic increase in option grants to executives. As already noted, in 1985, the value of options granted amounted to only 8% of the average total CEO compensation in the largest U.S. companies,<sup>39</sup> but grew steadily, peaking at 78% in 2000 and 76% in 2001.<sup>40</sup> Moreover, whereas in 1980, only 57% of the top executives had held options in their firms, in the year 1999 alone, 94% of the largest companies granted options to their executives.<sup>41</sup> The radical shift in executive pay practices ignited a debate on the efficacy of these new practices. Proponents argue that the practice of linking pay to performance is the result of an efficient bargain between firms (and, indirectly, the shareholders) and their executives.<sup>42</sup> Opponents assert, amongst other things, that the outcome is skewed since managers have the power to manipulate the pay-setting mechanisms in their favor and thereby ensure that they receive much pay without real performance.<sup>43</sup> But even under the most optimistic view of stock-based compensation as encouraging managers to take efforts to guard against harm to the firm, the incentives generated by current practices for earning manipulation and securities fraud are in no way negligible.

### **b. The Link between Stock-Based Compensation and Financial Misreporting**

A growing body of recent empirical literature is exposing the link between stock-

<sup>38</sup> See Bebchuk & Grinstein, *supra* note 7, at 285 tbl 1; see also Hall & Murphy, *supra* note 4, at 51 (reporting and discussing executive option grants).

<sup>39</sup> See Linda J. Barris, *supra* note 5, at 64 (an empirical study of 800 public firms).

<sup>40</sup> Bebchuk & Grinstein, *supra* note 7, at 290 tbl. 4 (reporting compensation figures for S&P 500 firms). See also Murphy, *supra* note 7, at 848 (discussing growth in executive compensation); Brian J. Hall, *The Six Challenges of Equity-Based Pay Design*, 15 J. APPLIED CORP. FIN. 21, 23 (2003).

<sup>41</sup> See Hall & Murphy, *supra* note 9, at 4 (reviewing executive compensation in the largest 500 U.S. firms); see also Kahan, *supra* note 9, at 1888 (reporting that, in 1996, in a sample of 250 large public firms, 90% of the companies used stock-option compensation).

<sup>42</sup> John E. Core, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, 9 ECON. POL'Y REV. 27, 28 (2003) ("However, unless beliefs are systematically biased, we expect that compensation contracts are efficient, on average, and that average equity incentive levels across firms are neither 'too high' nor 'too low.'").

<sup>43</sup> See BEBCHUK & FRIED, *supra* note 12 (developing the managerial power approach); Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive*

based compensation for executives and financial manipulation.<sup>44</sup> This work is rather new since the practice of heavily compensating managers with equity has been around for barely fifteen years and it took about a decade for the evidence to mount. Rather than surveying the literature in its entirety, I outline below four representative empirical studies in this area, portraying the different approaches to the analysis of the evidence. Regardless of the approach, however, a rather clear and compelling picture emerges: stock-based compensation instigates fraud, earning management, and misreporting in general.<sup>45</sup>

The first study focused on accounting restatements and their relation to the structure of executive pay.<sup>46</sup> An accounting restatement is a remake of previous financial reports that occurs when the corporation, its auditor, or the SEC finds significant accounting errors that resulted in a substantial misrepresentation in those earlier financial reports. Cases of restatement can be the product of innocent mistakes but are also often indicative of fraud. This study found that the likelihood of a misstated financial statement increases greatly when

*Compensation*, 69 U. CHI. L. REV. 751 (2002) (same); Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PER. 71 (2003) (same).

<sup>44</sup> This literature has strong theoretical backing, *see, e.g.*, O. BAR-GILL & L. BEBCHUK, MISREPORTING CORPORATE PERFORMANCE (Harvard Olin Discussion Paper No. 400, 2002), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=354141](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354141) [hereinafter BAR-GILL & BEBCHUK, MISREPORTING] (developing a model of the causes and consequences of misreporting corporate performance); OREN BAR-GILL & LUCIAN A. BEBCHUK, THE COSTS OF PERMITTING MANAGERS TO SELL SHARES (2003) (unpublished working paper), *available at* [http://www.law.harvard.edu/programs/olin\\_center/corporate\\_governance/papers/03.Bar-Gill.Bebchuk.cost-permitting.pdf](http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/03.Bar-Gill.Bebchuk.cost-permitting.pdf) [hereinafter BAR-GILL & BEBCHUK, COSTS OF PERMITTING] (analyzing the costs of permitting corporate managers to sell shares they hold prior to the end of their service at the company); JESSE M. FRIED, CORPORATE LAW'S CURRENT-OWNER BIAS (Berkeley Program in Law & Economics, Working Paper Series, Paper No. 181, 2006), *available at* <http://repositories.cdlib.org/blewp/art181> (analyzing the effect of noisy stock prices on firms' choice of governance arrangements and demonstrating that stock price noisiness leads firms to seek arrangements with a current-owner bias); Coffee, *supra* note 1; John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004); Jensen, *supra* note 13.

<sup>45</sup> Another recent study related to our discussion focuses on managers' motivations to manipulate disclosure in relation to share repurchases and shows that higher equity stakes intensify the problem, PAUL BROCKMAN, Inder K. KHURANA & XIUMIN MARTIN, VOLUNTARY DISCLOSURE AROUND ACTUAL REPURCHASES (2007), *available at* <http://ssrn.com/abstract=1011922> (showing that managers provide downward-biased earnings forecasts before share repurchases and that this opportunistic disclosure strategy intensifies when managers have higher equity stakes). *See ALSO* PAUL BROCKMAN, XIUMIN MARTIN & ANDY PUCKETT, VOLUNTARY DISCLOSURES AND THE EXERCISE OF CEO STOCK OPTIONS (July 9, 2008), *available at* <http://ssrn.com/abstract=1108119> (finding that managers manipulate disclosures around options exercise dates).

<sup>46</sup> Efendi, Srivastava & Swanson, *supra* note 11.

the CEO has very sizable holdings of in-the-money options.<sup>47</sup> Examining restatements announced during 2001 and 2002, the study compared a sample of ninety-five restating firms with a control sample matched on industry, size, and timeframe.<sup>48</sup> The researchers measured many factors that could potentially differentiate between the restating firms and the control sample, with the most influential factor found to be the CEO's compensation structure and, specifically, the value of the CEO's in-the-money stock options. The compelling findings gained greater force in the specific context of restatements involving major accounting irregularities and malfeasance.

The magnitude of the divergence between the restating firms and their non-restating peers is dramatic. The average value of CEO holdings at restating firms was \$50,106,370, whereas the average for the matched firms was only \$8,881,680.<sup>49</sup> Moreover, the average value of CEO holdings for CEOs at restating firms where there was evidence of accounting malfeasance was strikingly higher, at \$130,160,680, compared to the average of \$14,930,990 at the matched firms.<sup>50</sup> The study also found that restating firm CEOs benefited from the misreporting immediately. CEOs at companies that issued accounting restatements (where there was accounting malfeasance) exercised options worth an annual average of \$4,181,600 (\$7,744,240); this exceeded the average of \$436,930 (\$2,616,210) at matched firms.<sup>51</sup>

Finally, to show that the CEOs did, indeed, benefit from restatement, the study clarified that the restatements had inflated the value of the restating companies' stock (or at least backed an already-inflated value). Thus, the study found "that restating firms' returns exceed the market by about 20% (27% for firms with accounting malfeasance); in

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<sup>47</sup> In-the-money options are options that have a strike price that is lower than the current market value of the company's shares and, thus, if exercised reap an immediate profit.

<sup>48</sup> Many of the restatements had an earning effect. An income effect (always a decrease) occurred in 72 of the 95 sample firms (76%). *Id.* at [19 – in ssrn version].

<sup>49</sup> *Id.* at [33 – in ssrn version].

<sup>50</sup> *Id.* at [32 – in ssrn version].

<sup>51</sup> *Id.*



comparison, matched control firms receive approximately the market return."<sup>52</sup> These findings allowed the researchers to comfortably conclude that managers with stock-based compensation take action to support the inflated stock price through accounting manipulation.

A second study similarly concentrated on accounting restatements and their relation to executive compensation.<sup>53</sup> The study examined firms that announced a restatement of their financial statements during the period of 1995 to 2002 and a matched sample of firms that did not restate in that same period.<sup>54</sup> Like the first study, this research also found that stock options bring about aggressive accounting practices, which eventually lead to a proliferation of restatements.<sup>55</sup> This second study added a novel line of inquiry in measuring the magnitude of the restatement and its relation to the structure of manager compensation, finding a positive significant relationship between executive compensation sensitivity and the magnitude of the restatement. Higher incentives from stock options were found to be not only associated with a higher propensity to misreport but also with greater magnitudes of misreporting, as measured by the effect of the restatement on the net income of the firm involved.<sup>56</sup>

The third study targeted directly cases of securities fraud and linked them to executive compensation. Its query, as stated by the authors, was "Do the executives who commit fraud face greater financial incentives to do so?"<sup>57</sup> The study covered all firms that were the

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<sup>52</sup> *Id.* at [28 – in ssrn version].

<sup>53</sup> In total, the study gathered a sample of 215 restating firms. Natasha Burns & Simi Kedia, *The Impact of Performance-based Compensation on Misreporting*, 79 J. FIN. ECON. 35 (2006).

<sup>54</sup> *Id.* at 46.

<sup>55</sup> *Id.* at 63.

<sup>56</sup> *Id.* at 43 ("The average effect of the restatement on net income is a reduction of \$101.32 million ... . The mean (median) effect on net income for restating firms that overstated net income is higher at \$117.1 (\$13.8) million.").

<sup>57</sup> SHANE A. JOHNSON, HARLEY E. RYAN JR. & YISONG S. TIAN, MANAGERIAL INCENTIVES AND CORPORATE FRAUD: THE SOURCES OF INCENTIVES MATTER (EFA 2006 Zurich Meetings Working Paper No. 1, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=395960](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=395960). Another recent paper focuses on fraud cases and their relation to executive compensation by covering cases that were subject to private securities action lawsuits, Ling Peng & Alisa Roell, *Executive Pay and Shareholder Litigation*, 11 REV. FIN. (forthcoming 2007), available at <http://rof.oxfordjournals.org/cgi/reprint/rfl003v1>; see also David J. Denis, P. Hanouna, & A. Sarin, *Is There a Dark Side to Incentive Compensation?*, 12 J. CORP. FIN. 467 (2006) (finding a significant

subjects of the SEC's Accounting and Auditing Enforcement Releases ("AAERs") from 1992-2001, in which the Commission indicated it believed there to be sufficient evidence of accounting fraud to indict the firms or their executives.<sup>58</sup> In total, 53 firms (127 fraud years) were examined by the study and compared to a matched sample of "innocent" firms,<sup>59</sup> and, again, the evidence that emerged is compelling: "The unrestricted stock holdings of the median fraud executive are 92% greater than those of the median control executive; at the 75th percentile, the fraud executive has unrestricted stock incentives that are 180% greater than those of the control executive."<sup>60</sup> Moreover, during fraud years, the study showed that executives at fraud firms sell significantly more stock than do control executives.<sup>61</sup>

Finally, a fourth study used stock-based compensation and ownership data from the period of 1993-2000.<sup>62</sup> This study's contribution to the literature derives from the authors' analysis of firms that meet or just beat analysts' forecasts. They found a significantly higher incidence of meeting or just beating forecasts amongst firms with higher managerial equity incentives.<sup>63</sup> "[A] one standard deviation increase in unexercisable options increases by 16.3 percent the odds of meeting or just beating analysts' forecasts, while a one standard deviation increase in ownership increases by 30.5 percent the odds of meeting or just beating analysts'

positive relationship between the years 1993-2002 between a firm's use of option-based remuneration and securities fraud allegations).

<sup>58</sup> Johnson et al., *supra* note 57, at 6-7.

<sup>59</sup> *Id.* at 7.

<sup>60</sup> *Id.* at 2.

<sup>61</sup> *Id.* at 3.

<sup>62</sup> Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 ACCT. REV. 441 (2005).

<sup>63</sup> *Id.* at 470. See also Mary Lea McAnally, Anup Srivastava & Connie D. Weaver, *Executive Stock Options, Missed Earnings and Earnings Management: Evidence from Book-Tax Differences*, AAA 2007 FINANCIAL ACCOUNTING & REPORTING SECTION (FARS) MEETING PAPER (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=925584](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=925584) (showing that option grants sometimes encourage managers to miss a quarterly earning target intentionally and that, evidently, firms that miss earning targets have larger and more valuable subsequent grants); David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73 (2000) (empirically showing that managers time stock grants and disclosure to earn rents).

forecasts,”<sup>64</sup> and “[o]f 4,301 firm-years with equity incentives and earnings surprises in the period 1993-2000, 25 percent have zero earnings surprises, i.e., meeting analysts’ forecasts, 17 percent beat analysts’ forecasts by one cent, but less than nine percent miss analysts’ forecasts by one cent.”<sup>65</sup> Based on analyses that control for firm performance and other potential confounds, the authors concluded that their results are more consistent with earnings management induced by equity incentives as opposed to improved firm performance. The study further showed that managers with high equity incentives sell more shares after meeting or beating analysts’ forecasts than after missing analysts’ forecasts. In contrast, it did not find any evidence of this for managers with low equity incentives.<sup>66</sup> These results, too, conform to the notion that there is an increase in stock selling by managers with high equity incentives following earnings management. Lastly, the study found that high equity-incentive managers use, on average, more income-increasing accounting techniques (reporting abnormal accruals)<sup>67</sup> and that managers sell more shares after taking these income-increasing measures.<sup>68</sup>

From this sampling of recent empirical studies, an unquestionable link emerges between financial misreporting and manipulation and the new practice of stock-based compensation. Perhaps pay-for-performance does, indeed, create beneficial incentives to improve the firm, but it certainly also creates negative incentives to present a false state of firm improvement or to hide adverse information. While there are inherently harsh consequences to the incentive to hide adverse information, to whitewash, sugarcoat, twist information, or simply lie, the real problem goes even deeper. For there is significant

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<sup>64</sup> Cheng & Warfield, *supra* note 62, at 455.

<sup>65</sup> *Id.* at 452.

<sup>66</sup> *Id.* at 443.

<sup>67</sup> This is especially true for managers with less persistent equity incentives—those who are less concerned with the reversal of accruals, *id.* at 467.

<sup>68</sup> *Id.*

evidence that the market is irrational in the sense that it is influenced by the manner of accounting representation, even when all the information is accurately described by the firm.<sup>69</sup> If this is in fact the case, then managers can influence the price of their companies' shares by simply selecting a specific manner of disclosure, without the need to misreport, hide, or twist information. For instance, and related to the studies described above, even the manner in which a firm announces its intention to restate its previous financial statements can influence the market's reaction to the restatement. Accordingly, one study found that companies providing a less prominent press release disclosure of their restatement enjoy a lower decrease in the value of their shares on the exchange and are less likely to be sued for securities fraud.<sup>70</sup> This outcome, however, has nothing to do with the severity of the accounting irregularity involved or the relevant transparency of the information, but, rather, relates simply to the relative prominence of the restatement announcement.<sup>71</sup>

There are many other cases that directly involve accounting representations, and there is considerable evidence that firms choose income-increasing accounting treatments

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<sup>69</sup> The notion that the market is irrational and suffers from behavioral biases, at least for some lengthy periods, is now pretty commonly accepted. *See, e.g.*, ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000) (a comprehensive discussion of market inefficiency and behavioral biases); Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in *HANDBOOK OF THE ECONOMICS OF FINANCE* 1053 (2003) (a survey of the literature on the subject); Owen Lamont & Richard Thaler, *Can the Market Add and Subtract? Mispricing in Tech Stock Carveouts*, 111 *J. POL. ECON.* 27 (2003) (discussing the well-known case of market inefficiency in mispricing firms and their subsidiaries); Bradford Cornell & Quiao Liu, *The Parent Company Puzzle: When Is the Whole Worth Less Than One of Its Parts?* 7 *J. CORP. FIN.* 341(2001). For a discussion of the concept of market efficiency versus irrationality, see *Efficient Markets Hypothesis*, in *THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS* 782-793 (Steven N. Durlauf & Lawrence E. Blume, 2d ed. 2008).

<sup>70</sup> Some firms issue a press release that discloses the restatement in the headline; others give a press release headlined by a different subject (for example, earnings news) but discuss the misstatement in the text; a third tactic is to simply change the comparative-period amounts reported in an earnings release, with no direct mention of the restatement. In all three cases, there are immediately negative stock returns following the announcement but they differ substantially in terms of disclosure prominence (-8.3% for the first type of restatement announcement, -4.0% for the second type, and -1.5% for the third group). *See* EDWARD P. SWANSON, SENYO Y. TSE & REBECCA WYNALDA, *STEALTH DISCLOSURE OF ACCOUNTING IRREGULARITIES: IS SILENCE GOLDEN?* (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1004299](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1004299).

<sup>71</sup> *Id.* at 30.

even when these maneuvers are utterly transparent to the market.<sup>72</sup> Perhaps the two best-known examples are the use of the "pooling," versus "purchase," accounting treatment for acquisitions and the resistance to expensing employees' stock-option grants.<sup>73</sup> Pooling-of-interest accounting treatment for mergers generally allows firms to report higher income and earnings. For this reason, managers invest much time, effort, and capital to squeeze their merger transactions into the mold of the requirements for preferable treatment, and the evidence indicates that the market values these choices.<sup>74</sup> Since accounting treatment does not impact the intrinsic value of these transactions, this managerial behavior and market response are telling signs of the market's obsession with accounting numbers rather than with fundamental values.

With regard to expensing stock-option compensation, it took regulators almost twenty years to overcome managers' fierce resistance and enact a requirement to expense

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<sup>72</sup> See, e.g., Richard G. Sloan, *Do Stock Prices Fully Reflect Information in Cash Flows and Accruals About Future Earnings?*, 71 ACCT. REV. 289 (1996) (finding that stock prices act as though investors "fixate" on earnings, failing to fully reflect information contained in the accrual and cash flow components of current earnings until that information impacts future earnings); Charles J.P. Chan, Shimin Chen & Xijia Su, *Is Accounting Information Value-relevant in The Emerging Chinese Stock Market?*, 10 J. INT'L ACCT., AUDITING & TAX'N 1 (2001) (reporting fairly convincing evidence that accounting information is value relevant to investors in the Chinese market despite the young age of the market and the perception of inadequate accounting and financial reporting in China); John R. Hand, Patricia J. Hughes & Stephan E. Sefcik, *Insubstance Defeasances: Security Price Reactions and Motivations*, 64 J. ACCT. & ECON. 587 (1990) (examining stock-price reactions to the announcement of insubstance defeasances and finding a negative stock price reaction). There is also ample evidence that the market does not perfectly adjust to changes in accounting treatment. See, e.g., Gary C. Biddle & William E. Ricks, *Analyst Forecast Errors and Stock Price Behavior Near the Earnings Announcements Dates of LIFO Adopters*, 1988 J. ACCT. RES. 169 (1988) (presenting evidence suggesting that the negative excess returns were associated with, and possibly due to, analysts' systematic overestimates of earnings of firms adopting LIFO in 1974); Kevin C.W. Chen & Michael P. Schoderbek, *The 1993 Tax Rate Increase and Deferred Tax Adjustments: A Test of Functional Fixation*, 38 J. ACCT. RES. 23 (2000) (exploring the magnitude and nature of analysts' and investors' functional fixation on reported accounting numbers); John R.M. Hand, *1974 LIFO Excess Stock Return and Analyst Forecast Error Anomalies Revisited*, 33 J. ACCT. RES. 175 (1995) (reexamining three LIFO anomalies reported by Ricks & Biddle with the aim of investigating the degree of analyst and investor sophistication in responding to fiscal 1974 LIFO adoptions).

<sup>73</sup> Both examples are discussed at length at Fried, *supra* note 44, at 26-28.

<sup>74</sup> Linda A. Vincent, *The Equity Valuation Implications of the Purchase and Pooling Methods of Accounting*, J. FIN. STATEMENT ANALYSIS 2 (Summer 1997) (finding that pooling firms enjoy an equity valuation advantage over purchase firms); P. Hopkins, R. Houston & M. Peters, *Purchase, Pooling and Equity Analysts' Valuation Judgments*, 75 ACCT. REV. 257 (2000) (providing evidence that analysts' stock-price judgments depend on the method of accounting for a business combination and the number of years that have elapsed since the business combination).

stock options.<sup>75</sup> Expensing stock-option compensation has a sharp impact on firms' bottom line; for example, it would have reduced the earnings of S&P 500 firms in 2001 by 21 percent.<sup>76</sup> However, even without a requirement to expense stock options for accounting purposes, managers cannot hide their cost as their value must be disclosed regardless.<sup>77</sup> Nevertheless, it seems that both managers and the market care more about accounting net profits than any other type of disclosure that could convey the same information. This reality exacerbates the misreporting problem, as it can drive managers to bend accounting standards so as to increase net profits, even when a rational investor would seemingly not be misled by such distortion.<sup>78</sup>

### c. Can Executive Pay Reform Solve the Problem?

Manager pay practices have recently come under attack.<sup>79</sup> Some reform proposals have been implemented, including those aimed at alleviating managers' perverse incentives to manipulate earnings.<sup>80</sup> While reforms could possibly remedy part of the problem, two points

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<sup>75</sup> Share-Based Payment, Statement of Fin. Accounting Standards No. 123R (Fin. Accounting Standards Bd. 2004).

<sup>76</sup> See Fried, *supra* note 44, at 29.

<sup>77</sup> SEC Act Rels. 6940, 51 SEC Dock. 1168 (1992) (proposal); 6962, 52 SEC Dock. 1961 (1992) (adoption); 6966, 52 SEC Dock. 2378 (1992) (correction to adoption release); 7032, 55 SEC Dock. 1352 (1993) (technical amendments).

<sup>78</sup> The link between irrational markets and managers' incentives to cheat and take actions to manipulate earnings has been widely acknowledged in the literature. See, e.g., Jeremy C. Stein, *Efficient Capital Markets, Inefficient firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989) (showing that when investors are sophisticated, in equilibrium, investors rationally expect managers to engage in earnings management, which they do). See also BAR-GILL & BEBCHUK, MISREPORTING, *supra* note 44; BAR-GILL & BEBCHUK, COSTS OF PERMITTING, *supra* note 44; Fried, *supra* note 44; Jensen, *supra* note 13.

<sup>79</sup> See BEBCHUK & FRIED, *supra* note 12 (concentrating on the disincentives to improve performance); Bebchuk, Fried & Walker, *supra* note 43 (same); Coffee, *supra* note 44, at 297-98 (discussing perverse incentives to manipulate earnings).

<sup>80</sup> For example, the claw-back provision in the Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amendment in scattered sections of 15, 18 U.S.C.) [hereinafter "SOX"], 15 U.S.C.A. § 7243 (2006) (SOX § 304); timely disclosure of equity grants (amendment of section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p) (15 U.S.C. § 7201 (2000)) (SOX § 403); and blackout periods for sales of securities, 15 U.S.C.A. § 7245 (2006) (SOX § 306). On blackout periods, see also Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715, 742 (2003); Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 844 (2003).

are noteworthy in this context. First, even an ideal compensation contract could not overcome the problem in its entirety, and moreover, any reform aimed at solving only part of the problem would entail costs of its own. Second, it is important to acknowledge that corporations do not have adequate incentive to adopt the optimal pay structure since managers' earnings manipulations sometimes benefit existing shareholders at the expense of creditors and future shareholders. These two important points are the background to the discussion in Part III, which examines the role of gatekeepers in alleviating the harmful incentives that exist for managers to misreport.

Executive compensation reform can and does alleviate some of managers' negative incentives. A good example of this is the simple solution to the infamous controversy surrounding stock option backdating:<sup>81</sup> once a requirement of immediate disclosure of grant date was introduced under the Sarbanes-Oxley Act, it became quite hard to play around with disclosures and backdate grant dates to a more favorable timing.<sup>82</sup> Other reforms could also work against managers' incentives to manipulate financial reporting, such as claw-back provisions that confiscate profits earned through fraud or accounting errors that lead to

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<sup>81</sup> The SEC has launched investigations into more than one-hundred companies with respect to the timing and pricing of stock options they granted during the boom years of the late 1990s and early 2000s. This phenomenon has been discussed in numerous papers, *see, e.g.*, LUCIAN A. BEBCHUK, YANIV GRINSTEIN & URS PEYER, LUCKY CEOs (Harvard Law & Economics Discussion Paper No. 566, 2006), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=945392](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=945392); LUCIAN A. BEBCHUK, YANIV GRINSTEIN & URS PEYER, LUCKY DIRECTORS (Harvard Law & Economics Discussion Paper No. 573, 2006), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=952239](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952239); David Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561 (2007); Randall A. Heron, Eric Lie & Todd Perry, *On the Use (and Abuse) of Stock Option Grants*, 63 FIN. ANALYSTS J. 17 (2007). As expected, there is evidence that executive equity compensation was a major incentive for the practice of backdating. *See* DANIEL W. COLLINS, GUOJIN GONG & HAIDAN LI, CORPORATE GOVERNANCE AND BACKDATING OF EXECUTIVE STOCK OPTIONS (2007), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=934881](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=934881) (showing that the tendency to backdate is stronger when stock options are more important have greater weight in CEO compensation and that firms with weaker governance structures that allow CEOs to exercise greater power over the board and its committees are more likely to engage in executive option backdating).

<sup>82</sup> In fact, this is the reason that backdating was exposed in the first place. The passage of the Sarbanes-Oxley Act reduced managers' returns from option grants dramatically, causing researchers to search for the cause of the change. *See, e.g.*, Eric Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 805 n.3 (2005) ("[E]ffective August 29, 2002, the SEC changed the reporting regulations with respect to stock option grants. Specifically, firms must now report executive stock option grants within two business days. This is likely to affect the timing of stock option grants documented herein.").

restatements. Along these lines, section 304 of the Sarbanes-Oxley Act provides, "If an issuer is required to prepare an accounting restatement ... as a result of misconduct ..., the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for— (1) any bonus or other incentive-based or equity-based compensation ...; (2) any profits realized from the sale of securities of the issuer during that 12-month period."<sup>83</sup>

These statutory arrangements and similarly-formulated contractual arrangements serve to reduce the incentive to commit fraud, but they are a far stretch from a comprehensive solution to the problem. If all fraudulent activities were eventually to be exposed, reputation concerns as well as fear of adjudication could prevent most managers from committing fraud.<sup>84</sup> However, in the absence of this inevitability, managers most often simply hope that their actions will go unnoticed. Managers who inflate profits often hope that income will eventually rise, before their fraudulent actions are detected, or alternatively, they hide their actions by disclosing a steeper-than-actual fall in sales at a later period.<sup>85</sup> While claw-back provisions that confiscate manager profits from fraudulent activity (once such activity has been exposed) supposedly add another layer of protection against fraud, they do not overcome the fundamental hurdle of fraud detection. Moreover, a considerable extent of financial reporting manipulation occurs in the gray area. Accounting is based on assessments and involves discretion,<sup>86</sup> and at times, a number of possible reporting standards can be arguably legitimate, with one simply better suited to the financial status of the issuer. This reality of the accounting and financial disclosure practice leads to much bending, stretching, slanting,

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<sup>83</sup> 15 U.S.C.A. § 7243 (2006) (SOX § 304).

<sup>84</sup> On how exposed fraud cases are only the tip of the iceberg, see, e.g., Coffee, *supra* note 1, at 199 ("one suspects that these announced restatements were but the tip of the proverbial iceberg, with many more companies negotiating changes in their accounting practices with their outside auditors that averted a formal restatement").

<sup>85</sup> See Coffee, *supra* note 44, at 277 (discussing the concept of misappropriation of future period earnings and premature income recognition).

<sup>86</sup> As we will discuss below, accounting practice is moving towards even greater discretion as rules-based accounting is being replaced worldwide with principles-based accounting.



exaggerating, distorting, whitewashing, and selective reporting that do not necessarily result in accounting restatements or public exposure of the faulty behavior.

Another oft-suggested reform proposes setting extended holding periods for managers' equity compensation, based on the notion that earning manipulation and fraud cannot last forever.<sup>87</sup> Managers can hide a downturn in the firm's profitability or evade missing one quarter of analyst expectations, but the real economic situation will eventually emerge.<sup>88</sup> Lengthy holding periods could, therefore, reduce misreporting incentives since short-run deception would not be very profitable for managers. Yet this solution is also far from perfect. Any scheme would necessarily have to allow managers to eventually sell their shares at some point, thus failing to eliminate all short-run incentives to cook the books.<sup>89</sup> More importantly, however, even if extended holding periods could eliminate much of the incentive to misreport, this would not necessarily entail that an optimal employment contract would include such a provision. Holding periods expose managers to the fundamental risk of fluctuations in the company's value, and the longer the holding period, the greater the risk they bear.<sup>90</sup> Since managers' human capital and reputation are already invested in their firms, it might be simply excessive to require them to undertake extremely high risks vis-à-vis a huge considerable portion of their compensation and capital assets.<sup>91</sup> In fact, the empirical

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<sup>87</sup> See Coffee, *supra* note 44, at 308 ("[T]he real problem here is not equity compensation ... but rather excessive liquidity that allows managers to bail out at will. Only firm-specific answers, such as holding periods and retention ratios, seem likely to work effectively to solve this problem.").

<sup>88</sup> This does not mean that short-run misreporting would be exposed as fraud since the firm can often postpone the timing of reporting certain economic outcomes for some time without detection.

<sup>89</sup> Theoretically it is possible to require managers to sell their equity stakes only following a certain period after they have left the company. However, risk-averse managers would substantially discount the value of such an equity grant, for two reasons: 1) Once the manager has left the firm, she has no control over the business performance of the firm, which expose her to the untested skill of the future managerial team. 2) Manager turnover is often the result of crises, which would mean that the manager is entitled to sell at times when the firm equity is most likely to be worth the least.

<sup>90</sup> For a discussion of the concept of fundamental risk, see Owen A. Lamont & Richard A. Thaler, *Can the Market Add and Subtract? Mispricing in Tech Stock Carve-Outs*, 111 J. POL. ECON. 227, 229 (2003).

<sup>91</sup> See, e.g., Cheng & Warfield, *supra* note 62, at 444-45 ("Due to these equity-based holdings, managers' wealth is sensitive to their firms' stock prices and managers therefore bear the idiosyncratic risk of the firm ... [F]rom the perspective of risk diversification, risk averse managers want to reduce their exposure to the

evidence shows exactly just to what extent managers fear holding too much of their firms' equity for a lengthy period of time. One extensive study found that, on average, managers sold approximately 680 already-owned shares for every 1000 new options granted and sold 940 already-owned shares for every 1000 new restricted shares granted.<sup>92</sup> These findings should serve as a warning sign. Precluding managers from selling their shares for extended periods of time comes at a significant cost, and ameliorating incentives to misreport is not justified at any or all costs.<sup>93</sup> Moreover, there are other proposed remedies that can and should be taken into account, such as the proposal raised in this paper. Indeed, the optimal mix of remedies might point to much shorter holding periods than those that are theoretically possible.<sup>94</sup>

One additional point should be noted. As far as misreporting is concerned, it is far from a given that shareholders would want managers to refrain from this practice. Short-term inflation in share prices can benefit existing shareholders at the expense of future shareholders and creditors.<sup>95</sup> Any artificial increase in share value leads to a transfer of value between a shareholder who decides to sell her shares and the future shareholder who buys the shares; thus, the existing shareholder can benefit from management misreporting while

idiosyncratic risk of the firm. Consequently, managers want to sell shares if the risk exposure level is higher than the equilibrium level ...").

<sup>92</sup> See Eli Ofek & David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 J. FIN. 1367, 1376 (1997).

<sup>93</sup> This is perhaps the essence of agency cost theory: one would not want to invest one dollar in preventing harm caused by agency relations if such a measure would result in a less than one-dollar reduction in residual loss. See Jensen & Meckling, *supra* note 42 (creating the framework of agency cost theory).

<sup>94</sup> The short survey above does not purport to exhaust the flaws in the existing common practices of executive compensation. For instance, one recent study revealed that corporations manipulate the use of compensation peer groups by selecting peer firms that will comfortably justify high wages for their own executives. See MICHAEL W. FAULKENDER & JUN YANG, *INSIDE THE BLACK BOX: THE ROLE AND COMPOSITION OF COMPENSATION PEER GROUPS* (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=972197](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972197) (showing that firms select highly-paid peers as a mechanism to increase CEO compensation). One partial and recent response to this flaw has been the requirement to disclose the peer group composition, which was previously a voluntary disclosure, found in section 229.201 of the SEC amendments to the disclosure requirements for executive and director compensation, 17 C.F.R. § 229.201 (2006).

enjoying immunity from any direct liability as she does not directly participate in the false disclosure. Moreover, backed with overvalued equity, the firm can raise additional capital by issuing shares at an inflated value, thereby diluting the stakes of existing shareholders far less than would be the case were issuance set at the accurate price. It is therefore not surprising that shareholders lack perfect incentives to counter securities fraud and mechanisms that generate such behavior, such as skewed incentive pay programs.<sup>96</sup> Similar dynamics in the relationship between shareholders and creditors augment shareholder incentive to neglect their oversight duty in the context of manager incentive compensation. Incentivizing managers to inflate share prices and skew accounting figures can result in a better credit rating for the firm and avoidance of default provisions in its debt contracts; both enable the firm to finance its operation at a lower cost (relative to accurately disclosing firms) to the benefit of its shareholders. Once again, it is no wonder that shareholders cannot be trusted to reform executive pay schemes towards instituting socially optimal incentives for accurate disclosure.

The two hurdles discussed here—namely, that even the optimal compensation scheme leaves ample incentive to misreport and that shareholders cannot be relied upon to fight for an optimal compensation scheme—raises the role of gatekeepers in capital markets. Gatekeepers are assumed to guard against manager incentive to manipulate disclosure, even when the shareholder body has abandoned its watch. The next Part of the paper will discuss this role and explain why gatekeepers too often cave in and fail to perform their required function. This discussion will lead us, in turn, to a reform proposal, outlined in Part IV.

<sup>95</sup> See, e.g., Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005) (discussing the tension between current and future shareholders).

### III. The Unfulfilled Promise of Gatekeeper Independence

Throughout the 1990s and the beginning of the twenty-first century, auditors failed to meet their potential as gatekeepers and did not forestall the massive wave of fraud and misreporting. Given managers' perverse incentives to act fraudulently, discussed in Part II, this should come as no surprise. The crises that ensued after the exposure of the fraudulent activity spurred aggressive legislation and regulatory responses aimed at improving securities disclosure.<sup>97</sup> While the benefits of this intervention are debatable, it clearly entails high costs, including the sky-rocketing cost of audits. This Part concludes its discussion with criticism of one of the pillars of auditor regulation: the ideal of auditor independence. While it is indeed important that auditors enjoy independence from managers, this is not a sufficient condition to ensure that they withstand pressure from management to compromise the quality of the financial statements. In order to make certain that auditors act to counter managerial incentives to inflate earnings and hide adverse events, their incentives must be calibrated in a radical manner, as a mirror-image of the managerial incentives. This discussion will lead us to the reform proposal presented in Part IV.

#### a. Crises and Failure

The term gatekeepers, which was adopted by jurists in the late 1980s<sup>98</sup> and has since maintained its appeal in the corporate governance discourse,<sup>99</sup> refers to certain agents, such as

<sup>96</sup> In Fried's terms, this shareholder tendency leads to a "current owner bias" in corporate law. Fried, *supra* note 44.

<sup>97</sup> See Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 Conn. L. Rev. 393 (2006) (an historical survey demonstrating that stock market bubbles almost invariably coincide with epidemics of securities fraud and, in turn, enhanced regulation).

<sup>98</sup> Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

<sup>99</sup> John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (presenting gatekeepers' failure as an alternative explanation for the wave of accounting and financial reporting irregularities that surfaced in 2001-2002); John C. Coffee, *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293 (2003) [hereinafter Coffee, *The Attorney as*

auditors and legal counsel, who are in a position to prevent corporate wrongdoing, including misreporting. Given the negative incentives of management and the inability of manager compensation schemes to overcome this problem, gatekeepers have a sacrosanct role in corporate governance. Since they are not affected by the same perverse incentive structures that drive corporate insiders and given their reputation concerns and deep pockets, gatekeepers are expected to stand up to opportunistic behavior. It is no secret, however, that gatekeepers failed to live up to their promise when they did not safeguard the capital markets against the corporate fraud surge of the late 1990s and early twenty-first century.<sup>100</sup> During the same period that executive pay skyrocketed, there was a veritable explosion in accounting restatements, a central symptom of financial irregularity. From an annual average of about 50 public company restatements in the period of 1990 to 1997,<sup>101</sup> the number rose to 201 in 2000 and to 225 in 2001,<sup>102</sup> the year before the introduction of the Sarbanes-Oxley legislation. Together, this amounted to an unimaginable volume of 1 in every 10 U.S. public firms issuing at least one restatement between 1997 and 2002.<sup>103</sup> Some argue that the actual number of

*Gatekeeper*] (claiming that securities attorneys can and do perform a limited gatekeeping function); Hamdani & Kraakman, *supra* note 22 (comparing two possible legal regimes of outside directors outside directors' rewards and liability. The gatekeeper term was adopted also by the Securities and Exchange Commission, *see, e.g.*, Securities Act Release No. 7870 (June 30, 2000) 2000 SEC LEXIS 1389 ("the federal laws... make independent auditors 'gatekeepers' to the public securities markets").

<sup>100</sup> This notion is the essence of Coffee's paper, *What Caused Enron?*, Coffee, *supra* note 44. The previous title of an earlier version of the same paper, *Understanding Enron: It's About the Gatekeepers, Stupid*, reflected the notion well, JOHN C. COFFEE, JR., UNDERSTANDING ENRON: IT'S ABOUT THE GATEKEEPERS, STUPID (Columbia Law & Economics Working Paper No. 207, 2002), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=325240](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=325240). *See also* Coffee, *The Attorney as Gatekeeper*, *supra* note 99.

<sup>101</sup> George B. Moriarty & Philip B. Livingston, *Quantitative Measures of the Quality of Financial Reporting*, 17 FIN. EXECUTIVE 53, 53-54 (2001).

<sup>102</sup> U.S. Gen. Acct. Office, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges*, Rep. No. GAO-03-138, at 12 (October 2002), *available at* <http://www.gao.gov/new.items/d03138.pdf> [hereinafter GAO, *Financial Restatements*]. *But cf.* KAREN M. HENNES, ANDREW J. LEONE & BRIAN P. MILLER, *THE IMPORTANCE OF DISTINGUISHING ERRORS FROM IRREGULARITIES IN RESTATEMENT RESEARCH: THE CASE OF RESTATEMENTS AND CEO/CFO TURNOVER* (2007), *available at* <http://ssrn.com/abstract=948929> (a cautionary note on the importance of distinguishing bona fide errors from irregularities in the GAO database on restatements).

<sup>103</sup> *Id.* at 4.

restatements was even higher and in fact grew tenfold from 1990 to 2000.<sup>104</sup> Recall also that restatements are only required in cases of the most acute form of accounting failure. Many, if not most, of the accounting schemes and sugarcoating cases simply go unnoticed or fail to reach the extreme of requiring a restatement.

In any event, this syndrome had devastating effects on the American market.<sup>105</sup> The federal government's accountability office estimated at least \$100 billion in total market losses for restating firms;<sup>106</sup> and one academic study showed that its sampled restating firms had lost, on average, no less than 25% of their market value.<sup>107</sup> Yet these numbers, too, are an understatement of the real loss. There was a reasonable belief amongst investors that not all cases of fraud and financial irregularity had been exposed.<sup>108</sup> Indeed, one study showed that accounting restatements that adversely affect shareholder wealth at the restating firm also induce share price declines among non-restating firms in the same industry.<sup>109</sup> Moreover, these latter declines were found to be linked to factors in the accounting quality in the sampled firms. Thus, for instance, non-restating firms using the same external auditors as the restating firms or non-restating firms with high discretionary accounting accruals experienced

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<sup>104</sup> The evidence is summarized in Coffee, *supra* note 1, at 201.

<sup>105</sup> The discussed outcomes underestimate the amount of fraud that was going on. One significant, scandalous matter that was uncovered only a few years later was the stock-option backdating that took place at the end of the 1990s and the beginning of the twenty-first century. See Walker, *supra* note 81, at 563: "In the year since the scandal was uncovered, the SEC has launched investigations into suspicious timing and pricing of stock options granted during the go-go years of the late 1990s and early 2000s at more than one hundred companies... recent papers suggest that this figure represents only the tip of the iceberg—that perhaps 10% to 20% of options issued to senior executives during this period may have been backdated in order to reduce option exercise prices."

<sup>106</sup> GAO, Financial Restatements, *supra* note 102, at 24.

<sup>107</sup> SCOTT A. RICHARDSON, A. IREM TUNA & MIN WU, PREDICTING EARNINGS MANAGEMENT: THE CASE OF EARNINGS RESTATEMENTS 16 (2002), available at <http://ssrn.com/abstract/338681>.

<sup>108</sup> Fraud and financial misrepresentation cases that were exposed and subject to enforcement action are reported in JONATHAN M. KARPOFF, D. SCOTT LEE & GERALD S. MARTIN, THE LEGAL PENALTIES FOR FINANCIAL MISREPRESENTATION (2007), available at <http://ssrn.com/abstract=933333> (providing an integrated analysis of private and regulatory penalties for financial misrepresentation).

<sup>109</sup> CRISTI A. GLEASON, NICOLE THORNE JENKINS & W. BRUCE JOHNSON, THE CONTAGION EFFECTS OF ACCOUNTING RESTATEMENTS (AAA 2005 FARS Meeting Paper, 2007), available at <http://ssrn.com/abstract=591689> (predicting and finding that accounting restatements that adversely affect shareholder wealth at restating firms also induce a parallel share price decline among non-restating firms in the same industry).

a sharper drop in share prices than other non-restating firms.<sup>110</sup> Together, the direct and indirect outcomes of financial fraud and misreporting contributed to the crash of U.S. capital markets, which, during the years 2001 to 2002, plummeted by 32 percent.<sup>111</sup> Congress acted swiftly in response to these events, with, as one scholar explained, "the Sarbanes-Oxley Act of 2002 understandably focus[ing] on gatekeepers."<sup>112</sup>

### **b. The Costs and Limits of the Sarbanes-Oxley Legislation**

As noted, the 2002 Sarbanes-Oxley Act has both its critics and proponents. There can be no doubt, however, about the huge costs this legislation entails. Since the objective of this paper is to propose reform aimed at improving gatekeeper performance, it is important to understand in what ways it diverges from the reform introduced by Sarbanes-Oxley. Indeed, the Act prescribed several new requirements relating to gatekeepers, placing great, albeit not exclusive,<sup>113</sup> emphasis on auditors. To compare between the reform proposed in this paper and the Act, the discussion will focus on some of the latter's provisions that address auditors and, more broadly, the preparation of financial statements.<sup>114</sup>

The Sarbanes-Oxley Act constitutes the consolidation of a series of corporate governance initiatives and new disclosure requirements that were incorporated into the

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<sup>110</sup> *Id.* at 18.

<sup>111</sup> Bengt Holmstron & Steven N. Kaplan, *The State of US Corporate Governance: What's Right and What's Wrong*, 15 J. APPLIED CORP. FIN. 8 (2003)

<sup>112</sup> Coffee, *supra* note 1, at 204.

<sup>113</sup> Another important gatekeeper targeted by the Act is the corporate lawyer, Rules of Professional Responsibility For Attorneys, 15 U.S.C.A. § 7245 (2006) (SOX § 307); *see also* Coffee, *The Attorney as Gatekeeper*, *supra* note 99.

<sup>114</sup> One provision in the Sarbanes-Oxley legislation not discussed below is the section that created a new public board to oversee auditors ("PCAOB"), in effect establishing a new regulator directed exclusively at the auditing profession. *See* Inspections of Registered Public Accounting Firms, 15 U.S.C.A. § 7214 (2006) (SOX § 104). It is hard to measure the costs and benefits of this new institution whose main function is to conduct inspections of every registered public accounting firm. *See* HELEN M. ROYBARK, AN ANALYSIS OF AUDIT DEFICIENCIES BASED ON PCAOB INSPECTION REPORTS ISSUED DURING 2005 (2007), *available at* <http://ssrn.com/abstract=1008206> (compiling data from PCAOB findings over the years 2004-2005). Other relevant and important provisions in the Sarbanes-Oxley Act address audit partner (and audit firm) rotation, 15

federal securities laws alongside enhanced disclosure requirements.<sup>115</sup> One measure introduced by the Act, discussed in the context of the limits of executive pay reform, is the claw-back provision, which requires the forfeit of compensation gained through fraud or misreporting.<sup>116</sup> Another important provision relating to financial reporting is the section 301 requirement that all public companies have an audit committee composed entirely of independent directors.<sup>117</sup> Since the audit committee is a sub-committee of the board that oversees the corporation's relationship with its auditor, this requirement was aimed at improving the monitoring of management in the context of financial disclosure. While such a requirement is not necessarily a bad idea, the empirical literature has raised doubts as to whether audit committees with independent directors can actually overcome management's biased incentives vis-à-vis disclosure.

In U.S. firms, corporate boards, including audit sub-committees, are already packed with independent directors.<sup>118</sup> Moreover, the evidence has always been inconclusive with regard to the connection between board independence and firm performance.<sup>119</sup> To attack the

U.S.C. § 78j-1(j) (2006) (SOX § 203); 15 U.S.C.A. § 7232 (2006) (SOX § 207), which are analyzed in *infra* Part IV as part of the discussion of the present paper's proposed reform.

<sup>115</sup> An example of an enhanced disclosure requirement is the treatment of off-balance-sheet transactions, 15 U.S.C.A. § 7261 (2006) (SOX § 401(a)).

<sup>116</sup> See *supra* Part II.c.

<sup>117</sup> 15 U.S.C. § 78j-1(m)(3)(A) (2006) (SOX § 301). In addition, section 407 of SOX requires disclosure of the financial expertise of the members of the audit committee and an explanation, if relevant, for any lack of such expertise, 15 U.S.C.A. § 7265 (2006) (SOX § 407). See also LAWRENCE A. CUNNINGHAM, REDISCOVERING BOARD EXPERTISE: LEGAL IMPLICATIONS OF THE EMPIRICAL LITERATURE (GWU Law School Public Law Research Paper No. 363, 2007), available at <http://ssrn.com/abstract=1024261> (showing that the Sarbanes-Oxley requirement led firms to appoint more directors with financial expertise, especially to the audit committee, and that this measure (in particular when the expertise involved was accounting expertise) enhances firm performance).

<sup>118</sup> JEFFREY N. GORDON, INDEPENDENT DIRECTORS AND STOCK MARKET PRICES: THE NEW CORPORATE GOVERNANCE PARADIGM (Columbia Law & Economics Working Paper No. 301, 2006), available at <http://ssrn.com/abstract=928100> (showing that over the 1950-2005 period, the composition of large public company boards dramatically shifted towards independent directors, from 20% to 75%, and arguing that independent directors have become a complementary institution to an economy of firms directed at maximizing shareholder value).

<sup>119</sup> Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (a survey of the literature on board independence); Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277 (1996) (same).



Sarbanes-Oxley legislation,<sup>120</sup> Romano turned to the findings of sixteen different studies on the link between audit committee independence and firm performance (including audit quality): the overwhelming majority showed no link between total independence of the audit committee members and performance.<sup>121</sup> The findings were even mixed as to whether a majority of independent directors on a committee (the prevailing situation prior to the Act) has any effect on firm performance.<sup>122</sup> These findings are hardly surprising in light of the arguments made in this paper. Independent directors do not have any intimate knowledge of the firm's financial status. As will be discussed at the beginning of Part IV, auditor-client negotiations over the financial statements are conducted between two highly sophisticated and knowledgeable parties: the CFO and her staff on the one side and the audit partner and her staff on the other.<sup>123</sup> To truly improve the outcome of these negotiations, auditors' incentives must be addressed directly, as suggested in this paper. This is at least one good way to effectively counter executives' perverse incentives, which are driven by the new model of executive incentive pay.

A third important provision in the Sarbanes-Oxley legislation is the requirement for executive certification of financial statements and the institution of internal controls. The CEO and CFO of listed firms must certify that their firm's periodic reports fairly represent its financial condition and results of operations.<sup>124</sup> This requirement alone does not seem impressive in itself, as these executives had always signed the company's reports and had

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<sup>120</sup> Romano's criticism is based, at least in part, on her general view that one set of norms cannot possibly suit all corporations. *See, e.g.,* SANJAI BHAGAT, BRIAN J. BOLTON & ROBERTA ROMANO, THE PROMISE AND PERIL OF CORPORATE GOVERNANCE INDICES (2007), available at <http://ssrn.com/abstract=1019921> (empirically showing that corporate governance is an area where a regulatory regime of ample flexibility across firms is particularly desired).

<sup>121</sup> *See* Romano, *supra* note 17, at 1604 tbl. 4.

<sup>122</sup> *Id.* at 1532.

<sup>123</sup> For the non-verifiable nature of the outcomes of auditor-client negotiations over financial statements, see ABIGAIL B. BROWN, INCENTIVES FOR AUDITOR COLLUSION IN PRE-SARBANES-OXLEY REGULATORY ENVIRONMENT (2007), available at <http://ssrn.com/abstract=976169> (explicitly modeling the possibility of

been subject to liability under securities laws.<sup>125</sup> Its significance, rather, lies in the duty it imposes on CFOs and CEOs to establish and maintain internal controls that can attest to the verity of the financial reports and the executives' certification thereof. Section 404 of the Act augments this requirement with an additional requirement, to file a report assessing the firm's internal controls, which must include confirmation from the external auditor.<sup>126</sup>

While these seemingly benign measures may have indeed improved the quality of disclosure,<sup>127</sup> they have also imposed huge costs. One survey estimated that the cost of compliance with the certification requirement in terms of audit fees, external consulting, and software expenses would add up to about \$2.9 million in additional fees for companies with revenues of over \$5 billion;<sup>128</sup> a more recent empirical work has showed that the certification requirement alone practically doubled the relevant fees for the sampled firms.<sup>129</sup> In fact, the total costs of compliance with the Sarbanes-Oxley legislation are much higher, with one report finding an almost 350% TT increase in audit fees between 2001 and 2006.<sup>130</sup> And these out-of-pocket expenses are certainly not an exhaustive list of the costs of compliance. In addition to the direct audit fees, consulting fees, software costs, increased insurance, and

collusion between manager and outside auditor in a context where the outcome of the auditor-client negotiations is unverifiable).

<sup>124</sup> 15 U.S.C. § 7241 (2006) (SOX § 302).

<sup>125</sup> 17 C.F.R. § 240.10b-5 (2007); *see also* 3 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 199-207 (5th ed. 2005).

<sup>126</sup> In its report, the registered public accounting firm must express an opinion concerning management's assessment of the effectiveness of the firm's internal control over financial reporting, 15 U.S.C. § 7262 (2006) (SOX § 404).

<sup>127</sup> The empirical data on this issue do not necessarily support the efficacy of these requirements, *see* Romano, *supra* note 17, at 1541-42 (summarizing the empirical literature and criticizing the certification requirement). *But cf.* PETER ILIEV, THE EFFECT OF THE SARBANES-OXLEY ACT (SECTION 404) ON AUDIT FEES, ACCRUALS AND STOCK RETURNS (2007), *available at* <http://ssrn.com/abstract=983772> (showing that the requirement for a certification report induced managers to cut back on discretionary accruals).

<sup>128</sup> The survey conducted by the Financial Executive International organization is summarized in Romano, *supra* note 17, at 1587-88.

<sup>129</sup> Iliev, *supra* note 127 (showing that firms with a public float of about \$75 million dollars incurred double their previous annual audit fees amount due to the certification requirement, with audit fees rising on average from \$370,700 to \$882,300).

<sup>130</sup> According to a recent report from the Corporate Library, the median increase in audit fees between 2001 and 2006 was almost 350%, *see* <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070822/REG/70822008/1036>.

additional outside directors fees,<sup>131</sup> there are indirect costs, from simple business disruption and increased rates of firms going private<sup>132</sup> to less frequent M&A activity due to fear of compliance problems in newly acquired divisions.<sup>133</sup> It is therefore hardly surprising that a recent study showed that U.S. firms experienced statistically significant negative abnormal returns around key Sarbanes-Oxley legislation events.<sup>134</sup>

A positive account of the Sarbanes-Oxley Act might explain that these costs are worth the benefits produced by the legislation. For instance, one recent study showed that the proportion of securities fraud uncovered by auditors has risen substantially in the post Sarbanes-Oxley era.<sup>135</sup> Prior to the legislation, auditors were responsible for only 7.2% of all cases of exposed securities fraud, whereas subsequently, this increased impressively to 28.9%.<sup>136</sup> Before proceeding to Part IV, which proposes a new method of improving disclosure and audit quality, perhaps at a much lower cost, one final provision of Sarbanes-Oxley should be examined, namely, that aimed at ensuring the principle of auditor

<sup>131</sup> JAMES S. LINCK, JEFFRY M. NETTER & TINA YANG, EFFECTS AND UNINTENDED CONSEQUENCES OF THE SARBANES-OXLEY ACT, AND ITS ERA, ON THE SUPPLY AND DEMAND FOR DIRECTORS (AFA 2006 Boston Meetings Paper, 2007), available at <http://ssrn.com/abstract=902665>, found that with the legislation of the Sarbanes-Oxley Act, the size of boards and proportion of independent directors on those boards have increased significantly. This increase in the size of boards implies additional directors' fees, as well as also possibly entailing the cost of harm to the board's ability to act as a monitoring mechanism. See, e.g., David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 193 (1996) (finding "an inverse association between board size and firm value in a sample of 452 large U.S. industrial corporations between 1984 and 1991").

<sup>132</sup> See, e.g., EHUD KAMAR, PINAR KARACA-MANDIC & ERIC L. TALLEY, GOING PRIVATE DECISIONS AND THE SARBANES-OXLEY ACT OF 2002: A CROSS-COUNTRY ANALYSIS (USC CLEO Research Paper No. C06-5, 2006), available at <http://ssrn.com/abstract=901769> (finding that the Sarbanes-Oxley Act caused small-size firms to go private); Stanley B. Block, *The Latest Movement to Going Private: An Empirical Study*, 14 J. APPLIED FIN. 36 (2004) (surveying firms going private and their motivation for doing so).

<sup>133</sup> This fear exists when the contemplated object of acquisition is a foreign firm or a closely held firm that has never withstood a compliance test.

<sup>134</sup> See IVY ZHANG, ECONOMIC CONSEQUENCES OF THE SARBANES-OXLEY ACT OF 2002 (Feb. 1, 2007), available at <http://ssrn.com/abstract=961964> (an event-study investigation of the Sarbanes-Oxley Act examining market reactions to related legislative events).

<sup>135</sup> I.J. ALEXANDER DYCK, ADAIR MORSE & LUIGI ZINGALES, WHO BLOWS THE WHISTLE ON CORPORATE FRAUD? (AFA 2007 Chicago Meetings Paper, 2007), available at <http://ssrn.com/abstract=891482> (reviewing a sample of 230 cases of corporate fraud between 1996-2004).

<sup>136</sup> *Id.* at 67 tbl. 13. See also MARY ELLEN CARTER ET AL., CHANGES IN BONUS CONTRACTS IN THE POST-SARBANES-OXLEY ERA (2007), available at [http://accounting.wharton.upenn.edu/faculty/carter/clz\\_111507.pdf](http://accounting.wharton.upenn.edu/faculty/carter/clz_111507.pdf) (showing that Sarbanes-Oxley and related reforms led to a decrease in earnings management and that firms responded by placing more weight on earnings in bonus contracts).

independence.<sup>137</sup>

### c. The Auditor Independence Requirement in Sarbanes-Oxley and Beyond

A central provision in the Sarbanes-Oxley Act, which addresses an issue that lay at the heart of the legislative deliberation,<sup>138</sup> is the prohibition on accounting firms to provide the majority of non-auditing services to the firms they audit.<sup>139</sup> This provision led to sweeping change in the practices prevailing at the time of its legislation. For instance, in 2000, GE paid its auditor KPMG LLP \$23.9 million for audit fees, \$11.5 million for information system design and implementation, \$13.8 million for tax services, \$15.5 million for due diligence procedures associates with M&A activity, and \$38.9 million for "all other services consisting primarily of information technology consulting ... not associated with financial statements."<sup>140</sup> In 2005, there was a drastic shift as a result of the Sarbanes-Oxley prohibition, with GE paying the same auditor \$73.3 million in audit fees and audit-related fees, but only \$6.5 million in tax fees and \$2.5 million in all other fees.<sup>141</sup>

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<sup>137</sup> The Sarbanes-Oxley Act cannot be blamed for all of the costs that emerge from U.S. financial regulation, for the United States has over 115 federal and state agencies that are involved in regulating some aspect of financial services, with Congress contemplating adding new agencies to the list. ELIZABETH F. BROWN, *THE TYRANNY OF THE MULTITUDE IS A MULTIPLIED TYRANNY: IS THE UNITED STATES' FINANCIAL REGULATORY STRUCTURE UNDERMINING U.S. COMPETITIVENESS?* (2007), available at <http://ssrn.com/abstract=1008969>.

<sup>138</sup> Romano, *supra* note 17, at 1549.

<sup>139</sup> See 15 U.S.C. § 78j-1(g) (2006) (SOX § 201) (adding section 10A (g) of the 1934 Securities Exchange Act). The full list of banned non-audit services now appears in Regulation S-X, Rule 2-01(c)(4), 17 C.F.R. 210.2-01(c)(4) (2006).

<sup>140</sup> See the Independent Auditor Fees section in the 2001 General Electric Proxy Statement, Form DEF 14A, available at <http://www.sec.gov/Archives/edgar/data/40545/000095013001001223/0000950130-01-001223.txt>.

<sup>141</sup> See the audit fees section in the 2007 General Electric Proxy Statement, Form DEF 14A, available at <http://www.sec.gov/Archives/edgar/data/40545/000119312507040510/ddef14a.htm>. This is by no means a unique phenomenon. As a comparison, the 2000 Microsoft expenditure on audit fees was \$4.7 million, and \$14.7 million in other fees were paid to its audit firm, see the 2001 Microsoft Proxy Statement, Form DEF 14A, available at <http://www.sec.gov/Archives/edgar/data/789019/000103221001501143/ddef14a.htm>. In contrast, in 2006, Microsoft expended \$16.4 million on audit fees, with only \$0.8 million paid to its auditor for tax services and \$0.7 million for all other services, see 2007 Microsoft Proxy Statement, Form DEF 14A, available at <http://www.sec.gov/Archives/edgar/data/789019/000119312507205208/ddef14a.htm>. A similar shift occurred in General Motors: in 2000, it paid \$17 million in audit fees, \$2 million for financial information systems design, and \$77 million in "all other fees", see 2001 General Motors Proxy Statement, Form DEF 14A, available at <http://www.sec.gov/Archives/edgar/data/40730/000089016301000190/0000890163-01-000190-0001.txt>. In

The rationale for this prohibition was that non-audit services can generate high fees, the prospect of which, in turn, can compromise the external auditor's diligence in performing its task.<sup>142</sup> This logic fits with a concept that is almost sacred in securities regulation: auditor independence.<sup>143</sup> Critics of the Sarbanes-Oxley Act argue that there is voluminous empirical literature showing that, by and large, not much improvement in audit quality can be achieved with the new restriction.<sup>144</sup> This paper takes an entirely different approach: Independence is simply not enough. Instead of fine-tuning the concept of auditor independence, as Sarbanes-Oxley attempted, the focus should be on shaping incentives that rest on the quality of the auditor's work.

The principal of auditor independence is anchored in the preamble to the regulation prescribing auditor qualifications:

Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions of financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.<sup>145</sup>

The simple yet fundamental limitation of this extensive independence requirement is that it fails to provide an affirmative incentive for auditors to counter fraud and improve the quality of disclosure. Any independence requirement will merely reduce auditor incentives and

2006, GM paid \$50 million in audit fees, \$12 million in audit-related fees, \$7 million in tax fees, and only \$4 million in "all other fees," *see* 2007 General Motors Proxy Statement, Form DEF 14A, *available at* [http://www.sec.gov/Archives/edgar/data/40730/000089016307000284/s11-7040\\_def14a.htm](http://www.sec.gov/Archives/edgar/data/40730/000089016307000284/s11-7040_def14a.htm).

<sup>142</sup> The empirical work on the subject prior to the Sarbanes-Oxley legislation clearly shows that the non-audited services provided by the audit firm generated much of its total income. *See* FERDINAND A. GUL, BIKKI JAGGI & GOPAL V. KRISHAN, AUDITOR INDEPENDENCE: EVIDENCE ON THE JOINT EFFECTS OF AUDITOR TENURE AND NON-AUDIT FEES 11-12 (2007), *available at* <http://ssrn.com/abstract=984656> ("The mean (median) of audit fees is \$0.59 (\$0.22) million, whereas the mean (median) of nonaudit fees is \$1.34 (\$0.23) million respectively.").

<sup>143</sup> Indeed, in 2000, certain non-audit services were already banned by the SEC on the rationale that they compromise auditor independence. *See* Romano, *supra* note 17, at 1534.

<sup>144</sup> The empirical literature is discussed and analyzed extensively in Romano, *supra* note 17, at 1536-37. Audit quality is measured by a variety of variables, including abnormal and discretionary accruals, earnings surprises, variables related to earnings conservatism, financial restatements, and the issuance of qualified audit opinions, *id.* at 1535.

<sup>145</sup> See the preliminary note to Regulation S-X, Rule 2-01, 17 C.F.R. 210.2-01 (2006).

inclination to favor executives.<sup>146</sup> But any residual tendency on the part of auditors to favor executives, if for the sole reason that they belong to the same socio-economic group of reference, could substantially compromise auditor performance in the absence of any countervailing incentive to fight manipulation and disorder in the firm. Auditor independence, therefore, cannot be relied upon to counter the social and psychological forces that may cause auditors to favor managers over the amorphous group of constituents that are harmed by imprecise disclosure.<sup>147</sup> Simply put, the auditor bears no immediate and real costs if she chooses to act collegially and avoid conflict.

As explained in Part IV below, negotiations between the auditor and the firm-client are conducted behind closed doors, and both sides have a significant extent of private knowledge regarding the firm, since the auditors conduct an intensive auditing procedure. The private and sophisticated nature of this interaction and the imprecise nature of the accounting profession to a great degree shield the auditor from reputation backfire and legal liability.<sup>148</sup> This reality heightens the need for an adequate structuring of auditor incentives, something that has only intensified since executives began to receive compensation in the form of stock options and the like. Indeed, the idea is to make auditors not only independent

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<sup>146</sup> This claim follows closely the lines of Bebchuk & Fried's argument for the insufficiency of the requirement of outside director independence. BEBCHUK & FRIED, *supra* note 12, at 203. Given auditors' professional skills, which may assist them in countering executives' negative incentives to manipulate earnings, this argument becomes increasingly important in relation to auditors.

<sup>147</sup> One of these psychological forces is the self-serving bias that causes people to overlook matters that can cause them disutility and, in our case, the necessity to engage in a conflict with management. See Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 649 (1999) (describing an experiment in which students who were designated as either plaintiff or defendant were asked to make an objective assessment of the monetary judgment in the case, with assessments of students designated as plaintiffs emerging as much higher than those of students designated as defendants, although both groups considered the same case). See generally Norbert L. Kerr, Robert J. MacCoun & Geoffrey P. Kramer, *Bias in Judgment: Comparing Individuals and Groups*, 103 PSYCHOL. REV. 687 (1996) (discussing the operation of the self-serving bias in groups). One should also keep in mind that social interactions and connections often translate into financial gain. Hence, a person would prefer to maintain a good relationship with an influential executive rather than make enemies in so-called corporate America.

<sup>148</sup> Beyond the evidentiary difficulties, the conceptual possibility of auditors' bearing legal liability is tenuous in the U.S. to begin with. See the discussion at *infra* Part IV.c. For a comparison of auditors' legal liability in the U.S. and U.K. respectively, see generally TIM BUSH, STELLA FEARNLEY & SHYAM SUNDER,

of management but also dependant on the fate of future shareholders who may be harmed by earnings manipulation and bad-faith disclosure.

#### IV. The Gatekeeper's Option: Towards a New Format of Gatekeeper Compensation

Any outsider to the corporate world who happens to read an audit opinion affirming the financial statements of a given corporation is bound to get the wrong impression. For a literal reading of a typical audit opinion would wrongly imply that corporate insiders had produced the financial statements and that the audit firm, in turn, had conducted its audit and verified whether those financials accurately represent the financial status of the firm and its operations according to generally accepted accounting principles.<sup>149</sup> One example of the typical format of an auditor's opinion can be found in Yahoo's unqualified audit report and similarly appears in thousands of other reports:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Yahoo! Inc. and its TTsubsidiaries ... . These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.<sup>150</sup>

Nothing could be farther from the truth than this literal depiction of the essence of the auditing process. In reality, corporate insiders, chiefly the CFO and her staff<sup>151</sup> (although,

AUDITOR LIABILITY REFORMS IN THE UK AND THE US: A COMPARATIVE REVIEW (2007), *available at* <http://ssrn.com/abstract=1011235> (discussing reforms in auditor liability regimes).

<sup>149</sup> The Report of Independent Registered Public Accounting Firm attached to Yahoo Inc., 2004 Annual Report (2004), available at <http://www.secinfo.com/dVut2.z62k.htm?Find=3721&Line=4519#6yya>. See also The Consent of Independent Registered Public Accounting Firm, attached to General Motors Corp. 2007 Annual Report (2007), available at

<http://www.sec.gov/Archives/edgar/data/40730/000095012407001502/k11916exv23.htm> and The Report of Independent Registered Public Accounting Firm attached to Microsoft Corp. 2007 Annual Report (2007) available at <http://www.sec.gov/Archives/edgar/data/789019/000119312507170817/d10k.htm>.

<sup>150</sup> See the Report of Independent Registered Public Accounting Firm attached to Yahoo Inc., 2004 Annual Report (2004), *supra* note 149.

<sup>151</sup> Michael Gibbins, Susan A. McCracken & Steve S. Salterio, *The Chief Financial Officer's Perspective on Auditor-Client Negotiations*, 24 CONTEMP. ACCT. RES. 387 (2007) ("CFOs are the managers responsible for the financial statements used by markets and others... yet their views are largely absent from the accounting research literature").

interestingly enough, not the members of the audit committee),<sup>152</sup> negotiate with the audit partner and her staff over the numbers and any other feature of the financial statements.<sup>153</sup> There is nothing wrong with this practice. Insiders are typically biased in their firm's favor, both knowingly and subconsciously leaning towards smooth and positive numbers and representations,<sup>154</sup> whereas auditors are professionals led by ethics and reputation concerns and therefore typically counterbalance insiders' incentives. And since financial reporting involves a great deal of evaluations, contingencies, appraisals, interpretations, and discretion, there is much to negotiate. Moreover, it is extremely hard to determine from the outside whether the financial statements that were produced at the end of these negotiations actually constitute a fair representation of the corporation's financial position.<sup>155</sup> Put differently, the

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<sup>152</sup> There is mounting evidence that audit committee plays a passive role in resolving accounting disputes with the auditor. See, e.g., Jeffrey R. Cohen et al., AUDITOR EXPERIENCES OF CORPORATE GOVERNANCE IN THE POST SARBANES-OXLEY ERA (2007), available at <http://ssrn.com/abstract=1014029> (showing that usually the auditor and the management try to resolve issues before they come to the attention of the audit committee); see BRADLEY POMEROY, AUDIT COMMITTEE MEMBER INVESTIGATION OF SIGNIFICANT ACCOUNTING DECISIONS (June 2008), available at <http://ssrn.com/abstract=962783> (stating that recent research suggests that audit committee members are not involved in material auditor-client negotiations and that they are often not even informed that accounting decisions were negotiated).

<sup>153</sup> This common and inevitable practice is documented in a large body of literature. See, e.g., Michael Gibbins, Susan McCracken & Steve S. Salterio, *Negotiations Over Accounting Issues: The Congruency of Audit Partner and Chief Financial Officer Recalls*, 24 AUDITING: J. THEORY & PRACTICE 171 (2005) (collecting data on accounting auditor-client negotiations as viewed from the audit partner's and CFO's perspectives); Michael Gibbins, Steven Salterio & Alan Webb, *Evidence About Auditor-Client Management Negotiation Concerning the Client's Financial Reporting*, 39 J. ACCT. RES. 535 (2001) (developing a model of auditor-client accounting negotiations and demonstrating important aspects of the sampled accounting negotiations); Gibbins, McCracken & Salterio, *supra* note 151 (reporting a sample of Canadian CFOs' views on the negotiation process with the audit firm); R.C. HATFIELD, C.P. AGOGLIA & M.H. SANCHEZ, THE EFFECT OF CLIENT CHARACTERISTICS ON THE NEGOTIATION TACTICS OF AUDITORS (Working Paper, Drexel University, 2005), available at <http://ssrn.com/abstract=892465> (empirically studying different negotiation strategies); Terence Bu-Peow Ng & Hun-Tong Tan, *Effects of Authoritative Guidance Availability and Audit Committee Effectiveness on Auditors' Judgments in an Auditor-Client Negotiation Context*, 78 ACCT. REV. 801 (2003) (showing that auditors' perceived negotiations' outcome is influenced by audit committee effectiveness); Ken T. Trotman, Arnold M. Wright & Sally Wright, *Auditor Negotiations: An Examination of the Efficacy of Intervention Methods*, 80 ACCT. REV. 349 (2005) (examining the effectiveness of three pragmatic intervention methods for enhancing auditor negotiation performance).

<sup>154</sup> Millstein noted even prior to the market crash in the early 2000s that "[t]he current concern with financial reporting is primarily fueled by a perceived need for corporations to constantly 'make the numbers'—to match or exceed analysts' expectations and projections." Ira M. Millstein, *Introduction to the Report and the Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057, 1059 (1999).

<sup>155</sup> See Gibbins, *supra* note 153 ("Much of what takes place in auditor-client management negotiations occurs in unobservable settings and normally does not result in publicly available archival records") [we need a



quality of the auditor's work is difficult to measure or second-guess.

The breadth and complexity of this issue is most evident when it is understood that almost any section of the financial statements, even if seemingly benign, entails intricate assessments and discretion, which, in turn, require auditor-client negotiations with outcomes not easily assessed from the outside. Some elements of the financial report, such as contingent liabilities, which include pending liabilities that may result from litigation, clearly leave much room for considerable discretion on the part of the firm's executives and auditors.<sup>156</sup> What is less obvious is that this type of discretion is, by and large, applied with regard to almost all components of the financial report. For instance, the accounts receivable section presumably consists of the amounts owed to the firm by its customers and hence would seem relatively easy to measure objectively. However, both accounting principles and the complicated nature of commerce render this presumption naive. To begin with, there is the problem of doubtful debts. The corporation and, subsequently, its auditors must decide on the size of the deduction to be made for such items. This determination involves many assumptions, assessments, and evaluations, and their reasonableness can be judged only by those intimately acquainted with the corporation's business. The complexity of the accounts receivable section does not end here. Some industries, including the pharmaceutical and computer hardware industries, are fraught with supply pressures from competitors that can substantially and quickly drive down prices due to innovations and the uncertain scope of patent protection. This phenomenon causes distributors and retailers to order less than optimal levels of inventory so that they can fully enjoy future price cuts. One frequent solution to this problem of suboptimal inventories and ordering is a commitment on the part

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<sup>156</sup> See, e.g., CLYDE P. STICKNEY & ROMAN L. WEIL, FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES 384-436 (10th ed. 2006) (discussing the concept of contingent liabilities).

of manufacturers to return to clients the amount of any price reduction in already-purchased inventory in the event that one occurs. In instances of such a commitment, the manufacturer's financial statements must include an allowance for the possibility and deduct it from accounts receivable (and the firm's profit). This leaves companies with a wide scope of discretion to significantly alter the entire operations results, for any increase in this allowance will reduce the representation of the firm's profits and any decrease will increase the figure.<sup>157</sup> The reasonableness of the size of this allowance can be determined only with an understanding of the nature of the firm's business, anticipated future developments in the industry, and what reactions to these possible changes the firm is contemplating. Upon completing its audit, the external auditor may then be equipped with the tools necessary to second-guess the decision made by the firm's executives; from the outside, however, it is virtually impossible to ascertain the fairness of the outcome of this non-transparent procedure. Although it will eventually emerge as to whether the firm's assessments were correct, it will be extremely hard to blame the firm or auditor for their inability to make accurate determinations. Believing in the verity of financial statements therefore requires much faith in the integrity of the auditor-client negotiations.

Unfortunately, however, these negotiations have ceased to be a level playing field. As discussed above, managers are increasingly compensated with stock options and the like, creating strong incentives to overplay firm performance and value, while auditors are "independent" at best, paid in a fixed amount. The old balance in negotiations between corporate insiders and auditors has thus tipped dramatically, with the one side of the equation becoming highly motivated to show improved results even if artificial. The evidence

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<sup>157</sup> For instance, at the world's largest pharmaceutical manufacturer of generic products, this allowance is almost 50% of the accounts receivable in the firm's balance sheet. See Note 5 of TEVA Pharmaceutical Industries Limited Notes to Condensed Consolidated Financial Statements (2007), available at <http://www.sec.gov/Archives/edgar/data/818686/000119312507232932/d6k.htm>.

presented in the previous parts of this paper indicates that the outcome of this shift in balance caused a major disorder that threatened the integrity of the U.S. capital markets. The Sarbanes-Oxley Act responded to this tilting in the auditor-client balance of power with extensive and expensive measures, and it is still being debated as to whether they are beneficial and justified. Accordingly, the main purpose of this paper is to suggest a different measure for restoring this balance: calibrating auditor compensation to counter management's undesirable incentives.

The fact that auditors are paid in a fixed amount that is not linked in any direct way to their performance as gatekeepers is in itself an oddity.<sup>158</sup> In the U.S. economy, pay-for-performance is increasingly becoming the norm. According to one study, the percentage of performance-pay jobs grew from 15% to 40% in the period between 1976 and 1998.<sup>159</sup> Consulting companies specializing in performance-pay compensation, such as Hay Associates, Hewitt, and Tower Perrin, have grown tremendously over the past thirty years, and SAP, a major supplier of software used to monitor worker performance, has multiplied its sales from DM150 million in 1985 to \$8.8 billion in 2006.<sup>160</sup> Pay-for-performance is even more pronounced within senior management, as already discussed,<sup>161</sup> and similar arrangements appear in agreements between firms and service providers, including legal contingent fee arrangements and payment in stock and stock options to lawyers.<sup>162</sup> It thus

<sup>158</sup> The formal argument that monitoring employees to enhance performance can achieve substantial gains can be traced back to the beginning of the twentieth century. See FREDERICK W. TAYLOR, *THE PRINCIPLES OF SCIENTIFIC MANAGEMENT* (1911).

<sup>159</sup> See THOMAS LEMIEUX, W. BENTLEY MACLEOD & DANIEL PARENT, *PERFORMANCE PAY AND WAGE INEQUALITY* tbl. 2 (IZA Discussion Paper No. 2850 37 2007), available at <http://ssrn.com/abstract=998266>. Performance-pay jobs are defined in this study as "employment relationships in which part of the worker's total compensation includes a variable pay component," *id.* at 13.

<sup>160</sup> *Id.* at 7.

<sup>161</sup> See *supra* Part II.a.

<sup>162</sup> For a discussion on lawyer contingent fees see Peter Melamed, *An Alternative to the Contingent Fee? An Assessment of the Incentive Effects of the English Conditional Fee Arrangement*, 27 *CARDOZO L. REV.* 2433 (2006). For a discussion on lawyer compensation with stock and stock options see Gwyneth E. McAlpine,

seems important to explore the possibility of compensating the firm's external auditor or audit partner using some form of variable pay aimed at fostering its performance as gatekeeper.

#### **a. The Mechanism of the Proposed Gatekeeper Compensation Plan**

The main mission of auditors is to ensure that a firm's financial statements fairly represent its financial position.<sup>163</sup> Instituting pay-for-performance would therefore entail that audit fees be contingent on the auditor's success at preventing misreporting, fraud, and irregularities.<sup>164</sup> Fraud and misreporting can support or lift share prices in the short-run but not for the long term. Eventually, the manipulation or mistake is either openly flushed out or else simply loses its effect. Thus, a drop in sales could be hidden for one or two quarters, but if the trend were to persist, it would ultimately surface; similarly, a shortage in the cash flow could be concealed for a certain time, but at some point creditors would discover this.<sup>165</sup> In general, accounting maneuvers and manipulations can shift costs and income from one period to another, but this cannot be successfully achieved in the long-run.

This makes using a stock-based mechanism in auditor compensation extremely tempting. Exposing the auditor to a future drop in the firm's share prices caused by

*Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549 (1999).

<sup>163</sup> If fairness cannot be confirmed, the auditor must produce a qualified opinion or refrain from giving any opinion. Qualified opinions in themselves are a strong signal to the market, as they reveal major problems in the issuer's financial statements. See CHARLES J.P. CHEN, XIJIA SU & RONALD ZHAO, MARKET REACTION TO INITIAL QUALIFIED AUDIT OPINIONS IN AN EMERGING MARKET: EVIDENCE FROM THE SHANGHAI STOCK EXCHANGE (Oct. 1999), available at <http://ssrn.com/abstract=192091> (discussing the market reaction to qualified opinions). Qualified opinions, however, are rare as corporate insiders prefer and are also required by law to correct faults that the auditor finds in the financials. See Securities Exchange Act of 1934, § 13(1), 15 U.S.C. § 78m(i) ("Each financial report ... shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.").

<sup>164</sup> The concept of contingent auditor fees, although currently banned by federal legislation, is not that anomalous. In 1988, the FTC suggested lifting the ban on contingent fees as it was perceived to be anticompetitive in that it narrowed the set of contracts that could be formulated between auditors and their clients. See Dye et al., *supra* note 25, at 1 (referencing the Wall Street Journal, Aug. 25, 1988).

accounting maneuvers (either illegal or simply improper) would induce it to work harder against such actions. The auditor would increase its efforts even when no one outside the auditor-client relationship could accurately judge the quality of the financial statements. The inevitable price drop would yield this result automatically without involving any assessment of the quality of the auditor's work. This is an extremely important point, since reputation concerns, professional ethics, and, to some degree, also exposure to legal liability already ensure a certain level of adequate performance on the part of the auditor. The benefit of stock-based performance is that it adds another layer to the auditor's incentives, even when the auditor's actions cannot be easily observed. Put differently, the compensation mechanism will bind the auditor to its intended task even when monitoring is minimal.

The idea, then, is to create an auditor-compensation mechanism that will be the reverse image of the existing structure of executive compensation and thereby create a countervailing force.<sup>166</sup> As explained in the Introduction, there are few ways to produce the necessary impact, each of which has a different payout structure for the auditor. In this paper, I suggest considering a mechanism that does not involve giving auditors put-options or making them short-sale the client stock,<sup>167</sup> but, rather, is founded on three other central

<sup>165</sup> See, e.g., Coffee, *supra* note 1, at 204 ("managers were systematically able to overestimate revenues and then recognize them prematurely in ways that ultimately compelled earnings restatements...").

<sup>166</sup> As we shall see below, the framework suggested in the text must be accompanied by a safe-harbor rule set by the Securities and Exchange Commission. See *infra* Part IV.b. The specific details of the arrangement adopted by each firm should be tailored to the firm's needs as determined by its audit committee and the compensation consultants it could hire. This procedure should be analogous to the process for setting executive compensation that is conducted by the compensation committee. Compensation committees often hire consultant firms such as Frederick Cook or Towers Perrin. See, e.g., MARTIN J. CONYON, COMPENSATION CONSULTANTS AND EXECUTIVE PAY: EVIDENCE FROM THE UNITED STATES AND THE UNITED KINGDOM (May 2008), available at <http://ssrn.com/abstract=1106729> (discussing the role of executive compensation consultants).

<sup>167</sup> Since call-options are the most common executive stock-based compensation, offering auditors put-options seems the obvious option for creating an exact mirror image. Indeed, put-options would make the auditor benefit from revealing price-reducing information. While I do not necessarily object to this particular mechanism, I prefer to use the mechanism outlined in the text as the starting point of this discussion. Given that this proposal should map out the path to be taken by the SEC and survive public debate, I believe it is best to put forth the least controversial proposal. Specifically, I do not want auditors who use this plan to be considered speculators, a title that sometimes attaches to traders who use price-perfecting mechanisms such as short-sales and put-options.

elements: 1) deferred compensation that would channel a significant proportion of auditor compensation to this mechanism; 2) rotation of the audit partner, as currently required by law, or, better yet, rotation of the audit firm; and 3) conversion of the deferred compensation into shares of the corporate client following rotation and subject to a holding period that would expose the auditor to the risk of future price drops. The first element of the scheme ties up a large proportion of the auditor's compensation in deferred compensation (secured in the hands of a trustee). This is necessary to provide the auditor with enough incentive to fight fraud. The precise proportion should be left to the parties to decide (a point to which I shall return), but it is important to keep in mind that, currently, over 50% of executive compensation is composed of stock and stock-based mechanisms.<sup>168</sup> As was shown, this compensation structure has made executives quite zealous with regard to the firm's value and, at times, over-aggressive in their disclosure practices. Therefore, an effective counter-scheme would necessitate devoting a large fraction, perhaps even the lion's share, of the audit fees to stock-based compensation.

Note that stock-based compensation involves risk (the fundamental risk of fluctuation in share prices) and, therefore, entails a cost. For instance, the literature has speculated that employees who receive options as compensation value each dollar's worth of option (in market terms) at less than 50 cents and are therefore willing to receive much less in salary than they actually receive in stock options.<sup>169</sup> This means that stock-based

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<sup>168</sup> See *supra* Part II.a.

<sup>169</sup> Employees are typically risk-averse. The value of stock-based compensation – which is a major component of employees' remuneration—is highly contingent on risk factors and uncertainties that are far beyond the control of the recipient employees. Risk-averse employees therefore discount the value of stock-based compensation. Firms could substitute this type of compensation with a much lower payment in cash that does not entail uncertainty. The difference between the two alternatives is the cost, or the waste, involved in stock-based compensation. Several leading economists have tried to quantify this cost, concluding that, operating under reasonable assumptions about risk aversion and diversification, employees value options (with ordinary features) at “only about half of their cost to the firm.” Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 56 (2003); see also Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209, 211 (2000); Brian J. Hall & Kevin J.

remuneration is more expensive to the firm than flat fees; the same is applicable with regard to the mechanism proposed in this paper. This notwithstanding, however, the executive population seems to be generally more vulnerable to this particular risk than the typical auditor or accounting firm. First, the executive is an individual whereas the audit firm is a deep-pocket entity, making it much less risk-averse. Second, even if the audit partner as an individual were to be subject to a stock-based compensation mechanism, she could diversify her portfolio by accepting this type of compensation from several clients.<sup>170</sup> Unlike the executive, therefore, all her eggs would not be placed in one basket. This diversification advantage is magnified at the accounting firm level.<sup>171</sup> And note that diversification does not undermine the incentives generated by the scheme to counter inflated share prices. The fact that a person repeatedly plays the lottery does not mean that she would be willing to accept deficient lottery tickets that do not meet their promised returns. Finally, the auditor compensation scheme suggested here requires shorter holding periods, as will be discussed below, than those commonly used in executive compensation schemes, thus exposing auditors to less fundamental risk than that borne by executives.<sup>172</sup>

Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 12-13 (2002). Another study estimated that, for every dollar worth of options, companies actually waste \$0.64 to cover the risk premium for employees. PAUL OYER & SCOTT SCHAEFER, WHY DO SOME FIRMS GIVE STOCK OPTIONS TO ALL EMPLOYEES? AN EMPIRICAL EXAMINATION OF ALTERNATIVE THEORIES 16 (Nat'l Bureau of Econ. Research, Working Paper No. 10222, 2004), available at <http://www.nber.org/papers/w10222>. Employee risk-aversion is also evidenced by the fact that they tend to exercise their options before the expiration date. See J. CARR BETTIS ET AL., THE COST OF EMPLOYEE STOCK OPTIONS 3 (Mar. 2003) (unpublished manuscript), available at [http://papers.ssrn.com/abstract\\_id=376440](http://papers.ssrn.com/abstract_id=376440) (finding that employees exercise options nearly five years prior to expiration and that employees in high-volatility firms exercise their options more than a year and a half earlier compared to employees in low-volatility firms).

<sup>170</sup> This can take away most of the risk except for that of market wide fluctuations, known as the systematic risk of the market. For a discussion on market (systematic) risk and diversification, see RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, CORPORATE FINANCE 154-72 (8th ed. 2006).

<sup>171</sup> Diversification cannot solve the risk of the entire market fluctuations (so called systematic risk). This risk could be partially solved however by indexing the proposed auditor stock based compensation to some market measure such as the average return of the other firms in the same industry. For a similar recommendation to index executive stock options see BEBCHUK & FRIED, *supra* note 12, at 159-89.

<sup>172</sup> The literature also shows that executives often receive equity-based compensation in addition to the cash amount of their previous salaries, and the switch between the two means of compensation has not been swift. This may be the result of the cash constraints of executives or the result of expropriation by executives. One way or another, this phenomenon makes equity-based compensation even more costly for shareholders. See

The second element of the proposed program is auditor rotation, either at the individual level of the audit partner or the entire auditing firm. The Sarbanes-Oxley Act made auditor rotation mandatory, requiring, as mentioned, that audit partners in charge of a client's file not handle the same client for more than five years in a row.<sup>173</sup> Section 207 of the Act also expressed an approach favoring audit firm rotation, in requiring the U.S. Comptroller General to "conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms."<sup>174</sup> Unlike audit partner rotation, however, the harsher audit firm rotation requirement has never been made mandatory;<sup>175</sup> perhaps this will have to wait for the next corporate crisis.<sup>176</sup>

A simple rationale for requiring audit rotation was presented in the Sarbanes-Oxley Act itself, as well as in the relevant literature: without rotation, the auditor may develop a relationship with the firm and its executives that may compromise its ability to conduct the audit and scrutinize the financials. Indeed, a new auditor ensures a fresh pair of eyes, whereas a long-time auditor might eventually fall asleep at the gate, especially if there have been no warning signs indicating that something is amiss for a number of years.<sup>177</sup> Some

Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1439-40 (2007). This problem does not attach to the mechanism of auditor remuneration proposed in this paper.

<sup>173</sup> 15 U.S.C. § 78j-1(j) (2006) (SOX § 203); *see also supra* note 28.

<sup>174</sup> 15 U.S.C.A. § 7232 (2006) (SOX § 207). Mandatory audit firm rotation exists in some non-U.S. jurisdictions, including Austria, Italy, Brazil, and, partially, Singapore and was previously the norm in Spain and Canada. *See* GAO U.S. Gen. Acct. Office, Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, Rep. No. GAO-04-216, at 48 (November 2003), *available at* <http://www.gao.gov/new.items/d04216.pdf> [hereinafter GAO, Potential Effects of Mandatory Audit Firm Rotation].

<sup>175</sup> In compliance with section 207 of the Sarbanes-Oxley Act, the U.S. General Accounting Office conducted an extensive survey of mandatory audit firm rotation and concluded that "the costs of mandatory audit firm rotation are likely to exceed the benefits and suggested postponing the decision on mandatory rotation. *See, id.* at 5.

<sup>176</sup> One of the explanations given by the GAO for not making audit firm rotation mandatory was that it was necessary to first wait and assess the full impact of the Sarbanes-Oxley reforms, since these reforms could be sufficient and serve as a proper alternative to audit-firm rotation. *Id.* at 43. It is my guess that insufficiency could be proven, if at all, only after crisis occurs.

<sup>177</sup> The upside of long auditor tenure is the learning effect of prolonged audit services and the enhanced incentives to develop firm specific audit capabilities. In practice, provisions calling for mandatory audit rotation have been debated intensively even before the Sarbanes-Oxley legislation, but most of the available empirical



regard the abovementioned advantages to audit rotation as in themselves capable of overcoming the benefits of protracted audit tenure (mostly useful learning on the part of the auditor and its increased willingness to make client-specific investments).<sup>178</sup> These, however, are not the points that make rotation crucial to the suggested mechanism, at least not directly. Rather, the importance of rotation in the proposed plan derives from the fact that the scheme requires that the auditor be allowed to divest its stock-based compensation only after it has ceased to provide services to the firm. This would cause the auditor to flush out problems immediately, while still in the firm's service, so as to prevent the possibility of a price drop in the value of its compensation after it is no longer auditing the company and can no longer conceal financial problems. Since audit partner rotation was recently made a requirement under law, an audit partner compensation plan can be designed in line with this paper's proposed model without needing to change the existing audit partner tenure. However, the mechanism presented here would be best applied as an ambitious overall scheme covering the remuneration of the audit firm in its entirety, which would then require audit firm rotation. The main reason that the latter plan is preferable is that loyalty between partners in the same accounting firm could operate against the incentives created by the plan to uncover fraud and misreporting. In addition, it is harder to monitor the incentive scheme of the individual audit partner within her audit firm than the audit fee paid to the firm. Finally, the audit firm is a

evidence is not conclusive. *See, e.g.,* Richard J. Fairchild, *Auditor Tenure, Managerial Fraud, and Report Qualification: A Game-Theoretic Approach*, 5 ICFAI J. AUDIT PRACTICE 42-54 (2008) (considering the effect of auditor tenure on auditor performance and discussing two competing effects—the "learning curve effect" and the "loss of independence effect"). One would expect that the beneficial learning effects would be especially strong in the first few years of the tenure while the harmful effects of prolonged tenure would become especially strong down the road. Indeed, at least one study found that auditor performance is weaker in the beginning of its tenure but also in cases of extended auditor-client relationships. *See* MARK SCHELKER, AUDITORS AND CORPORATE GOVERNANCE: EVIDENCE FROM THE PUBLIC SECTOR (Mar. 2008), *available at* <http://ssrn.com/abstract=959392> (empirically testing auditor performance in mandated auditor rotation cases in the public sector and suggesting that mandatory audit rotation is advisable for public firms as well).

<sup>178</sup> *See* U.S. General Accounting Office, Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation* 13-14, 33-48, GAO-04-216, Nov. 2003 (minority views of institutional investors that supported audit firm rotation).

much better risk-bearer than the audit partner, due to its greater wealth and diversification ability. Nevertheless, since audit firms hate to lose clients,<sup>179</sup> arguably the principal reason that the Sarbanes-Oxley Act did not mandate audit firm rotation,<sup>180</sup> it is quite plausible that the scheme proposed here would have to be tailored to apply to the audit partner and not the audit firm.

Before continuing to the third and crucial element of the suggested auditor-compensation plan, it might be helpful to recall the example from the Introduction of a plan that allows for a maximum tenure of three years, during which time the audit firm (or audit partner) defers a certain fraction of its compensation until it signs and certifies the last auditing report.<sup>181</sup> At such point in time, the auditor (or the relevant partner) would receive shares in the firm of a value equivalent to the amount of deferred compensation based on the market value of those shares *at the time of issuance*. Thus, if the price per share on the day after the release of the last audited report by the issuer is \$30 and the deferred compensation is \$30 million, then the auditor (or the partner) would receive one million shares. Those shares would then be restricted and could be sold only after a specified holding period.

This example illustrates the third element of the proposed plan, namely, the conversion of the deferred compensation into restricted shares in the corporate client

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<sup>179</sup> Some of the current audit-client relationships are amazingly long, and both parties involved are quite proud of this connection. *See, e.g.*, 2001 General Motors Proxy Statement, Form DEF 14A, available at <http://www.sec.gov/Archives/edgar/data/40730/000089016301000190/0000890163-01-000190-0001.txt> (Deloitte & Touche LLP has audited the Corporation's books annually since 1918."). Note that a widespread usage of the advocated scheme would mean that many more clients would be up for grabs. Hence, the fear of losing clients as a result of the proposed scheme is not truly warranted.

<sup>180</sup> The common explicit reasons for the resistance to audit firm rotation are that "the additional financial costs and the loss of organizational knowledge associated with audit firm rotation, as well as the current reforms being implemented, may negate any benefits of rotating auditors." PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION (2003), *available at* [http://goliath.ecnext.com/coms2/summary\\_0199-35292\\_ITM](http://goliath.ecnext.com/coms2/summary_0199-35292_ITM).

<sup>181</sup> A three-year term of service for an audit firm is not extremely unique even today, in the absence of the proposed mechanism. In a survey of a large sample of 4720 U.S. public firms, the audit firms of 680 of the firms had provided services three years or less, Gul, Jaggi & Krishan, *supra* note 142 at 31 tbl. 2. The median audit tenure for the entire sample was 7 years, *id.* at 16.

following auditor rotation. Conversion following rotation and the holding period requirement place the auditor in a long position for a substantial period of time, thus creating incentive for the auditor to reveal any information that artificially inflates share value before conversion and to do all it can to prevent postponement of bad news until the period following conversion. This effect would be magnified by compensating the succeeding auditor under a similar scheme, who would therefore be similarly highly motivated to reveal any problematic matter left behind by the previous auditor. A holding period is, of course, vital, since it means that the auditor bears a risk that bad information that it did not force the firm to reveal will slip out and harm its compensation.

The down-side of the holding period is that it exposes the auditor to the risk of fluctuations in firm value that are unrelated to misreporting. Under the proposed compensation scheme, prior to the holding period and throughout the auditor's term providing services to the company, the auditor does not shoulder the risk of market fluctuations in the firm's value. Because the auditor receives its deferred compensation in shares based on their market price *following* termination of its service to the corporation, previous stock price variations do not affect the value of the auditor compensation package in its entirety (\$30 million in the above example). The number of shares the auditor receives will be set with this goal in mind, and it will thus receive fewer shares if the price per share increases and vice versa if the price per share drops. This means that the auditor bears no investment risk during the period it works for the firm,<sup>182</sup> but must still be alert to any misreporting that could

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<sup>182</sup> The exception to this is scenarios in which the firm collapses and the value of the shares drop to practically zero. In such an endgame scenario, the incentive plan set forth in this paper might seem to backfire since the auditor would lose all its compensation if he reveals the status of the firm. It is therefore suggested that the amount of deferred compensation be held by a trustee who would normally use the accrued amount to purchase shares from the corporation for the benefit of the auditor at the end of the audit term. However, if the corporation experiences bankruptcy, delisting from the stock exchange, deregistration by the SEC or other major failures so designated in the trust agreement, then the trustee would release the deferred compensation to the audit firm, preventing the perverse incentive of the endgame scenario mentioned above. Another benefit of

artificially inflate the value of the shares and could then backfire when it can sell its shares.

Only after the termination of the auditor's services to the firm and during the holding period does it become subject to the risk of fluctuation in firm value and to the market risk in general. It is important to note, however, that the holding period under the proposed scheme could be shorter than the typical period during which employees are required to hold on to equity-based remuneration, since the latter is intended for the purpose of encouraging a prolonged effort from the employees so as to improve firm value as well as constituting an employee retention mechanism.<sup>183</sup> The holding period in our case is merely required to ensure that information concealed during the period that the auditor worked for the firm is given enough time to leak out. Moreover, a shorter holding period leads to less risk-exposure and, consequently, makes the scheme less expensive (relative to employee stock-based compensation) for the corporation and, indirectly, its shareholders, who would eventually have to pay the auditor for its risk-bearing. Another important component of the proposed compensation scheme is intended to contend with Enron-like scenarios. Sometimes the disclosure of a corporation's actual status could lead to its immediate bankruptcy, which, in turn, would eliminate the value of the auditor's incentive pay package. In order to overcome auditors' incentives to conceal such devastating information the trustee holding the auditor's deferred compensation should be instructed to release the deferred compensation in cash to the auditor in the event of such a disastrous outcome.

Finally, it is true that the proposed arrangement produces not only beneficial incentives for the auditor to fight against artificial inflation of share prices but also a

using a trustee is the ability to issue the shares during the holding period to the trustee who will make sure that they are not sold by the audit firm until the end of the restricted period.

<sup>183</sup> A commonly-repeated argument in the literature is that options are "golden handcuffs," in that they help firms preserve their workforce and prevent attrition. Options undoubtedly do have this quality, as they usually vest gradually, normally along a four-year period, which makes it worthwhile for workers to maintain their positions at the firm. See Hannes, *supra* note 172, at 1429.

detrimental incentive to artificially deflate share prices. The auditor, however, does not work in a vacuum. Rather, it negotiates and scrutinizes reports that are prepared by corporate executives motivated by equity-based compensation.<sup>184</sup> Two sophisticated parties who are acquainted with the true state of the corporation and the appropriate accounting treatment now have opposing interests. The managers might derive benefit from artificially inflated stock prices while the auditor would benefit from just the opposite. This appears to be a level playing field, unlike the current imbalance with interested executives on one side and independent auditors on the other. It must also be recalled that auditors do not sit behind the driver's wheel of the company. They are involved only in the disclosure process. Securities law prohibits directors and officers from short sales of the company's securities,<sup>185</sup> a restriction that stems from the fear of corporate executives being incentivized to harm the value of the firm they run. Auditors, however, do not run the company, and thus, their incentive to block disclosure of information that will artificially inflate firm value does not have similar consequences.

The proposed compensation scheme raises additional issues that must be considered. For one, this paper assumes that corporations themselves may not have sufficient incentive to opt for such a plan. For this reason, the paper turns to institutional investors and major creditors to pressure firms into adopting this auditor compensation structure. It is also important to address the problematic possibility of collusion between the corporation and the auditor, which would undermine the goals of the scheme, and to compare the proposed reform with reforms raised by others. However, prior to any discussion of these matters and others, it

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<sup>184</sup> For the discussion on equity-based compensation, see *supra* Part II.a. For the discussion of audit-client negotiations, see *supra* Part IV. See also Assaf Hamdani, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53 (2003).

<sup>185</sup> Securities Exchange Act of 1934, § 16(3), 15 U.S.C. § 78p(c) (2000) ("It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal: (1) does not own the security sold ..."). See HAZEN, *supra* note 125, at ? (discussing the short-sale prohibition).

is necessary to consider the safe harbor rule this paper suggests introducing into the securities regulation in the context of auditor compensation. For in the current absence of such a safe harbor, the proposed plan is simply illegal, and any attempt to adopt it would be futile.

#### **b. The Need for a Safe Harbor Rule**

Current securities law quite clearly bars the possibility of adopting an auditor compensation regime of the type suggested by this paper. Since the intention of the proposed scheme is to enhance the auditor's *performance* as gatekeeper, its preclusion in fact undermines the purpose of the securities legislation. Most ironic is the fact that it is the auditor independence requirement that prevents the adoption of the proposed compensation structure.<sup>186</sup> Yet since the scheme detaches auditor incentives from management incentives, it should logically not be excluded by independence guidelines.<sup>187</sup>

The auditor independence regulation sets forth a general standard of auditor independence and then specifies a variety of applications of the general standard to particular circumstances, without purporting to cover all possible circumstances that raise autonomy concerns.<sup>188</sup> In any event, both the general standard and, even more so, the specific applications work against the compensation plan proposed here. The general standard states that the Securities Exchange Commission will not recognize an accountant as maintaining independence if it "would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement ...

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<sup>186</sup> Regulation S-X, Rule 2-01, 17 C.F.R. 210.2-01 (2006).

<sup>187</sup> The purpose of the independence regulation is outlined in the Preliminary Note to Regulation S-X, Rule 2-01, 17 C.F.R. 210.2-01 (2006) ("Rule 2-01 is designed to ensure that the auditors are qualified and independent of their audit clients both in fact and in appearance.").

<sup>188</sup> Regulation S-X, Rule 2-01(c), 17 C.F.R. 210.2-01(c) (2006) ("This paragraph sets forth a *non-exclusive* specification of circumstances inconsistent with paragraph (b) of this section.").

.<sup>189</sup> Objectivity can be impaired either because the auditor and client share a mutual interest, which is the concern at the heart of the independence requirement, or alternatively because the auditor and audit client have conflicting interests.<sup>190</sup>

Deferring a portion of the auditor's compensation and a commitment to purchase restricted shares in the audited client corporation could be interpreted as violating the objectivity requirement. Note, however, that the proposed remuneration scheme creates a conflict primarily between the audit client management and the auditor. Moreover, the conflict that arises is a constructive one in that it counterbalances the incentives produced by the typical executive compensation schemes. Indeed, this conflict is the crux of this paper and its scheme. But there is little point in haggling over the appropriate interpretation of the general standard, for as we will see shortly, the specific prohibitions set by the independence requirement prevent the adoption of the advocated arrangement.

At least three of the specific conditions for auditor independence set by the rule seem to be violated by our auditor payment scheme. First, the rule states that auditor independence is prejudiced when there is "any loan to or from an audit client."<sup>191</sup> Thus, under this provision, the deferred pay component of the scheme could undermine auditor independence, as it is arguably a loan to the audit client. The rationale behind precluding such loans is that they generate an auditor interest in the client's financial stability. Given the fact that the deferred compensation in our case is held by a trustee, the financial stability of the client is not an important concern from this paper's vantage point. Second, the rule provides that any investment, including in "stock, bonds, notes, options, or other securities," in the audit client

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<sup>189</sup> Regulation S-X, Rule 2-01(b), 17 C.F.R. 210.2-01(b) (2006).

<sup>190</sup> Preliminary note to Regulation S-X, Rule 2-01, 17 C.F.R. 210.2-01 (2006) ("In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service [].").

<sup>191</sup> Regulation S-X, Rule 2-01(c)(1)(ii)(A), 17 C.F.R. 210.2-01(c)(1)(ii)(A) (2006).

constitutes a violation of auditor independence.<sup>192</sup> Although the proposed compensation plan allows the auditor to hold shares of the audit client only once it has ceased to provide audit services, the prohibition in the regulation is formulated broadly enough to encompass also a commitment to purchase shares in the audit client.<sup>193</sup> Finally, the auditor independence rule bars payment of contingent fees.<sup>194</sup> Since the proposed compensation scheme ties the actual auditor fee to future contingencies relating to the client, this prohibition also blocks the advocated compensation arrangement.

The inevitable conclusion from the above is that the proposed gatekeeper compensation plan requires that the SEC promulgate a safe harbor rule applicable in this context.<sup>195</sup> A safe harbor rule sets forth conditions under which the Commission will presume that the law has been complied with.<sup>196</sup> Tailoring the auditor compensation plan to accord with the terms of a safe harbor rule would ensure immunity from SEC prosecution for any deviation from the auditor independence requirement. In accordance with the principles of the proposed scheme noted in Section a, the safe harbor rule should specify the features of the plan that would *be guaranteed* SEC clearance. The particular details of each compensation arrangement, as well as the very decision as to whether to adopt it, should be left to the private parties involved. The safe harbor could also serve to ensure against issuers'

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<sup>192</sup> Regulation S-X, Rule 2-01(c)(1)(i)(A), 17 C.F.R. 210.2-01(c)(1)(i)(A) (2006).

<sup>193</sup> Regulation S-X, Rule 2-01(c)(1), 17 C.F.R. 210.2-01(c)(1) (2006) ("An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest in the accountant's audit client ...").

<sup>194</sup> Regulation S-X, Rule 2-01(c)(5), 17 C.F.R. 210.2-01(c)(5) (2006) ("An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or commission, or receives a contingent fee or commission from an audit client.").

<sup>195</sup> For a general discussion of safe harbor rules, see HAZAN, *supra* note 125 at 47.

<sup>196</sup> Safe harbor examples include Rule 144 (exemption for secondary transactions), Rule 147 (exemption for interstate offerings), Rule 175 (forward looking statements), Reg. D. - Rules 501-508 (exemptions for offerings by an issuer not involving a public offering), Rule 10b-18 (stating that the announcement of a firm's intention to repurchase shares serves as a safe harbor against Rule 10b-5 allegations); and a most recent safe harbor created in Rule 14d-10(d)(2) (stating that approval of independent directors for compensation arrangements exempts such arrangements from the best-price rule in tender offers). See 17 C.F.R. §§ 230.144, 230.147, 230.175, 230.506.



using the compensation scheme as a smoke-screen, when they actually have no intention of providing their auditors with powerful incentives to counter fraud and misreporting. For instance, the safe harbor should forbid auditors from hedging their exposure to the risk involved in holding on to the client firm's shares throughout the holding period.<sup>197</sup> It is also important to make sure that managers do not time their equity grants to circumvent the purpose of the proposed scheme.<sup>198</sup>

### **c. Further Discussion of the Proposed Scheme**

The purpose of this subsection is to discuss the proper ways of encouraging the adoption of the compensation plan advocated in this paper, to advise the relevant board committees on how to avoid certain shortcomings of the plan, and to explain the advantages of the plan as compared to a high profile alternative reform proposal. While the main purpose of the safe harbor rule called for above is to legitimize and enable the proposed compensation plan and ensure integrity in its use, regulators should also consider granting firms that do choose to adopt it certain exemptions from the Sarbanes-Oxley legislation. There may be at least three reasons to give serious consideration to this option. First, as discussed above, the Sarbanes-Oxley Act entails considerable costs, in particular, its disputed section 404 with its extensive and expensive requirement for assessment of internal controls.<sup>199</sup> If improved auditor incentives, such as those generated by the proposed compensation scheme, can serve as a cheaper alternative to any of these measures, then it would be worthwhile to consider relinquishing some of the more expensive mechanisms. Second, exemptions can serve as an incentive for firms to adopt the scheme before it becomes a prevalent practice. There are certain advantages to the plan that will not materialize until the scheme is widely applied.

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<sup>197</sup> And for instance, the rule must require that the auditor not short-sell any shares of the client during the holding period.

<sup>198</sup> The analysis in section c below elaborates and accounts for this possibility.

Once many audit clients have adopted the model, auditors could diversify away much of the risk it imposes by taking on a number of different clients with similar plans. Furthermore, once many firms are using this type of plan in the version that includes audit-firm rotation, audit firms will feel less apprehensive about losing a client that offers such a compensation plan, as many other firms using similar schemes with other audit firms will eventually be up for grabs as clients upon culmination of the tenure periods. In addition, the literature on network externalities shows that issuers are generally wary of adopting novel legal arrangements until they become widespread.<sup>200</sup> Finally, as explained above,<sup>201</sup> since existing shareholders can sometimes benefit from inflated share prices at the expense of future shareholders and creditors, they have sub-optimal incentives to adopt a compensation plan that improves the accuracy of share prices. These low incentives should be counterbalanced by offering exemptions from expensive regulation.<sup>202</sup> Accordingly, for these various reasons, regulators may see fit to add to the proposed safe harbor rule certain exemptions from other SEC rules, which would make adopting the arrangement more attractive to issuers, at least until it becomes prevalent amongst firms.

Aside from these possible inducements from the regulator, market forces could also work to support the adoption of the proposed plan. To begin with, institutional shareholders and banks hold large stakes of equity and debt and are therefore vulnerable to misreporting

<sup>199</sup> See *infra* Part III.b.

<sup>200</sup> See Michael Klauner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995) (suggesting that legal products may be network products that provide much of their benefits only when they are widespread); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "the Economics of Boilerplate")*, 83 VA. L. REV. 713 (1999) (discussing the effect of network externalities on innovation and optimization of corporate contracts). See also Sharon Hannes, *Corporate Stagnation: Discussion and Reform Proposal*, 30 J. CORP. L. 51 (2005).

<sup>201</sup> See *infra* Part II.c.

<sup>202</sup> Recall also the managerial power theory that argues that managers control the mechanisms that set their pay and thus avoid optimal incentives to improve performance. See BEBCHUK & FRIED, *supra* note 12, at 159-89. This power can spill over to the mechanisms that set auditor pay as well.

and inaccurate share prices.<sup>203</sup> The proposed gatekeepers' compensation plan could ameliorate the problem. These powerful market players should, therefore, use their sway to back adoption of the advocated plan.<sup>204</sup> The same is true for third-party proxy advisors, such as the Institutional Shareholders Services. Since good corporate governance is a priority on these advisors' agenda, they can use their leverage to advocate the proposed plan. One way they could do so would be by showing greater leniency towards certain managerial sponsored proposals when their adoption is accompanied by the adoption of the mechanism proposed in this paper.

Internal corporate bodies, particularly, board of directors audit committees, will also play a crucial role in the decision whether to adopt the proposed plan. The independent directors on such committees must understand that, as outsiders, they have limited insight into the intricacies of the auditor-client negotiations. Therefore, their oversight role should concentrate on creating the right incentives for the auditor in its relationship with the corporation and its financial officers. In my view, the proposed plan can be used to calibrate such incentives, and each audit committee should decide whether the plan is suited to its corporation and, accordingly, adjust the plan to the firm's particular characteristics features (including the compensation structure of its executives).

Moreover, the audit committee, together with the compensation committee, will have an important role to play in overcoming certain perils involved in the proposed plan. It is

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<sup>203</sup> Despite corporate scholars' almost exclusive focus on shareholders and institutional investors, recent studies have shown that banks play a monitoring role that improves corporate governance. *See, e.g.*, JOANNA SHEPHERD, FREDERICK TUNG & ALBERT YOON, CROSS-MONITORING AND CORPORATE GOVERNANCE (2007), available at <http://ssrn.com/abstract=914229> (finding evidence that banks serve a monitoring role that improves firm value); ELIF SISLI, MONITORING BY AFFILIATED BANKERS ON BOARD OF DIRECTORS: EVIDENCE FROM CORPORATE FINANCING OUTCOMES (2006), available at <http://ssrn.com/abstract=973973> (showing that banker-directors whose banks have outstanding loans perform an important monitoring role on the company's board of directors).

<sup>204</sup> There is evidence that corporate fraud occurs often in forms with much leverage, indicating that banks and other creditors are the frequent victims of disclosure manipulation. *See, e.g.*, Patricia M. Dechow et al.,

especially important to ensure that the timing of managerial stock-option grants and their realization does not undermine the auditor compensation plan. For instance, if managers receive the stock-option grant soon after the firm's current auditor (compensated as advocated in this paper) issues its final audit report and exercise the options before the next auditor issues its final audit report, then they could get away with inflating share prices in the interim period between the two reports. This, of course, runs counter to the motivation behind the proposed gatekeeper compensation plan and should be prevented.

The audit committee would have yet another important function in blocking the possibility of auditors trying to build a reputation of not working harder despite receiving equity-based compensation. For if auditors were to be hired directly by the firm's managers (who may fancy auditors with such reputation) such a scenario would pose a significant threat to the objectives underlying the arrangement set forth in this paper. It is also important to understand that the advocated compensation scheme does not overcome the problem of severe and rare instances of auditor corruption. A corrupt auditor could simply accept a side payment that would eliminate any favorable incentive generated by the compensation plan. Most auditors, however, are far from corrupt and would never accept such a side payment or knowingly play along with dishonest managers. Nonetheless, the underlying rationale of the proposed plan rests on the notion that even honest auditors are human beings and their incentives should be calibrated to support the goal we want them to achieve.<sup>205</sup> In the absence of proper financial incentives for auditors, it is no wonder, as the empirical literature reveals, that they often fail as gatekeepers and cave in to manager pressure to accept distorted

*Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1, 21 (1996).

<sup>205</sup> As discussed earlier, in *supra* Part IV.b, this type of incentive-based compensation is currently prohibited by law. One could wonder why such compensation for auditors did not evolve prior to the imposition of this prohibitive regulation. I do not believe, however, that this is a fair question. Incentive-based compensation, which is currently the norm in many branches of the economy, is a relatively new phenomenon.

financial reports.

Before concluding the discussion, it seems imperative to compare the advantages of this paper's reform proposal with alternative reform proposals aimed at improving auditors' gatekeeper role. Chief among the latter is the proposal to enhance auditor exposure to legal liability.<sup>206</sup> Simply put, the Supreme Court's current interpretation of the securities regulation leaves hardly any opening for public shareholders to sue auditors for failing in their duties.<sup>207</sup> Accordingly, it has been suggested that either the judicial interpretation or the securities regulation itself be amended to the end of increasing auditors' potential liability.<sup>208</sup> Liability and incentive compensation are two mechanisms that, under certain circumstances, can achieve similar results, albeit by way of different apparatuses and at different costs. For brevity's sake, I will not delve into these significant differences and will only flesh out the unique advantages of the compensation plan proposed here that are not shared by alternative mechanisms.

As noted earlier, those cases of fraud and financial restatements that have been exposed constitute only the tip of the iceberg of the phenomenon of inaccurate or improper

*See* LEMIEUX, MACLEOD & PARENT, *supra* note 159. The inability to adopt incentive-based compensation is, therefore, relevant only nowadays when such an arrangement is prevalent throughout the economy.

<sup>206</sup> Other relevant reforms that I do not discuss here are those aimed at minimizing the adverse side-effects of management equity compensation. *See* Jesse M. Fried, *Hands-Off Options*, VANDERBILT L. REV. (forthcoming 2008), available at <http://ssrn.com/abstract=1091068> (suggesting a new design for option grants that overcome the manipulation incentive as well as managers' ability to abuse inside information). The most obvious downside to this type of reform, which my proposal does not suffer from, is the impairment to the compensation committee's discretion and flexibility in setting executive pay.

<sup>207</sup> *See, e.g.,* Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008) (restating previous rulings that private plaintiffs cannot sue third parties for aiding and abetting corporate so-called 10b-5 securities disclosure violations). *See also* Adam C. Pritchard, Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.: *The Political Economy of Securities Class Action Reform*, CATO SUPREME COURT REV. (forthcoming 2008), available at <http://ssrn.com/abstract=1159983> (describing the current legal state and arguing that courts, Congress, and the SEC are powerless to change the situation); BARBARA BLACK, *STONERIDGE INVESTMENT PARTNERS V. SCIENTIFIC-ATLANTA* (8TH CIR. 2006): WHAT MAKES IT THE MOST IMPORTANT SECURITIES CASE IN A DECADE? (Univ. Cincinnati Public Law Research Paper No. 07-21, 2007), available at <http://ssrn.com/abstract=1020102>.

<sup>208</sup> *See, e.g.,* Coffee, *supra* note 44, at 309 ("A more relevant public policy should also: (1) increase the legal threat to deter acquiescence in managerial fraud; ..."). For an international comparison of the current trends in auditor liability claims, see Jagdish Pathak, *Liability of Auditors: A Growing Concern*, 4 ICAFI J. AUDIT PRACTICE 7 (2007).

financial disclosure. Often fraud and accounting mistakes are unobservable and particularly difficult to prove in the courtroom. Business and financial climates change quickly, and economy-wide or business-specific downturns can wash away the traces of imprecise disclosures involving fraud. In other instances, accounting sugar-coating and whitewashing fall within the scope of legitimate accounting discretion and therefore never generate legal liability even when the legal standard is more favorable to plaintiffs. The cost to the economy of the consequent inflated and inaccurate share prices is enormous.<sup>209</sup> The unique benefits of the incentive compensation scheme are most pronounced where other mechanisms, including legal liability and reputation, fail. For even behind the closed doors of the auditor-client negotiations, where both sides possess private information that can never be verified in court, the auditor will have incentive to avoid inflated earnings, which would in the long run reduce the corporation's cash flows and impact future share prices. turning turn, even if no indications of fraud or accounting error can be proven, share prices would drop, and the auditor would share the losses borne by future shareholders. Put differently, the same reasoning that justifies equity-based compensation for corporate executives justifies also equity-based compensation (of the type suggested in this paper) for auditors. Both arrangements generate performance incentives even when no one is watching.

Finally, I wish to address two concerns that the proposed scheme gives rise to. First, under the plan, equity compensation is provided to the auditor based on the market price of the firm's shares following the auditor's certification of the final financial statement. Thus, for a number of years (three in the above example), share prices do not directly affect the auditor incentives. Does this mean, however, that the plan creates no incentives for the auditor until the auditor starts working on the final audit? If this is, indeed, the case, then we should not anticipate any improvement in the accuracy of disclosure and share prices until the

last year of the auditor's tenure. But while it is possible that the compensation scheme would cause the auditor to put extra emphasis on the final audit, I still believe that the plan generates beneficial incentives throughout the tenure period. Financial representations are based on the auditor's long-term interpretation of the accounting standards and its accounting policy given the specific circumstances of the client. An auditor must, therefore, be alert to any misreporting from the very beginning of its relationship with the client, for otherwise it would be hard pressed, in the audit-client negotiations, to maintain the status quo disclosure policy.

Second, the plan features a holding period during which the auditor is required to hold the shares of its client at least until the next auditor issues its first audit report. This feature is especially important since it means the auditor bears the risk that any hidden problem with the financial statements during its tenure period will at some point impact the share-prices during the holding period, when it is no longer in charge of certification. The longer the holding period, the higher the chances that hidden problems will surface and affect share prices. This notwithstanding, however, I suggest that prolonged holding periods be avoided in order to minimize the delay in payment to the auditor and the unrelated market risk created by an excessively long holding period. This does not mean that the auditor does not have to worry about errors in its audit that normally would not surface during a shorter holding period. The reason is that the next auditor, assuming it is offered a similar compensation structure, will have to do its utmost to uncover problems that the previous auditor failed to expose. Otherwise, the new auditor would have to bear the risk of the firm's share prices being adversely affected during the holding period of its own compensation scheme.<sup>210</sup> With this in mind, the first auditor will also be induced to fend against all

<sup>209</sup> See, e.g., Jensen, *supra* note 13; Shleifer & Vishney, *supra* note 33; Kahan, *supra* note 33.

<sup>210</sup> The same holds true for the next auditor and so on.

financial misrepresentations, even those that may emerge after the holding period.

## **V. Concluding Remarks**

At the core of this paper is the argument that the inability to observe audit quality justifies drafting an incentive contract that current law does not allow for. The paper has considered the costs and benefits of the structure of one such possible incentive scheme. Under the compensation plan advocated here, auditors would commit to becoming future shareholders of the corporation after they have concluded their tenure. And as future shareholders, they should seek to guard against financial misrepresentations that artificially and temporally inflate the value of the shares they would purchase from the client. Over time, share prices incorporate any adverse information that was not properly disclosed in the financial statements. Thus, the compensation arrangement automatically holds the auditor accountable for allowing such faulty reporting. The same unique benefits that have led to the widespread adoption of executive incentive compensation, therefore, support with equal force implementing auditor incentive compensation. The paper does not argue that the proposed plan is suitable for all firms, but its clear advantages should cause the regulator to support and allow it. Mid-cap and large-cap firms with stable performance and large auditors (mostly Big 4 audit firms) seem most suited to this plan. And once the regulator would be willing to accept the proposed scheme, major market players, such as institutional investors, lenders, and proxy advisors, that are interested in the integrity of share prices and good corporate governance should help to persuade firms and their auditors to adopt plans suited to their particular needs.

Finally, there is good reason to believe that the need for the auditor fee structure advocated here will soon grow in urgency. Worldwide accounting standards have recently undergone a revolution with the introduction of the International Financial Reporting



Standards (“IFRS”).<sup>211</sup> The most striking feature of these new standards is that all items in the balance sheet must be marked to market. Instead of the traditional use of historical prices,<sup>212</sup> each firm now has the discretion to evaluate and assess the market value of its assets and liabilities and include this in its disclosure. Under the IFRS, executives, who already have an extensive amount of discretion in financial disclosures, gain even more freedom. Outside the United States, this augmented freedom does not pose a major threat, as public firms outside the U.S. tend to have a concentrated ownership structure, with a controlling shareholder.<sup>213</sup> Since controlling shareholders seldom sell their holding stakes, they have little reason to engage in financial manipulation (at least not of the type often witnessed in the States).<sup>214</sup> In contrast, U.S. managers are usually subject to a dispersed ownership structure without any controlling shareholder that monitors their actions and with generous equity compensation schemes that tends to lead to manipulation. The combination of these features with the IFRS could be catastrophic.

Thus far, the U.S. has yet to adopt the IFRS, but there has been rapid movement in that direction. On November 15, 2007, the SEC adopted a proposal allowing foreign firms that trade on the U.S. securities market to choose the IFRS instead of the traditional U.S. Generally Accepted Accounting Principles.<sup>215</sup> In addition, the Commission issued a release

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<sup>211</sup> See HOLGER DASKE ET AL., MANDATORY IFRS REPORTING AROUND THE WORLD: EARLY EVIDENCE ON THE ECONOMIC CONSEQUENCES (Chicago GSB Research Paper No. 12, 2007), available at <http://ssrn.com/abstract=1024240> (examining the economic consequences of introducing mandatory IFRS reporting across the globe and pointing to indications of an increase in equity valuations).

<sup>212</sup> See STEPHEN A. ZEFF, THE SEC RULES HISTORICAL COST ACCOUNTING: 1934 TO THE 1970s (2007), available at <http://ssrn.com/abstract=956163> (discussing the principal of historical cost accounting).

<sup>213</sup> See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997) (reporting that U.S. firms, in contrast to firms in the majority of world economies, have a dispersed ownership structure); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (same).

<sup>214</sup> See Coffee, *supra* note 1, at 204 (“the controlling shareholder seldom, if ever, sells its control block in the public market”).

<sup>215</sup> See *Acceptance from Foreign Private issuers of Financial Statements Prepared in accordance with IFRS Without Reconciliation to U.S. GAAP* Mar. 4, 2008, at <http://www.sec.gov/rules/final/2007/33-8879.pdf>.

that raised the possibility of allowing all firms to similarly opt for the IFRS in the future.<sup>216</sup> Moreover, even if full adoption does not materialize soon, some form of convergence does seem imminent.<sup>217</sup> The implications are that U.S. executives will soon have far greater discretion in drafting their firms' disclosures and, in turn, auditors' responsibility for fending against abuse will substantially increase.<sup>218</sup> Innovative and well-crafted auditor incentive pay programs of the type advocated in this paper could counterweigh the resulting mounting pressures.

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<sup>216</sup> See *SEC Soliciting Public Comment on Role of IFRS in the U.S.*, July 25, 2007, at <http://www.sec.gov/news/press/2007/2007-145.htm>.

<sup>217</sup> See SHYAM SUNDER ET AL., A PERSPECTIVE ON THE SEC'S PROPOSAL TO ACCEPT FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) WITHOUT RECONCILIATION TO U.S. GAAP (2007), available at <http://ssrn.com/abstract=1020408> (discussing IFRS versus U.S. GAAP and suggesting that the U.S. allow all issuers to choose between the two regimes).

<sup>218</sup> IFRS adoption in the U.S. gave rise to much concern for the reason mentioned in the text above. See PATRICK E. HOPKINS ET AL., RESPONSE BY THE FINANCIAL REPORTING POLICY COMMITTEE OF THE FINANCIAL ACCOUNTING AND REPORTING SECTION OF THE AMERICAN ACCOUNTING ASSOCIATION TO THE SEC RELEASE: ACCEPTANCE FROM FOREIGN PRIVATE ISSUERS OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS WITHOUT RECONCILIATION TO U.S. GAAP (2008), available at <http://ssrn.com/abstract=1083679> (discussing the acceptance of IFRS for foreign firms listed in the U.S. and concluding that IFRS adoption was premature).