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AUDITOR CHANGES AND OPINION SHOPPING—A PROPOSED SOLUTION

Dale R. Rietberg*

Financial statements¹ have long been considered the “language of business.”² These statements provide a historical record of a company’s economic performance and, as such, play a crucial role in the efficient operation of the capital markets.³ Recognizing this important function, federal securities law authorizes the Securities and Exchange Commission (SEC) to require that

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1. “Financial reporting consists, in the first instance, of financial statements, *i.e.*, the balance sheet, the income statement, the statement of changes in shareholders’ equity . . . and the statement of changes in financial position.” Stanger & Gunther, *Big GAAP—Little GAAP: Should There Be Different Financial Reporting for Small Business?*, 56 N.Y.U. L. REV. 1209, 1210 (1981) (citing BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, Statement of Accounting Principles Board No. 4, ¶ 191 (Am. Inst. of Certified Pub. Accountants 1970)); REPORTING CHANGES IN FINANCIAL POSITION, Opinion of Accounting Principles Board No. 19 (Am. Inst. of Certified Pub. Accountants 1971)).

2. See, *e.g.*, Karmel, *A Delicate Assignment: The Regulation of Accountants by the SEC*, 56 N.Y.U. L. REV. 959, 960 (1981).

3. See *SEC and Corporate Audits: Hearings Before the Subcomm. on Oversight and Investigations of the House of Representatives Comm. on Energy and Commerce*, 99th Cong., 1st Sess. 181, 188 (1985) [hereinafter *Hearings*] (statement of the Financial Accounting Standards Board (FASB)) (“Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information.”); Stevens, *Who Will Audit the Auditors?*, ACROSS THE BOARD, Sept. 1985, at 57, 58; Wood, *Statements in Quotes: What Must Be Done: A Report from the POB*, J. ACCT., Aug. 1985, at 42 [hereinafter *POB Report*] (Arthur M. Wood, Chairman of the Public Oversight Board (POB) of the SEC practice section of the AICPA Division for CPA Firms, stating that the job of “assuring the integrity of the financial information on which our capitalistic society depends” has historically been the “unique function” of the accounting profession); see also *Hearings, supra*, at 402 (testimony of Frederick D. Wolf, Director, Accounting and Financial Management Division, General Accounting Office, discussing the overall role of accounting and the auditing profession in this country); Karmel, *supra* note 2, at 977 (discussing accountants’ role in enabling investors “to place capital where it is most needed and will be most efficiently utilized”); Note, *Failure to Maintain Independence: A Proposed Cause of Action Against Accountants*, 62 TEX. L. REV. 923, 924 n.8 (1984) (“If the public were to lose faith in the accounting profession’s ‘independent attestor’ function, the usefulness of financial data upon which investment decisions are based would decline, thus impeding the flow of capital.”).

financial statements of public companies be audited by certified public accounting firms.⁴ The audit ensures that the statements are prepared according to Generally Accepted Accounting Principles (GAAP), the profession's standards for proper accounting treatment.⁵ If a company's statements meet these standards, the auditor is free to render an unqualified opinion.⁶ Because any-

4. *Hearings, supra* note 3, at 459 n.8 (statement of John S.R. Shad, Chairman of the SEC); *see id.* at 455-66 (discussing more fully the SEC's statutory authority and rulemaking powers); *see also* *United States v. Arthur Young & Co.*, 465 U.S. 805, 808 n.1 (1984) (citing the statutes that indicate Arthur Young's responsibility for reviewing the financial statements of one of its clients).

For definitional purposes:

An audit is the process whereby an accountant examines the financial statements of an enterprise and expresses an opinion regarding the accuracy of the statements and their conformity with generally accepted accounting principles. Accountants who examine and report on such statements are called "independent auditors" because of their duty to act with integrity and objectivity.

Note, *supra* note 3, at 923.

5.

The term GAAP is basically self-defining. It originally was used to describe those conventions that had received general acceptance and "substantial authoritative support" throughout the accounting profession. Today, it also encompasses those pronouncements of standards that have been issued over the years by the various rulemaking bodies of the profession.

Stanger & Gunther, supra note 1, at 1209 n.1 (citation omitted); *see also Arthur Young & Co.*, 465 U.S. at 811 n.6 (indicating that "17 C.F.R. § 210.1-02(d) (1983) requires that the financial statements of a public corporation must be audited by an accountant 'in accordance with generally accepted auditing standards'"); *Hearings, supra* note 3, at 210 (statement of the FASB, noting SEC acceptance of FASB pronouncements on GAAP as authoritative); CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 110 (Am. Inst. of Certified Pub. Accountants 1972) [hereinafter SAS 1] (affirming the auditor's professional responsibility to conduct the audit in accordance with generally accepted accounting standards).

Other organizations involved in setting standards for the accounting profession include the Public Oversight Board, the American Institute of Certified Public Accountants (through its Auditing Standards Board, an Accounting Standards Executive Committee, an Ethics Committee, and its SEC Practice Section), the Governmental Accounting Standards Board, the National Association of State Boards of Accountancy, the 54 state licensing authorities, the International Federation of Accountants, and the International Accounting Standards Committee. *See Hearings, supra* note 3, at 452.

6. *See* SAS 1, *supra* note 5, § 150 (articulating the standards for the conduct of the audit and the content of the audit report).

An *unqualified opinion*, the most favorable report an auditor may give, represents the auditor's finding that the company's financial statements fairly present the financial position of the company, the results of its operations, and the changes in its financial position for the period under audit, in conformity with consistently applied generally accepted accounting principles. Alternatively, the auditor may give a *qualified opinion*, which states that the financial statements are fairly presented except for, or subject to, a departure from generally accepted accounting principles, a change in accounting principles, or a material uncertainty. An *adverse opinion* is a reflection of the auditor's determination that the corporation's financial statements do not fairly present the [company's] financial position [A]n adverse opinion is issued when the auditor determines that the corporation has materially misstated certain items on its financial

thing other than an unqualified opinion is sure to raise investor skepticism concerning the reliability of reported information, audited firms are obviously anxious to obtain this "seal of approval."⁷

The key to investor confidence in auditor opinions is the independence of the auditor.⁸ It is ironic, then, that the very firm subject to the audit both selects and compensates the auditor. Because auditors can be replaced at any time and for virtually any reason (or for no reason at all),⁹ an inherent conflict of in-

statements. Finally, a *disclaimer of opinion* expresses the auditor's inability to draw a conclusion as to the accuracy of the corporate financial records. A disclaimer of opinion is generally issued when the auditor lacks sufficient information about the financial records to issue an overall opinion.

Arthur Young & Co., 465 U.S. at 818-19 n.13 (citations omitted); see also *Hearings, supra* note 3, at 85-86 (providing a typical example of an unqualified opinion); *Auditors Have 4 Choices in Statements*, Wall St. J., June 5, 1985, at 6, col. 2.

7. See *Arthur Young & Co.*, 465 U.S. at 819 n.14.

Qualified statements also may affect management's personal wealth. It is not unusual for managers to purchase shares of their company's common stock for individual investment or to receive stock options as a form of incentive compensation. Because a qualified opinion tends to have an adverse effect on a security's market price, management has a very personal and even selfish incentive to avoid anything other than an unqualified opinion. Chow & Rice, *Qualified Audit Opinions and Auditor Switching*, 57 ACCT. REV. 326, 327 (1982); see also Berton, *Number of Qualified Opinions is Increasing*, Wall St. J., June 5, 1985, at 6, col. 1 (indicating that qualified statements can also lower a company's credit rating, turn away potential investors, involve regulators, and generally create difficulties for the firm in raising outside capital).

8.

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

Arthur Young & Co., 465 U.S. at 817-18 (1984); see also SEC Rule 2-01(b), 17 C.F.R. § 210.2-01(b) (1988) (providing that accountants must be independent in fact and designating relationships considered to impair that independence); SEC Rule 2-01(c), 17 C.F.R. § 210.2-01(c) (1988) (in evaluating independence, "the Commission will give appropriate consideration to all relevant circumstances"); SAS 1, *supra* note 5, § 150 (requiring "independence in mental attitude"); CODE OF PROFESSIONAL CONDUCT § 55 (Am. Inst. of Certified Pub. Accountants 1988) (stating that independence is a primary character trait expected of a public accountant); Note, *supra* note 3, at 924 ("Thus, the most important requirement of the accounting profession is that auditors be regarded by the public as truly independent from the interests of their clients."). See generally *Hearings, supra* note 3, at 467-76 (statement of Chairman Shad regarding accountants' independence).

9. "Registrants may change independent accountants at their discretion." Request for Comments on "Opinion Shopping," Exchange Act Release No. 22,197, 50 Fed. Reg. 28,219 (1985).

terest exists.¹⁰ The auditor is professionally concerned with rendering a truly independent assessment of the client's accounting treatment, yet he is also dependent on the client's satisfaction for continued audit revenue.¹¹ Ultimately, satisfying a client requires rendering an unqualified opinion.¹²

A client company may be tempted to exploit this situation. When a company changes accountants "because of a desire to obtain the services of an accountant willing to interpret generally accepted accounting principles . . . in a manner which frustrates the reporting of the true economic substance of transactions or events, the [firm] and the new accountant may be deemed to have participated in 'opinion shopping.'"¹³ Although frequently difficult to prove, this is precisely the type of insidious activity that both the profession and the SEC would like to prevent.¹⁴ A related concern, even more difficult to prove, is the situation in which the client firm uses the power of its purse to coerce its auditors to bend the rules to give the client firm an unqualified opinion, without ever actually changing auditors.¹⁵

10. See *Hearings, supra* note 3, at 879 (Public Oversight Board Report, Scope of Services by CPA Firms); see also *id.* at 561-62 (questioning by Congressman Luken of Chairman Shad) ("How can we really expect auditors to be independent when they are hired, fired and paid by the corporate managers?").

11. "A perceived conflict is created between the auditor accepting an accounting practice which particularly favors its client's reporting objectives and the auditor fulfilling his responsibilities to act as a 'watchdog' for the public." Request for Comments on "Opinion Shopping," *supra* note 9, at 28,219; see also *Hearings, supra* note 3, at 2 (question by Rep. John D. Dingell, presiding) ("How can the independent auditor on the job be expected to maintain independence when his or her personal success is linked to attracting clients and enhancing revenues?").

12. The percentage of qualified opinions that are actually published is extremely low. It would seem reasonable to assume that, in most cases, the auditor and client continue to negotiate over the accounting treatment until the auditor is satisfied that she may fairly render an unqualified opinion. The SEC's policy of refusing to accept anything other than an unqualified opinion to satisfy the Securities Acts' requirements provides a significant incentive to reach some accord. See, e.g., Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants, Accounting Series Release No. 165, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,187, at 62,395 (Dec. 20, 1974).

13. Request for Comments on "Opinion Shopping," *supra* note 9, at 28,219. A distinction should be made between "auditor shopping" and "opinion shopping." The latter is the practice of explicitly seeking a more favorable accounting treatment, while the former may be the entirely legitimate practice of merely seeking more competent or lower-cost accounting services. When auditor shopping becomes a subterfuge for opinion shopping, the two terms can easily become confused.

14. See, e.g., Serlin, *Auditing Developments*, J. ACCT., AUDITING & FIN., Fall 1985, at 74, 76 (describing the loss of credibility due to opinion shopping as "perhaps the SEC's and the profession's greatest concern").

15. "Critics frequently charge that the asymmetry of power between auditors and managers may seriously weaken the auditor's ability to exercise freely his professional judgment." Chow & Rice, *supra* note 7, at 326.

Moreover, there may be situations where the auditor has received no such express or even implied threats yet nevertheless feels pressured to give an unqualified opinion simply because there are other firms in the profession that will.¹⁶ Actual documented cases of auditor shopping may be the tip of the iceberg of a much larger problem.

In short, auditors may be jeopardizing their independence to maintain and appease the fee-paying client. To the extent that this occurs, financial statements are less reliable than otherwise, and statement users are forced to expend additional resources to obtain the quality information they desire. In the aggregate, this represents a significant and unnecessary social cost.

This Note argues that the existing regulatory mechanism has failed to address adequately the problem of opinion shopping, and that better means of ensuring the reliability of financial statements are needed. Part I describes the nature and extent of the opinion-shopping problem, including a discussion of its larger, macroeconomic impact. Part II argues that the underlying causes of the problem are systemic, and that present safeguards against opinion shopping are inadequate. Finally, Part III examines some alternative solutions and proposes a system of Accounting Issue Inquiry Centers under the direction and auspices of the SEC. These Centers would be designed to achieve more effectively the goal of truly independent public audits.

I. THE NATURE AND EXTENT OF THE PROBLEM

The initial impetus for this Note arose out of an SEC request for public comment on the practice of "opinion shopping."¹⁷ The Commission proposed various amendments to its disclosure requirements concerning auditor-client disagreements and related auditor changes.¹⁸ At the same time, the American Institute of Certified Public Accountants (AICPA),¹⁹ the Accounting Stan-

16. *Id.* (citing Sterling, *Accounting Power*, J. Acct., Jan. 1973, at 61, 66).

17. Request for Comments on "Opinion Shopping," *supra* note 9.

18. *Id.* (proposing changes in Item 304 of Regulation S-K, Item 9(c) of Schedule 14A, and Form S-18). Because of its concern that companies and accounting firms were perhaps being unduly narrow in their conception of "disagreements," the Commission also considered more direct forms of opinion-shopping disclosure. *See infra* text accompanying notes 75-76. The Commission has since adopted a variation of these proposed disclosure rules. *See infra* notes 86-87 & 91-97 and accompanying text.

19. The AICPA is a private organization founded in 1887 with a current membership of approximately 174,000 certified public accountants. Stanger & Gunther, *supra* note 1, at 1209 n.2.

dards Board, and the SEC Practice Section of the AICPA's Division for CPA Firms (SECPS) all began reviewing the problem in conjunction with other professional and ethical issues.²⁰ As if this were not enough attention to the problem, the House of Representatives Committee on Energy and Commerce conducted hearings on the SEC and its oversight of corporate audits.²¹ The accounting profession has not undergone such critical scrutiny since the 1976 Metcalf Hearings.²²

A. *An Illustrative Example*

A hypothetical example illustrates the nature of the problem.²³ Suppose that the research and development department of a publicly held manufacturing concern develops an exciting new technology with potential for significant product application. To exploit this technology, however, the manufacturer will be required to expend significant corporate funds over the next several years before receiving any financial payback on the investment. The manufacturer is concerned that, during the interim, the expenditures will have an adverse impact on the company's financial statements, reflecting negatively on company management.

As a solution to this quandary, the company's financial group proposes that a new subsidiary be created and its stock sold to third-party investors. The manufacturer would advance funds to the subsidiary for continued research and development of the technology and receive notes in return. These notes would be convertible into stock of the subsidiary at the election of the parent company. The parent company would also have a dominant position on the subsidiary's board of directors.

20. Request for Comments on "Opinion Shopping," *supra* note 9, at 28,220 n.8.

21. *Hearings, supra* note 3.

22. *Accounting and Auditing Practices and Procedures: Hearings Before the Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs*, 95th Cong., 1st Sess. 8 (1977). The impetus for these hearings was probably provided by the sensational failure of such companies as Penn Central Corporation and Lockheed Aircraft Corporation, companies that either had or currently were receiving substantial federal assistance. The increasing involvement by private accounting firms in public-sector accounting also contributed to congressional interest. See Karmel, *supra* note 2, at 963.

23. This example is derived from Serlin, *supra* note 14, at 74-75; see also Serlin, *Statements in Quotes: "Shopping Around": A Closer Look at Opinion Shopping*, J. Acct., April 1986, at 120 (reprinting an adapted version of the original article).

The company's current auditors assert that this arrangement elevates form over substance and insist that the financial statements of the subsidiary be consolidated with those of the parent corporation. Undaunted, the parent company solicits the advice of a second auditing firm, which somewhat surprisingly indicates its willingness to approve the transaction and separate the accounting treatment of the two entities. Despite the acquiescence of this second accounting firm, however, the current auditors refuse to reconsider their position. They inform the manufacturer that failure to comply with their approach will result in a qualified audit opinion, an option totally unacceptable to either the company's investors or the SEC. The parent company ultimately concludes that it must replace its existing auditors with the second auditing firm to obtain the accounting treatment it deems necessary. This is a classic case of opinion shopping.

B. *The Prevalence of Opinion Shopping*

Just how prevalent is this problem? Reliable data are difficult to obtain because firms can easily mask the true reasons for any auditor changes that they make.²⁴ Many—perhaps even most—auditor changes are entirely legitimate. The firm might simply want a fresh perspective on its financial controls. There may be personality conflicts with the firm's existing auditors.²⁵ Most commonly, though, the firm simply obtains a lower-cost bid from a competing accounting firm.²⁶

What motivated the SEC's attention, however, was a survey conducted by the National Association of Accountants (NAA) that found a seventy-five percent increase in auditor switching

24. See *Hearings, supra* note 3, at 714-15 (statement of Arthur W. Bowman, Editor, *Public Accounting Report*) ("It's hard to detect whether public companies interview CPA firms to get the 'right' kind of accounting treatment.").

25. See, e.g., 1985 AUDITOR CHANGES ANNUAL REPORT 4-6 (*Public Accounting Report* pub. 1986).

26. See *Hearings, supra* note 3, at 695 (testimony of Arthur W. Bowman) ("And clients firing big eight [accounting] firms cite high fees more often than any other reason. . . . [Companies'] decisions on hiring a new firm are often based on cost alone."); see also Berton, *Auditor Changes by Public Companies Set High as Accountants Compete More*, *Wall St. J.*, Jan. 29, 1985, at 12, col. 3 (citing *Public Accounting Report* to the effect that about 70% of companies in 1984 mentioned lower fees and better service as their reasons for changing auditors). But see Dykes & Hermanson, *Business Exchange: Price Wars—Public Accounting Under Fire*, *BUSINESS*, Apr.-June 1985, at 50, 51-52 (study showing that, of four dimensions clients considered most important in selecting an auditing firm, proposed fee ranked lowest).

from 1981 to 1984.²⁷ Of the companies changing accounting firms during that same three-year period, nineteen percent had recently received some form of qualified opinion.²⁸ When coupled with the complaints that it continued to receive concerning the practice,²⁹ and the publicity surrounding some rather suspicious auditor changes,³⁰ the SEC properly concluded that the problem deserved further consideration.

Two SEC enforcement actions provided further evidence of a problem. In April 1985, the Commission conducted an administrative proceeding against the Broadview Financial Corporation, alleging that it had improperly overstated its revenue and net income by approximately four million dollars.³¹ Without either admitting or denying guilt, the company restated the affected financial reports and agreed to adhere to GAAP in future real estate transactions.³² It was also discovered, however, that the company had gone to four Big Eight accounting firms³³—besides its original auditor—before finding an auditing firm that concurred with the improper treatment.³⁴ Although the SEC threatened to prosecute the company's new auditors for violating various portions of the federal securities laws, ultimately no enforcement action was taken.³⁵

27. See Middleton, *SEC Targets 'Opinion Shopping,'* Nat'l L.J., Sept. 23, 1985, at 9, col. 1; see also *Hearings, supra* note 3, at 694 (testimony of Arthur W. Bowman) ("More public companies changed auditors in 1984 than in any of the 7 years that Public Accounting Report has monitored public auditor changes. The number of companies switching has risen markedly in the last few years. Seventy-five percent more changed in 1984 than in 1981."); *id.* at 582 (testimony indicating that nearly 1000 publicly traded companies changed auditors in the preceding couple of years); Berton, *supra* note 26, at 12, col. 3 (citing *Public Accounting Report* for the fact that a record 523 publicly traded companies changed auditors in 1984).

28. Qualification or disclaimer was never claimed as a reason for changing firms, however. *Hearings, supra* note 3, at 695 (testimony of Arthur W. Bowman).

29. See *POB Report, supra* note 3, at 146.

30. See, e.g., *Hearings, supra* note 3, at 585 (citing the example of Chase Manhattan Corp.'s termination of its auditors only shortly after the improprieties of the Penn Square and Drysdale Securities audits were revealed).

31. *In re Broadview Fin. Corp.*, Exchange Act Release No. 21,949, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,454, at 63,196 (April 17, 1985).

32. *Id.* at 63,202-04; see Middleton, *supra* note 27, at 9, col. 2; Ingersoll, *SEC Warns Accountants, Public Firms Against 'Shopping' for Audit Opinions*, Wall St. J., Apr. 18, 1985, at 7, col. 1.

33. *In re Broadview*, at 63,196. The Big Eight accounting firms are, in decreasing order based on annual revenues: Peat, Marwick, Mitchell & Co.; Arthur Andersen & Co.; Coopers & Lybrand; Ernst & Whinney; Price Waterhouse; Arthur Young & Co.; Deloitte, Haskins & Sells; and Touche Ross & Co. Berton, *Mixed Marriage: Accountants' Merger Tests Idea of Meshing Partners World-Wide*, Wall St. J., Apr. 22, 1987, at 1, col. 6.

34. *In re Broadview*, at 63,196; see Middleton, *supra* note 27, at 9, col. 4; Ingersoll, *supra* note 32.

35. Middleton, *supra* note 27, at 9, col. 4.

The SEC elected to take more stringent action, however, in *In re Wade*.³⁶ There, two savings and loan companies had dismissed their original auditors in favor of a new auditor who permitted an improper deferral of losses to future years. This time, the Commission invoked Rule 2(e) to discipline the professionals involved.³⁷ Two of the accounting firm's partners were barred for three years from any involvement with companies that might file with the Commission; the third partner involved was completely prohibited from undertaking any consulting or auditing work with public companies.³⁸

These examples illustrate two blatant cases of opinion shopping. Other examples can also be cited.³⁹ But the real nature of the problem may not be limited to those cases where firms actually switch auditors. A much more pervasive problem is that accountants may be deterred from giving qualified opinions for fear that a client may switch auditors whenever it feels that some other firm may give it more favorable treatment.⁴⁰ Even if those fears are never realized, the subtle pressure may be leading auditors to render less than completely objective, independent opinions.⁴¹ In other words, it is possible that the NAA statistics underestimate the magnitude of the problem.

Three recent developments in the industry heighten the probability that these fears and pressures might be a significant problem. First, the profession is becoming increasingly competitive, especially where audit services are involved.⁴² Management

36. *In re Steven O. Wade*, Exchange Act Release No. 21,095, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,432, at 63,130 (June 25, 1984).

37. *In re Wade*, at 63,130; Middleton, *supra* note 27, at 10, col. 1; see also *infra* note 109 (discussing the SEC's enforcement and remedial powers).

38. *In re Wade*, at 63,137; Middleton, *supra* note 27, at 10, col. 1.

39. See, e.g., *Hearings*, *supra* note 3, at 715-16 (examples provided in statement by Arthur W. Bowman).

40. See *supra* note 16 and accompanying text.

41. See *Hearings*, *supra* note 3, at 1 (statement of Rep. John D. Dingell, presiding) ("In a world where the self-interested claims of corporate managers cannot be verified by those outside the corporation, the Nation needs an independent umpire who will examine those claims and call fair or foul, as the case may be, *without any fear of intimidation*." (emphasis added); see also *id.* at 561 (statement of Clarence Sampson of the SEC) ("[W]e have to recognize that the payment of fees by the client could be considered to be a pressure on the accountant with respect to his independence.").

42. See generally *POB Chairman Urges Major Changes in Self-Regulatory Program for Accountants*, C.P.A. J., Sept. 1985, at 7 (remark by Arthur M. Wood, Chairman of the POB, that the practice of opinion shopping is a "by-product of today's intensely competitive economy"); Sack, *Commercialism in the Profession: A Threat to be Managed*, J. Acct., Oct. 1985, at 125; Berton, *Total War: CPA Firms Diversify, Cut Fees, Steal Clients in Battle for Business*, Wall St. J., Sept. 20, 1985, at 1, col. 6 [hereinafter Berton, *Total War*]; Berton, *Audit Fees Fall as CPA Firms Jockey for Bids*, Wall St. J., Jan. 28, 1985, at 33, col. 3 [hereinafter Berton, *Audit Fees Fall*].

frequently views audits as fungible commodities.⁴³ "Bidding wars" among auditors are not uncommon.⁴⁴ Mergers and consolidations reduce the number of potential audit clients, contributing to the sometimes cutthroat competition.⁴⁵ One need only observe the dramatic growth in advertising and marketing by accounting firms to appreciate the increased commercialism of the profession today.⁴⁶

43. See Berton, *Audit Fees Fall*, *supra* note 42 (quoting a partner at a medium-sized accounting firm as saying: "Many of our clients are treating the audit as a commodity, like shopping for cheaper gasoline."); see also *Hearings*, *supra* note 3, at 84; Pearlman, *Accounting and Auditing, Committee Commentary on Current Developments*, C.P.A. J., Oct. 1985, at 85.

Dykes and Hermanson explain this phenomenon as follows: "[S]ome executives may view accounting firms as essentially identical: the firms are all bound by strict professional standards and procedures and have highly trained personnel. Therefore, any accounting firm's 'clean' opinion would be acceptable. Using this reasoning, the opinion that is the least costly would be preferable." Dykes & Hermanson, *supra* note 26, at 51.

44. Discounts of 30% to 50%—or more—off base fees are apparently no longer unusual. Berton, *Audit Fees Fall*, *supra* note 42. "Many companies are taking advantage of the cut-rate environment. Biotech Capital Corp., a small New York-based venture-capital concern, recently asked four big CPA firms to bid for its audit, which previously had been done by Arthur Young & Co. for \$40,000 to \$45,000 a year. Deloitte, Haskins & Sells won the competition with a \$12,500 bid." *Id.*

Another example is provided by Dykes & Hermanson, *supra* note 26, at 50:

You are the chief executive officer of a manufacturing company with current sales of \$20 million. You have been requested by your company's creditors to obtain audits for the current year and for two prior years. After receiving proposals from three different accounting firms, you must choose among bids of \$35,000, \$5,000, or zero. What would you do?

Id. To explain why an accounting firm would be willing to bid as low as zero for some audits, Eli Mason, CPA, Managing Partner, Mason & Co., says that the firms are essentially "purchasing the account for one year's fee." *Hearings*, *supra* note 3, at 734; see also *id.* at 695, 705-06 (statement by Arthur W. Bowman) (providing examples of cut-rate bidding).

45. See Berton, *supra* note 26 ("Mergers accounted for 20% of the [auditor] changes in 1984, up from 16% in 1983 and only 13% in 1982."). One major accounting firm, for example, blames mergers for costing it three of its largest clients since 1981. *Id.*

46. See, e.g., Berton, *Total War*, *supra* note 42, at 24, col. 4 (reporting that large CPA firms "speak with pride of beefed-up marketing efforts for clients of all sizes," and citing examples of the dramatic expansion in the use of marketing personnel and techniques by various Big Eight accounting firms); see also Pearlman, *supra* note 43, at 85 (the emphasis on marketing has contributed to the perception that accounting professionalism is on the decline); Sack, *supra* note 42, at 126 (referring to "the hype surrounding the public estimation of annual firm revenues"); Seiler, *Competition and Independence*, C.P.A. J., Oct. 1987, at 4, 4 ("The stage has been set for commercialism to take the place of professionalism.").

A good explanation for this recent emphasis on marketing and aggressive pricing is provided by Dykes & Hermanson, *supra* note 26, at 50 (discussing the impact of certain Supreme Court decisions and subsequent revisions to the AICPA Code of Professional Ethics).

The second factor is the dynamic growth of management advisory services (MAS) by large public accounting firms.⁴⁷ The significance of this aspect of the practice is that obtaining new auditing clients, and retaining existing ones, is necessary not only to bring in audit fees, but also—and perhaps even more importantly—because it can bring in lucrative management consulting fees.⁴⁸ The pressure to satisfy clients is greater than ever before.⁴⁹

Finally, it should be emphasized that even if accountants are, in fact, resisting these pressures, the SEC and the profession it-

47. See *Hearings*, *supra* note 3, at 697. Arthur W. Bowman describes the trend as follows:

The intense competition for SEC clients has not only driven the price of audits down; it has slowed the dollar growth in the accounting and auditing practices of the big eight firms. To compensate, the firms have placed new emphasis on marketing their tax and management consulting abilities, practice areas that have grown almost twice as fast as auditing and accounting.

Traditionally, accounting and auditing accounted for about 75 percent of the large firms' revenue. The figure is now dropping. The chairman of the AICPA's Future Issues Committee, Richard Hickok, predicted 2 years [ago] that the percentage would drop to 55 percent. . . .

. . . [B]etween 1982 and 1984, revenue from accounting and auditing for the big eight firms grew 14 percent from \$2.8 billion to \$3.2 billion. Tax billings increased 28 percent from \$936 million to \$1.2 billion, and revenue from management consulting jumped 33 percent from \$625 million to \$830 million.

Id. at 697-98.

48. See *Hearings*, *supra* note 3, at 97 (statement of Abraham J. Briloff that "the ostensibly independent audit has become the loss leader for the lucrative MAS [Management Advisory Services] coin"); *id.* at 28 (statement of Robert Chatov that accounting firms retain their management advisory services "not because the service is a necessary adjunct to the accounting function, but because of its lucrative potential"); *id.* at 144 (statement of Abraham J. Briloff criticizing the "subsidization" of the audit function by management advisory services); *id.* at 157 (testimony of Abraham J. Briloff regarding "lowballing," the practice "whereby audit firms go out competing for audit situations to buy in the audit, hoping against hope that through their extension into the nonaudit field they might somehow or other be able to compensate for the losses that they are prepared to take on the audit function").

Some have expressed the concern that offering consulting services could lead to the situation where the accountant is asked to audit his own work. See, e.g., *Hearings*, *supra* note 3, at 570-77 (questioning directed to Chairman Shad regarding the Drysdale Securities audit). Others, conversely, have vigorously contended that management advisory services have no adverse effect whatsoever on the independence of the auditor. See, e.g., THE COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS (1978) (often referred to as the COHEN COMMISSION REPORT, it is the product of an independent commission established by the AICPA in 1974 to study the role and responsibilities of independent accountants). Perhaps the problem is "not so much lack of independence in fact as the appearance of lack of independence." See *Hearings*, *supra* note 3, at 877.

49. "The increasing diversification of accountant services to clients has created new stresses on an auditor's ability to remain independent and objective in conducting financial evaluations." Note, *supra* note 3, at 944.

self must continue to concern themselves with the appearance of independence.⁵⁰ The general view that accounting professionalism is on the decline is fairly widespread.⁵¹ This public perception of audits is crucial: when public faith in the independence of audits erodes, the economic costs to society can be significant.

C. *The Societal Costs of Auditor Shopping*

As audited firms come to learn that they can successfully pressure their auditors into giving favorable opinions, they are likely to become increasingly aggressive in their financial reporting.⁵² This puts pressure on more conservative firms to follow their example. The problem snowballs.

Accountants similarly face the "bandwagon" syndrome. To the extent that some accounting firms are able to compete successfully by bending the rules, the pressure increases upon other firms to follow suit, if only to remain economically competitive.⁵³

Ultimately, the capital markets and the general public suffer the costs of this type of behavior. When faith in the quality and

50. "If the public were even to perceive that opinion shopping is widespread—regardless of whether it achieves the end result sought by those who engage in such activity—public confidence would be severely damaged." Address by SEC Commissioner James C. Treadway, Jr., 17th Annual Rocky Mountain State-Federal-Provincial Securities Conference, Denver, Colorado (Oct. 19, 1984), quoted in Serlin, *supra* note 14, at 75; see also *Hearings, supra* note 3, at 2 (comments of Rep. John D. Dingell, presiding); *id.* at 469 (statement of Chairman Shad, citing SAS 1, *supra* note 5, § 220: "Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."); Accounting Series Release No. 165, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,187, at 62,395 (Dec. 20, 1974) ("It is essential that both the fact and the appearance of independence be sustained so that the confidence of the investing public in the reliability of audited financial statements and the integrity of the public accounting profession will be maintained and enhanced.").

51. "A crisis of confidence and credibility is confronting the accounting profession. . . . [T]he criticisms of the profession are widespread and harsh." Anderson, *A Fresh Look at Standards of Professional Conduct*, J. Acct., Sept. 1985, at 91, 91; see also Pearlman, *supra* note 43, at 85 (acknowledging the "growing perception . . . that professionalism is on the decline" and referring to the "tarnished image" of the profession).

52. "The mere fact that opinion shopping occurs encourages to some extent a belief among issuers and disgruntled executives that this form of pressure is an effective, legal, and acceptable way to bludgeon accountants into submission on disputed accounting issues." Address by James C. Treadway, Jr., *supra* note 50. In the U.S. economy, where businesses must "compete for scarce capital on the basis of their financial prospects, there is a tremendous incentive for them to present the best possible picture in their financial statements." *Hearings, supra* note 3, at 389 (statement of Donald J. Kirk, Chairman of the Financial Accounting Standards Board).

53. Serlin, *supra* note 14, at 76.

reliability of financial reporting decreases, the capital markets become correspondingly more risky. Investors protect themselves by discounting the value of equity investments, effectively discouraging the use of equity financing as a source of capital for corporate investment. Creditors likewise protect themselves by charging higher rates of interest to compensate for the increased risk that they incur. Ultimately, the cost of capital rises, corporate investment declines, productivity increases at a slower pace than it otherwise might, and society experiences a lower standard of living than could otherwise have been achieved.⁵⁴

II. BUT IS THERE REALLY A PROBLEM?: THE PROFESSION'S RESPONSE

The auditing profession raises a variety of defenses whenever it encounters accusations of opinion shopping. Some members rationalize the shopping problem as simply being inherent in the nature of auditing as a profession, especially where auditors must compete in a free-market economy. Others rest their case on various structural and protective mechanisms already in place. This Section examines some of these responses and concludes that, despite all the rhetoric, the fundamental nature of the problem remains unresolved.

A. *The Nature of the Auditing Profession*

The most persuasive argument raised by the profession is that auditing, by its very nature, is judgmental. Accounting standards leave room for honest differences of professional opinion about how best to record a given transaction.⁵⁵ This judgmental, discretionary element of accounting is an important factor in ex-

54. For discussions of the role of financial disclosure in the capital markets, see R. MAUTZ & W. MAY, *FINANCIAL DISCLOSURE IN A COMPETITIVE ECONOMY* (1978) and V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 1059-1235 (2d ed. 1979).

55. Serlin, *supra* note 14, at 78.

Accounting is an art, not an exact science. While that concept perhaps is difficult for the public to accept, it is for that reason that different auditors, given the same set of facts, can come to different conclusions regarding the accounting for a transaction or event Given the possibility that there can be more than one "right" answer, management is entitled to know the differing viewpoints.

Id.

plaining why it has generally been considered one of the learned professions. The fact that one auditor would permit more lenient treatment than another auditor is not necessarily a problem.

Nevertheless, most accountants would readily agree that the choice of accounting treatment has never been left entirely to the judgment of the particular auditor at hand. Indeed, the recognition of GAAP is designed to ensure a certain degree of uniformity and consistency among accounting treatments.⁵⁶ Absent some level of consistency, it becomes very difficult to compare information across firms or over time.⁵⁷ The information, accordingly, would have considerably less value. Thus, there are limits to the degree of discretion left to any individual practitioner.

Occasionally, reference will be made to the practice in the medical field.⁵⁸ Just as medical patients are encouraged to seek a second opinion, why not permit a business firm to do the same? This analogy is faulty, however, for two reasons. First, patients are not encouraged to look for doctors who will only give "good" opinions. They seek rather to obtain the benefits of varied experience that another physician might bring, hoping to assess more accurately the realities of an existing physical condition. In contrast, the opinion shopper already knows what answer it seeks and is merely looking for some auditor to lend credibility to the firm's chosen approach.⁵⁹ Second, in the medical setting, the opinion has immediate implications only for the patient. In the financial environment, the opinion is primarily for the benefit of third parties (e.g., creditors and investors), not the party seeking the opinion, who generally knows quite well the economic reality of the situation.⁶⁰ Second opinions should not normally be encouraged in the accounting of economic transactions.

56. See *infra* notes 137-38 and accompanying text.

57. See *infra* notes 137-38 and accompanying text.

58. See, e.g., Sack, *supra* note 42, at 126, 128.

Analogies have also been made to the accepted practice of obtaining second or additional legal interpretations, asset appraisals, engineering reports, and actuarial valuations. In some cases, the failure of management to obtain such additional reports might even be deemed an act of negligence. Serlin, *supra* note 14, at 78. If nothing else, analogies of this sort suggest that some forms of opinion shopping may be quite legitimate.

59. Sack, *supra* note 42, at 128. "The most glaring cases of accounting shopping don't involve merely a second opinion; rather, they involve explicit searches for an auditor who will agree." *Id.*

60. *Id.* Over 50 years ago, Arthur Andersen, after whom one of the Big Eight accounting firms is named, said: "[I]t has long been recognized that the published financial statements of corporations are clothed with a public interest and that the accountant has a responsibility to the public as well as to his client." *Id.* at 125. This theme was reiterated in 1972 by Robert M. Trueblood, a former chairman of Touche Ross & Co.: "The public is the accountant's only client in the world today. The public is the accountant's consumer." *Id.*; see also Karmel, *supra* note 2, at 959 ("Although accountants serve the

Another frequently cited response by accountants is that any attempt to reduce auditor changes will likely have an anticompetitive effect on the auditing industry. The result of any restrictions on switching auditors may be to entrench existing auditors with their present clients.⁶¹ In fact, accountants suggest, there may be situations where firms do not switch auditors often enough.⁶² Although theoretically this might be a valid concern, recent developments in the profession suggest that, if anything, the profession is more than sufficiently competitive at the present time.⁶³ In any event, the thesis of this Note is not that auditor changes should be proscribed or that their frequency be even moderately reduced. The concern is, rather, over auditor changes made solely or primarily for the purpose of obtaining a different, and presumably more favorable, accounting interpretation. Ideally, the proper recording of financial events should be independent of the individual firm responsible for auditing those records.

A related argument is that companies may have legitimate reasons for switching auditors; proposals that address the specific problem of opinion shopping often cannot distinguish between valid and invalid reasons for making a change. Firms may well have a combination of reasons for making a change.⁶⁴ Although this is a realistic concern, it should be emphasized that a fair number of reported auditor changes do involve auditor-client conflicts over accounting treatment. One study reports that fourteen percent of all auditor changes followed disagreements

particular enterprises that retain them, their work is intended for the use and benefit of third parties who have an interest in the financial statements of those enterprises.”).

61. “Independent auditors were also accused of surrendering their independence when they served a corporation too long and became too comfortable with management that controlled the appointment of its external auditors. Finally, external auditors were accused of performing less than professional audit services when their appointments became routine.” Kunitake, *Auditor Changes by Audit Committees and Outside Directors*, AKRON BUS. & ECON. REV., Fall 1983, at 48, 48; see also *Hearings*, *supra* note 3, at 551 (suggesting that some auditor-client relationships have continued for as long as 30 years).

62. *Hearings*, *supra* note 3, at 551 (questioning by Congressman Shelby indicating that perhaps audit terms should be limited by the SEC so that companies would get a “fresh look” by new auditors on a periodic basis).

63. See *supra* notes 42-46 and accompanying text.

64. Interviews with public companies that had recently changed auditors revealed that 32% had done so because they could obtain the service at a lower cost, 29% because they sought better service, and 19% because they required the services of a larger accounting firm, although frequently more than one reason was cited. Interestingly, a qualified or disclaimed opinion preceded 19% of the changes. *Hearings*, *supra* note 3, at 701 (statement of Arthur W. Bowman).

between client and auditor.⁶⁵ This figure only represents cases where the SEC requires this disclosure because there has been an actual auditor change; there are likely many more cases where disagreements went unreported because the auditor was not replaced. The company may have acceded to the auditor's choice of treatment, or the auditor may have "compromised" his standards to appease the client. Even where the auditor was replaced, disagreements may never have been reported because the auditor believed, correctly or incorrectly, that other more significant factors were responsible for the client's decision.⁶⁶ In any event, auditor-client disputes over accounting treatment frequently do occur.⁶⁷ When coupled with the tremendous competitive pressures in the profession, the temptation for auditors to lower their "independent" standards is, undoubtedly, very great.

B. Past Regulatory Attempts

Opinion shopping is not a new activity. George O. May, former head partner of Price, Waterhouse & Co., addressed the problem in a speech in 1926.⁶⁸ The SEC likewise has, on different occasions, expressed its concern over the practice. In 1974, it published Accounting Series Release (ASR) 165, which amended Form 8-K to make the resignation or dismissal of accountants a reportable event.⁶⁹ The release also clarified the Commission's intent "to require a description of all disagreements [between auditor and client], including those where the disagreement was resolved to the satisfaction of the accountant."⁷⁰ This latter requirement was watered down two years later in ASR 194, which demanded disclosure of a previously reported disagreement only in those cases where a successor auditor adopted an approach rejected by the client's previous accountant.⁷¹ In 1978, the Com-

65. McConnell, *Auditor Change Disagreement Involvement: Big Eight and Non-Big Eight Firms*, OHIO C.P.A. J., Winter 1984, at 21, 22.

66. See Request for Comments on "Opinion Shopping," *supra* note 9, at 28,220 n.13 ("In other words, some accountants may have a tendency to rationalize their loss of a client in an attempt to avoid any ill will or for other reasons.").

67. For an example of a case where Arthur Andersen & Co. lost a client because of a disagreement over accounting treatment, see *Hearings*, *supra* note 3, at 697.

68. Newman, *SEC Commentary: Opinion Shopping*, C.P.A. J., Jan. 1986, at 81, 83.

69. Accounting Series Release No. 165, *supra* note 50, at 62,395. Prior to that release, only the engagement of a new accountant triggered the Form 8-K disclosure. *Id.*

70. *Id.* at 62,396.

71. Accounting Series Release No. 194, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,216, at 62,514, 62,516 (Apr. 29, 1976).

mission voiced its concern that the practice of reporting disagreements in Form 8-K filings had seriously deteriorated, referring to filings where the registrant had indicated no disagreements, while the former accountant's letter had concluded that reportable disagreements did occur.⁷²

Apparently the SEC was not particularly satisfied with the results.⁷³ In July 1985, it issued a concept release in which it solicited comments on proposals for further disclosure requirements.⁷⁴ The Commission basically considered three variations of opinion-shopping-related disclosure. The first proposal would have required disclosure whenever "(1) the registrant solicited opinions from other accountants on specific accounting issues concerning existing or contemplated transactions, or (2) the registrant engaged an accountant expressing an opinion which is different from its former accountant's position."⁷⁵ Such disclosure would be mandated even in the absence of a "disagreement," although only where the actions were accompanied by an actual change in auditors. The second proposal was more stringent, requiring disclosure whenever a company asked another accountant for an opinion on an accounting issue, regardless of whether a change in accountants occurred. The third approach required a company to disclose the names of any accountants consulted prior to adopting any change in accounting principles.⁷⁶

The comments received by the SEC were overwhelmingly negative.⁷⁷ Most of the respondents believed that the existing self-regulatory system was more than sufficient.⁷⁸ Others were willing to submit to additional disclosure requirements, but only when there had been an actual change in auditors, not just a disagreement.⁷⁹ If any of the proposals were going to be adopted, however, the consensus seemed to be that the first option was the most palatable, with the second variation the least acceptable.⁸⁰

The accounting profession apparently began to appreciate the seriousness of the SEC's concern, however, because it initiated certain reforms of its own during the period immediately subse-

72. Accounting Series Release No. 247, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,269, at 62,711 (May 26, 1978).

73. Nor has Congress been particularly thrilled with the SEC's efforts in this regard. See, e.g., *Hearings, supra* note 3, at 590 (remarks by Congressman Wyden).

74. Request for Comments on "Opinion Shopping," *supra* note 9.

75. *Id.* at 28,220.

76. *Id.*

77. Newman, *supra* note 68, at 81.

78. *Id.* at 81-82.

79. *Id.* at 82.

80. *Id.* at 81-82.

quent to the issuance of the concept release. One of these changes involved the amendment of the requirements for membership in the SEC Practice Section of the AICPA's Division for CPA firms.⁸¹ As of January 1, 1986, all members were required to establish standards for the rendering of accounting advice to non-audit clients and to subject these standards to periodic peer review.⁸² The AICPA also drafted a letter to the SEC proposing certain changes to the Form 8-K requirements in connection with auditor changes.⁸³ At about the same time, the Accounting Standards Board adopted the Statement on Auditing Standards 50 (SAS 50), Reports on the Application of Accounting Principles.⁸⁴ Like the SECPS requirements, SAS 50 prescribes detailed guidelines for, and documentation of, consultations with nonclients regarding accounting applications.⁸⁵

Convinced that more disclosure was required, however, the SEC proposed additional disclosure rules in June 1987.⁸⁶ These rules were, with minor modification, formally adopted by the Commission effective May 20, 1988.⁸⁷ Only time will tell whether these changes will materially reduce the incidence of opinion shopping.

81. See Maltzman, *Issuing Reports on the Application of Accounting Principles Under SAS No. 50 (the "Opinion Shopping" statement)*, C.P.A. J., Jan. 1987, at 93, 94.

82. *Id.*

83. See *Washington Update: AICPA Urges Revisions to Form 8-K On Auditor Changes*, J. Acct., Nov. 1986, at 72.

84. REPORTS ON APPLICATION OF ACCOUNTING PRINCIPLES, Statement on Auditing Principles No. 50, § 625 (Am. Inst. of Certified Pub. Accountants 1986) [hereinafter SAS 50]; see *Opinion Shopping is Focus of New SAS*, J. Acct., Oct. 1986, at 24; Urbancic, *New SAS on Opinion Shopping*, C.P.A. J., Sept. 1986, at 101.

85. SAS 50, *supra* note 84; see Urbancic, *supra* note 84, at 101. The Statement essentially identifies the factors that should be considered and the "due diligence" review that should precede the rendering of advice on a particular application of GAAP. It also enumerates the content of any written report that accompanies such advice. SAS 50, *supra* note 84.

86. See *Disclosure Amendments to Regulation S-K and Forms 8-K and N-SAR Regarding Changes in Accountants and Opinion Shopping*, Exchange Act Release No. 24,608, 52 Fed. Reg. 24,018, at 24,021 (1987) [hereinafter *Disclosure Amendments (proposed)*].

87. *Disclosure Amendments to Regulation S-K, Form 8-K and Schedule 14A Regarding Changes in Accountants and Potential Opinion Shopping Situations*, Exchange Act Release No. 25,578, 53 Fed. Reg. 12,924 (Apr. 20, 1988) (to be codified at 17 C.F.R. §§ 229, 240 & 249) [hereinafter *Disclosure Amendments (final)*]. See *infra* notes 91-97 and accompanying text. While the proposed draft was still open for comments, the National Commission on Fraudulent Financial Reporting, led by Chairman James C. Treadway, Jr., submitted its final recommendations on how the profession should address the problem of fraudulent financial reporting. One of its recommendations, interestingly, was that there be additional disclosure of auditor changes by public companies. See *Fraud Commission Issues Final Report*, J. Acct., Nov. 1987, at 39 (highlighting the Fraud Commission's final recommendations).

C. Existing Structural Safeguards

Among the existing structural mechanisms designed to discourage opinion shopping, certainly the most visible and direct are the SEC disclosure rules. Until recently, Item 4 of Form 8-K ("Changes in Registrant's Certifying Accountant") required a registrant with the SEC to identify its reason or reasons for changing auditors.⁸⁸ The Item also required the registrant to request that the replaced auditor "furnish the registrant with a letter addressed to the Commission stating whether it agrees with the statements made by the registrant . . . and, if not, stating the respects in which it does not agree."⁸⁹ Despite this requirement, many companies and accounting firms remained unwilling to acknowledge that differences of opinion may constitute "disagreements."⁹⁰

The SEC's recent adoption of significant new disclosure rules is an attempt to correct this problem.⁹¹ These rules amend Form 8-K, Regulation S-K, and Schedule 14A to provide, in connection with a change in auditors, for: 1) a statement as to whether the former auditor resigned, declined to stand for reelection, or was dismissed; 2) a statement on whether the auditor's report for either of the past two fiscal years contained anything other than an unqualified opinion; and 3) a statement on whether the auditor change was approved by an audit or similar committee

88. Form 8-K, Item 4, 42 Fed. Reg. 4430 (1977) (amended 1988). "Item 4 requires disclosure whenever an accountant resigns, indicates he declines to stand for re-election after the completion of the current audit, is dismissed or another independent accountant is engaged." *Hearings, supra* note 3, at 471 n.13 (statement of Chairman Shad). In addition, if a company has received anything other than an unqualified opinion within the two years prior to changing auditors, it must also provide a description of that opinion. *Id.* at 471 n.15.

89. Item 4(d), 42 Fed. Reg. at 4430.

90. See Request for Comments on "Opinion Shopping," *supra* note 9, at 28,220 n.13; see also *Hearings, supra* note 3, at 152 (testimony of Dr. Briloff); *id.* at 568-83 (testimony of Chairman Shad); *id.* at 720 (testimony of Arthur K. Bowman).

"Disagreements are defined [by the SEC] as disputes, whether resolved or not, occurring at the decision-making level involving accounting principles or practices, financial statement disclosure or auditing scope or procedures." McConnell, *supra* note 65, at 21.

91. See *supra* note 87 and accompanying text. The SEC has also issued a companion release that proposes to shorten the time periods for filing Form 8-K and for filing the former accountant's letter in response; it would also require the registrant to file the former creditor's letter with the Commission within 48 hours of its receipt. See Amendments to Regulation S-K Regarding Changes in Accountants; Acceleration of the Timing for Filing Forms 8-K Relating to Changes in Accountants and Resignations of Directors, Exchange Act Release No. 25,579, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,230 (Apr. 7, 1988).

of the board of directors.⁹² Perhaps more significantly, the rules also provide for a broader definition of disagreements⁹³ and for the identification and disclosure of certain "reportable events."⁹⁴ In addition, the rules prescribe further disclosure of the nature of any consultations by the registrant within the last two fiscal years with its newly engaged auditor regarding 1) specific accounting applications or 2) any disagreements or "reportable events" with its former auditors.⁹⁵ Other less significant changes

92. Disclosure Amendments (final), *supra* note 87, at 12,929 (to be codified at 17 CFR § 229.304(a)(1)(i-iii)).

93. Disclosure Amendments (final), *supra* note 87, at 12,929 (to be codified at 17 CFR § 229.304(a)(1)(iv)). The registrant must:

State whether during the registrant's two most recent fiscal years and any subsequent interim period preceding such resignation, declination or dismissal there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of the former accountant, would have caused it to make reference to the subject matter of the disagreement(s) in connection with its report. Also, (A) describe each such disagreement; (B) state whether any audit or similar committee of the board of directors, or the board of directors, discussed the subject matter of each of such disagreements with the former accountant; and (C) state whether the registrant has authorized the former accountant to respond fully to the inquiries of the successor accountant concerning the subject matter of each of such disagreements and, if not, describe the nature of any limitation thereon and the reason therefore. The disagreements required to be reported in response to this Item include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Disagreements contemplated by this Item are those that occur at the decision-making level, i.e., between personnel of the registrant responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report.

Id.

The final draft of the regulations deleted the proposed disclosure of any consultations with other accountants whose views differed materially from that of the company's new auditor. *Compare* Disclosure Amendments (proposed), *supra* note 86, at 24,026 with Disclosure Amendments (final), *supra* note 87, at 12,925.

94. The amendment requires the disclosure of any of the following four "reportable events," even if there was no difference of opinion on the event between the registrant and its auditor:

(1) Where the auditor has advised the registrant that its internal controls are grossly inadequate;

(2) Where the auditor has notified the registrant that it can no longer rely on management's representations or that it is unwilling to be associated with the registrant's financial statements;

(3) Where the registrant has been advised by its auditor that the scope of the audit must be significantly expanded, and that further investigation might impact the fairness or reliability of past or pending financial statements; or

(4) Where the registrant has been notified by the auditor that it has information in its possession that would prevent it from rendering an unqualified opinion report on either past or pending financial statements and that, because of its resignation, dismissal, or declination to stand for reelection, the issues have not been satisfactorily resolved.

95. Disclosure Amendments (final), *supra* note 87, at 12,930 (to be codified at 17 C.F.R. § 229.304(a)(2)). In such cases, the registrant is required to disclose (1) the nature

also were effected by the rules, including a transfer of many disclosure requirements from Item 4 of Form 8-K to Item 304 of Regulation S-K.⁹⁶ The SEC asserts that these rules will not impose significant new costs on registrants.⁹⁷ Unfortunately, these additional rules are simply more of the existing remedy and do not address the fundamental roots of the opinion-shopping problem.

The AICPA has also attempted to address the problem of auditor shopping through its "peer review" requirement.⁹⁸ This requirement covers most public auditors, because members of the AICPA Division for CPA firms audit eighty-six percent of all publicly traded U.S. companies.⁹⁹ Membership entails numerous obligations. Every three years, for example, members permit their audit practices to be reviewed by fellow auditors.¹⁰⁰ The members also agree, among other things, to rotate audit partners every seven years, to provide for second-partner review on all SEC-registered clients, to notify the client's board of directors or audit committee of any serious disagreements with management, and to conduct an annual quality-control review.¹⁰¹

of the issues discussed, (2) the views of the newly engaged accountant on the issue, and (3) the former auditor's view, if consulted on the issue. In addition, the registrant must request both the new and the former auditors to review the company's disclosure and file, as an exhibit, any letter from either auditor that attempts to clarify or correct the registrant's disclosure. *Id.*

96. 53 Fed. Reg. at 12,928. The amended rules also revise Item 9(d) of Schedule 14A to provide that the disclosure of auditor changes for proxy statement purposes encompasses the two most recent fiscal years and any subsequent interim period, and not just the period since the most recent proxy statement for the annual meeting of shareholders. *Id.*

97. *Id.*

98. The primary mechanism for the self-regulation of accounting firms is the AICPA's division for CPA firms. Created in 1977, it consists of an SEC practice section (SECPS) and a private companies practice section (PCPS). Membership in either organization is voluntary. The POB is the entity charged with the oversight of the SECPS. For a brief description of the history and activities of these organizations, see *Peer Review and the Public Oversight Board: Doing the Job*, J. Acct., May 1985, at 122 [hereinafter *Peer Review and the POB*].

99. *AICPA President Responds to Plan for New Oversight Group*, J. Acct., Feb. 1986, at 14, 14.

"According to the POB 1983-84 annual report, almost 1,700 firms are members of the Division [for CPA Firms], 430 of which are members of the SECPS. Of the 430 members, 196 have one or more SEC registered clients. These 196 firms audit approximately 85% of all SEC registrants." *Hearings*, *supra* note 3, at 511 (statement of Chairman Shad).

100. See *Peer Review and the POB*, *supra* note 98, at 122.

101. *Id.* In addition, the chairman of the Public Oversight Board "has recently recommended that SECPS membership requirements be revised to explicitly require successor accountants to document their consultations with predecessor firms, and that peer reviewers examine such documentation and make appropriate inquiries of the predecessor firms when necessary." Request for Comments on "Opinion Shopping," *supra* note 9, at 28,220 n.9.

This seemingly comprehensive self-regulatory system has its critics, however. One problem, of course, is that a number of public auditing firms are not participants in the peer review process.¹⁰² The far more significant criticism, however, is that the reviews have no "teeth."¹⁰³ The vast majority of firms pass the reviews, and for those that fail there are only very limited sanctions.¹⁰⁴ The problem of auditor shopping, moreover, is not one of audit technique (e.g., failure to conduct basic audit tests), but rather one of tainted judgment: dare we certify the client's choice of accounting treatment? The reviews tend to concentrate

102. "It has been estimated that as many as 700 firms that audit at least one Commission [SEC] registrant do not participate in the profession's voluntary self-regulatory program." Thomas, *SEC Oversight Role in Self-Regulation*, C.P.A. J., May 1983, at 10, 12; see also Karmel, *supra* note 2, at 974 (describing the absence of a compulsory membership requirement as a "troublesome problem").

One of the peer review requirements, the second-partner review, applies only to audits of SEC registrants. This exempts audits of private companies from the rule. The case of E.S.M. Government Securities, Inc., where massive fraud went undetected by public audit, is an example of a private company exempt from the peer review requirements. See Stevens, *supra* note 3, at 57-59.

103. "Despite continual press reports of audit and accounting problems, the peer review system has not found much to criticize in the way its members perform their responsibilities." *Hearings*, *supra* note 3, at 3 (introductory remarks by Rep. John D. Dingell, presiding).

Sandy Burton, former Chief Accountant to the SEC, claims that it is our "antitrust laws [that] make it extremely difficult for [any] profession to develop a process with any real disciplinary teeth." Burton, *The Profession's Institutional Structure in the 1980's*, J. Acct., Apr. 1978, at 63, 66-67.

104. POB statistics indicate that 95 of the approximately 3200 audits reviewed, or about three percent (3%), were determined to be substandard. In only one-third of these cases were the auditors required to perform additional procedures or to revise and reissue their opinions. *Peer Review and the POB*, *supra* note 98, at 131.

The SECPS's corrective actions may involve one or more of the following: ordering accelerated or special peer reviews; requiring firms to hire additional personnel or make various personnel changes; imposing additional continuing education requirements on partners and employees; and requiring supplemental supervision over certain audit work. The Section's ultimate sanction is expulsion of the firm from membership in SECPS (membership that, incidentally, was voluntary) and public disclosure of the expulsion. *Id.*

Despite these sanctions, the record has not always been impressive. "In one glaring case, Price Waterhouse issued a relatively clean opinion for Fox & Company shortly before that firm was found to have systemic deficiencies in its audit practice, culminating in an SEC-imposed one-year ban on the acceptance of new publicly listed clients." Stevens, *supra* note 3, at 61. Indeed, while the Section has been successful in obtaining voluntary cooperation, it has yet to impose any "formal" sanctions to date. See Thomas, *supra* note 102, at 14. Even the chairman of the Public Oversight Board, Arthur M. Wood, has described as "disquieting" the fact that none of the firms under scrutiny by the Dingell subcommittee had ever received an adverse or negative audit opinion. *POB Report*, *supra* note 3, at 142. He goes on to say that this "suggests that we cannot take much comfort from the statistic that the overwhelming majority of member firms conduct their practices in accordance with [professional] standards." It may, he concludes, imply the need for "changes of a more fundamental nature." *Id.*

on the former over the latter.¹⁰⁵ Furthermore, the pressure to satisfy clients is firm-wide and is usually not limited to one particular delinquent partner.¹⁰⁶ Any intrafirm checks are likely to be fairly ineffective.

The vast majority of large, publicly held U.S. companies now have independent audit committees.¹⁰⁷ Although the change has probably been for the better, at least one empirical study has concluded that the presence or absence of audit committees does not appear to affect the frequency with which companies change auditors.¹⁰⁸ Consequently, the net impact of independent audit committees on the practice of opinion shopping is not clear.

Accountants also often respond that the threat of SEC injunctions and disciplinary actions,¹⁰⁹ not to mention civil and crimi-

105. Dr. Briloff provides a colorful analogy:

Insofar as PR [peer review] is concerned, I am reminded of the drunk who lost his keys in the middle of the block, but went looking for them at the corner where the light was better. Thus, the PR team studies the form of the work papers, manuals of practice, employment and promotion practices (to the extent they are reduced to paper) and the like. What's missing? The recognition that the critical judgment calls are essentially behavioral phenomena—and these cannot generally be recognized by a hard trail.

Hearings, supra note 3, at 127-28.

106. The second-partner review, for example, has been criticized as follows:

Second-partner review, the critical check on improper activity, is compromised by the close working relationship between audit partners. The tendency, especially in those offices where the partners have worked together for years, is to regard the review as a back-scratching exercise. You scratch mine, I'll scratch yours. Because audit partners are overwhelmed with work stemming from their own engagements, their capacity to focus clearly on what is essentially someone else's responsibility is questionable. Although they are warned repeatedly that the firm's reputation rests with their diligence, checking the other guy's audit gets pushed into the "low-priority" column.

Stevens, *supra* note 3, at 61; see also Request for Comments on "Opinion Shopping," *supra* note 9, at 28,221 (referring to "the potential for 'shopping' for a different engagement partner within the registrant's current accounting firm").

107. Only outside directors are now permitted on the audit committees of companies listed on the New York Stock Exchange. Kunitake, *supra* note 61, at 48. The American Stock Exchange only recommends such audit committees. *Id.* at 49. As of mid-1980, about 78% of companies listed on the American Stock Exchange had independent audit committees. *Id.*

Audit committees have also received strong SEC encouragement. See, e.g., Accounting Series Release No. 123, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,125 at 62,300 (Mar. 23, 1972); Accounting Series Release No. 247, *supra* note 72, at 62,710.

108. Kunitake, *supra* note 61, at 52. The author also discusses the concern that outside directors tend to replace smaller audit firms with larger ones, concluding, however, that the data do not seem to confirm those fears. *Id.*

109. The SEC has a variety of enforcement and remedial powers at its disposal: obtaining a federal court injunction, perhaps including ancillary equitable relief; instituting administrative proceedings, which often require the issuers to reissue defective financial statements; publishing reports of investigations; censuring individual firms for failing to apply GAAP properly or for participating in a violation of federal securities law; and denying, either temporarily or permanently, the privilege of appearing or practicing

nal lawsuits,¹¹⁰ acts as a powerful deterrent to "cooking the books." Critics, however, have asserted that the few direct enforcement actions undertaken by the SEC against large accounting firms amount to little more than slaps on the wrist, even against repeat offenders.¹¹¹ Rarely will there be any admission of wrongdoing; consent decrees are frequently the most severe sanction.¹¹² Civil suits usually are similarly fruitless, if only because the auditor can easily find refuge from liability within the gray areas of "generally accepted accounting principles." When even the auditor is not sure whether she has violated any standard or law, or when the audit result is at least arguably defensible, it is not likely that stiffer sanctions would be a solution anyway.¹¹³

If nothing else, the defenders assert, the Code of Professional Conduct¹¹⁴ will act as a significant restraining force on auditor misbehavior. Until January 1988, the Code essentially required a "shopped" auditor to consult first with the company's present auditors so as to be fully informed about the facts surrounding the disputed issue.¹¹⁵ The Code's definition of opinion shopping, however, was so broad as to encompass many situations that au-

before the Commission. *Hearings, supra* note 3, at 482-85 (statement of Chairman Shad); see also Gruenbaum, *The SEC's Use of Rule 2(e) to Discipline Accountants and Other Professionals*, 56 NOTRE DAME LAW. 820 (1981).

110. See Request for Comments on "Opinion Shopping," *supra* note 9, at 28,220 n.10, for a concise description of possible securities law violations. See Note, *supra* note 3, at 934-44, for an excellent discussion of auditor liability both under the common law and under federal securities law.

111. "The few direct enforcement actions undertaken by the SEC in its enforcement responsibilities against large accounting firms appear to result in what can properly be termed mere wrist slaps, even when the firm is a repeat offender." *Hearings, supra* note 3, at 3 (opening remarks by Rep. John D. Dingell, presiding). Just one example of this is the Broadview Financial Corp. situation described *supra* notes 31-35 and accompanying text. Although the SEC had challenged the accounting treatment of the transaction, it declined to take any enforcement action against Deloitte, Haskins & Sells, Broadview's auditors. Ingersoll, *supra* note 32.

For a summary of SEC enforcement actions against auditing firms, partners, and employees, see *Hearings, supra* note 3, at 679-93. In all fairness, perhaps it ought to be added that the Commission has attempted to step up its enforcement actions in recent years. The SEC brought 18 cases of alleged misconduct in 1984, compared to 11 in 1983 and only three in 1982. *Id.* at 482 (statement of Chairman Shad).

112. See *Hearings, supra* note 3, at 153-54. A consent decree is an arrangement whereby the accounting firm agrees to revise its opinion or take other remedial action as determined by the SEC, without admitting any error or wrongdoing.

113. Cf. Karmel, *supra* note 2, at 976-77 (opposing the thesis that legal liability for accountants "is the most effective mechanism for assuring that independent auditors perform their public responsibilities competently and diligently").

114. CODE OF PROFESSIONAL CONDUCT, *supra* note 8.

115. *Id.* at § 201-3 (1978) (deleted 1988).

ditors did not believe merited such extensive action.¹¹⁶ The result was that auditors sometimes found the rule impracticable.¹¹⁷ A special committee of the AICPA charged with studying the Code concluded that accountant behavior had ceased to be influenced by the rules.¹¹⁸ In 1988, the Code was substantially revised, and the provision dealing with opinion shopping was deleted.

Finally, there are those who assert that the auditor's concern for his reputation and his sense of professional pride are sufficient to ensure the highest standards of financial reporting. One would like to think that this alone would serve as an adequate check on audit abuse. Unfortunately, even the chairman of the Public Oversight Board (POB) recently commented that the accountant's sense of professionalism "has not been sufficient to snuff out the insidious practice of 'opinion shopping.'"¹¹⁹

III. WHAT CAN BE DONE? A ROLE FOR LEGAL REFORM

A variety of approaches, including more expansive disclosure, have been advocated as solutions to the problem of opinion shopping. As the next Section indicates, however, many of these approaches have serious inadequacies. What is needed is a plan that enables the client and its auditor to identify the most appropriate accounting treatment in a specific case—free from the concern that some other accounting firm might have "permitted" a more lenient treatment. This Section proposes such a plan.

116.

Broadly interpreted, the AICPA definition would encompass . . . even a casual inquiry by a company officer at a cocktail party—for example, how goodwill arising from a recent acquisition might be amortized. The Ethics Rule interpretation conceivably covers not only executed transactions, but proposed transactions as well. The interpretation might also encompass services to assist a client in researching and interpreting the accounting literature.

Serlin, *supra* note 14, at 77.

117. Serlin was perhaps too cautious when he concluded that "it may be impracticable to comply with the consultation requirement in every case." *Id.*

118. Anderson, *supra* note 51, at 92.

119. *POB Report*, *supra* note 3, at 146.

A. *Alternative Approaches to the Problem*

One obvious approach to the problem of opinion shopping is to emphasize the benefits of greater disclosure, as the SEC has done.¹²⁰ The problem with this approach is that it fails to address the fundamental difficulty of identifying the "correct" accounting treatment in individual cases. Even the SEC recognizes that disputes regarding the appropriate recording of complex or unconventional events are often legitimate and expected.¹²¹ But rather than encourage frank discussion of such issues, the disclosure rules discourage and stifle open dialogue by their implicit presumption that the registrant is attempting to thwart the fair reporting of an accounting event. The disclosure rules impose a red flag on the disagreement similar to the scarlet letter that Hester Prynne was forced to wear in Hawthorne's immortal work.¹²² Such a heightened level of public scrutiny will only serve as a disincentive to bring disputes into the open.¹²³ As past experience has proven, accountants have been very reluctant to recognize "disagreements" when to do so might entail further disclosure.¹²⁴

120. See *supra* notes 88-97 and accompanying text. The chairman of the Public Oversight Board, Arthur M. Wood, has also advocated more disclosure. Specifically, he would amend the peer review process to require documentation that firms made appropriate inquiry of the predecessor auditor before accepting a new audit client. *POB Report, supra* note 3, at 146.

121. See Serlin, *supra* note 14, at 78.

122. N. HAWTHORNE, *THE SCARLET LETTER* (1850).

123. An editor's comment to a recent article describing the SEC's proposed disclosure rules (before they were formally adopted) provides a unique insight into management's perspective on the utility and desirability of such disclosure:

Corporate officers at major companies are generally opposed to such disclosures. They do not think that trying to find the most favorable application of accounting principles need necessarily be labeled opinion shopping. *In their opinion, tough new rules would serve no useful purpose and would only inhibit discussions with helpful accounting firms other than their auditors.* Forcing companies to disclose every discussion with their accounting firms is disclosure-overkill that could create apprehension and confusion among investors.

Proposed SEC Rules Would Provide for Increased Disclosure of Disagreements and Possible Opinion Shopping Situations in Connection With a Change in Accountants, C.P.A. J., Dec. 1987, at 98, 99 (emphasis added).

124. See *supra* note 90 and accompanying text. The SEC itself has listed, without necessarily endorsing, a number of reasons for not mandating disclosure, as an earlier Accounting Series Release indicates:

Opposition commentators argued that the disclosure [of reasons for changing independent accountants] was probably not useful and, in their view, meaningful information would not be presented for a variety of reasons. Most often cited were that the disclosures would take the form of "boilerplate" (e.g., "audit rotation policy," "need a fresh look," etc.); that accountants would be unable to make meaningful comments on subjective reasons (e.g., "poor service," "high

The more significant problem, however, is that additional disclosure does not attempt to resolve the underlying dispute. The SEC's approach provides no new mechanism for assisting the independent auditor in making what can occasionally be very difficult judgment calls on these issues. Instead, the new rules bury legitimate issues under the guise (ironically) of additional disclosure.

The above problems are related to another recent phenomenon in the profession. At least partly because of the competitive pressure to interpret accounting rules most favorably for the client, accountants have gradually relegated more and more judgmental issues to GAAP (as defined by the FASB). In doing so, the profession has come to rely more on legalistic rules to determine appropriate accounting treatment, with less of a concern for which treatment actually best describes reality in specific applications. The profession has thus begun to lose touch with the needs of the users of financial information. The accountant has become a rule interpreter, often finding it necessary to "bend" the rule to fit an unforeseen or unconventional situation. Once this is understood, it becomes easy to see why firms are tempted to seek a more favorable interpretation of a rule. Economic reality is no longer the relevant criterion; the only thing that matters is the auditor's willingness to give a particular interpretation to a formalistic rule.

A second approach to the opinion-shopping problem is to limit directly the ability of client firms to change auditors. These proposals vary from outright prohibitions on auditor changes that exceed some standard of frequency—e.g., more than once every five years—to requirements of a showing of "business reason" for any auditor change. There may, however, be some very good reasons for permitting more frequent auditor changes, especially if one wishes to preserve any of the benefits of competition in the industry.¹²⁵ Unfortunately, a firm may very easily identify legitimate reasons for an auditor change while masking

fees"); that disclosure of reasons for all changes might downgrade or obscure the disclosures of disagreements now required; that candid disclosures would not be made for fear of litigation involving libel or other allegations; and that disclosure might inhibit changes in accountants (i.e., that it might tend to lead to a continuation of unsatisfactory situations in an effort to avoid disclosure).

Accounting Series Release No. 247, *supra* note 72, at 62,711.

125. By statutory mandate, the SEC is required to consider the impact any of its proposed rules or regulations would have on competition. *See, e.g.*, Securities and Exchange Act of 1934, 15 U.S.C. § 78 w(a)(2) (Supp. IV 1986); *see also supra* notes 61-63.

other less legitimate sources of discontent;¹²⁶ there could be good reasons, bad reasons, or a combination of good and bad reasons for any particular change of auditors.¹²⁷

A third approach is to take auditing from the private sector and make it a public function.¹²⁸ Proponents suggest this as the only way to resolve the inherent conflict of interest in a situation where the "independent" auditor is compensated by the audited company itself.¹²⁹ Examples of this third approach range from proposals to have the federal government award audit fees and assignments to private accountants through a central clearing-house,¹³⁰ to the establishment of a Federal Board of Public Accountancy,¹³¹ to the creation of a federal corps of auditors.¹³²

These types of proposals have generally been rejected for one of two reasons. First, any such recommendation is certain to meet with formidable resistance from the profession.¹³³ Accountants have a long and cherished tradition as being a self-regulated profession.¹³⁴ They have invested much in the way of structural devices designed to maintain their historically high standards of professional conduct. Such reforms simply are not

126. Dr. Briloff, for example, has indicated that any disclosure as to the reasons for an auditor change is bound to be couched in "cover your anatomy" rhetoric, suggesting that auditors can avoid this sort of disclosure "rather expeditiously." *Hearings, supra* note 3, at 152; see also *supra* note 124 (regarding the "boilerplate" problem).

127. See *supra* note 64 and accompanying text.

128. For an historical account of the decision to rely on the private sector for the development of accounting principles, see Cooper & Robinson, *Who Should Formulate Accounting Principles? The Debate Within the SEC*, *J. Acct.*, May 1987, at 137.

129. See *supra* notes 9 & 11 and accompanying text.

130. See *Hearings, supra* note 3, at 10, 31 (testimony and statement, respectively, of Robert Chatov).

131. See *id.* at 728 (testimony of Eli Mason, managing partner of Eli Mason & Co., New York City, and chairman of the National Conference of CPA Practitioners). Joseph E. Connor, chairman and senior partner of Price Waterhouse, has also recommended the establishment of a federally created self-regulatory organization (SRO) that would essentially replace the SECPS. *News Report: AICPA President Responds to Plan for New Oversight Group*, *J. Acct.*, Feb. 1986, at 14.

132. See *Hearings, supra* note 3, at 10, 27 (testimony and statement, respectively, of Robert Chatov describing what he calls the "GAO model"). Apparently, Congress considered establishing a corps of government auditors at the same time it legislated the formation of the Securities and Exchange Commission. See Karmel, *supra* note 2, at 965 (citing *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 57-59 (1933) (remarks of Sens. Adams and Reynolds) (1933)).

133. See, e.g., *infra* note 166 and accompanying text (discussing the advantages of self-regulation over government intervention).

134. The professional pride to which many accountants aspire is amply evident in this appeal by one accountant: "Even with the occasional bad publicity, we need not feel negative about our profession. Our record outshines that of any other professional calling and we should defend the profession to the press, in Washington, to our clients, and among our social and business clients. Show your pride!" Pearlman, *supra* note 43, at 85.

politically feasible.¹³⁵ Second, traditional western ideology prefers private enterprise over public control to the extent that the private sector can equally address the needs of society. Any form of centralized planning or nationalization should only be instituted where the mandate for such action is very clear.

B. What is Needed

The solution to these problems rests in separating the client-retention question from the choice-of-accounting-treatment question.¹³⁶ The investing public has no qualms about auditor changes per se; what it desires is consistency and comparability in reporting, regardless of who happens to be conducting the audit.¹³⁷

The establishment of the Financial Accounting Standards Board was designed to achieve exactly that result.¹³⁸ The Board's approach, however, has been to take accounting issues under advisement and, after much study, to pronounce an accounting standard.¹³⁹ Unfortunately, the FASB faces an overwhelming workload. In attempting to legislate standards for every possible contingency, it has created its own albatross. The result is that most accounting issues never reach the level that warrants an official "pronouncement." For those that do, it is often only after months or even years of study.¹⁴⁰ In the interim, accountants are left on their own to wrestle with the issues in-

135. "Financial standard development responsibility has been in the hands of the private sector so long that they regard it as legitimately institutionalized . . ." *Hearings, supra* note 3, at 28 (testimony of Robert Chatov).

136. *See* Sack, *supra* note 42, at 128.

137. *Hearings, supra* note 3, at 276 (testimony of Donald J. Kirk, FASB Chairman); *id.* at 390 (FASB response to written questions).

138. *Id.* at 178-79, 276 (testimony of Donald J. Kirk); *id.* at 214-17 (statement of the FASB); *id.* at 390 (FASB response to written questions).

Since 1973, the FASB has been recognized by both the SEC and the AICPA as the organization primarily responsible for establishing the profession's financial reporting standards. Its seven member Board is under the auspices of the Financial Accounting Federation, an entity designed to be independent of all other business and professional organizations, including the AICPA. The FASB allegedly maintains an amicable and cooperative working relationship with the SEC characterized by "mutual non-surprise." *Id.* at 178 (testimony of Donald J. Kirk).

139. *See id.* at 193, 200-01 (statement of the FASB) (describing the significant "due process" that the Board goes through in adopting and implementing an accounting standard); *see also* Van Ripper, *Statements in Quotes: How Accounting Standards are Set*, J. Acct., April 1987, at 130.

140. *See Hearings, supra* note 3, at 193, 200-01; *see also id.* at 210 (the 1984 Report of the SEC to Congress concluded that "the Commission believes that there is need for more timely guidance on emerging issues."); *id.* at 393 (FASB response to written ques-

volved.¹⁴¹ Even where these pronouncements are timely, they must then be applied to a wide variety of real world situations. Unfortunately, many economic events today do not fit into nice, clean categories. Novel or unconventional transactions occur with increasing frequency; even routine transactions may have countless variations and subtleties.¹⁴² In these cases, the accountant must still exercise his professional discretion and judgment.¹⁴³ These judgment calls, by their very nature, are not

tions) (“[A] continuing challenge for the FASB is the ability to provide timely solutions to new accounting problems without compromising due process.”).

141.

Even the FASB and the Commission do not have answers to all of today’s accounting issues as indicated by the fact that both bodies solicit comments, sometimes over long periods of time, in order to reach an appropriate resolution of a particular issue. Consequently, since registrants have the primary responsibility for their financial statements, they should have the right to consult with other accountants for legitimate purposes

Newman, *supra* note 68, at 82 (quoting one CPA firm’s response to the SEC’s request for comments regarding opinion shopping disclosure).

In response to this acknowledged problem, the FASB has recently created an Emerging Issues Task Force (EITF). The Board has also expanded the scope of its Technical Bulletins to address both emerging and implementation issues. For a broader discussion of these changes and the background that led to them, see *Hearings, supra* note 3, at 225-30 (statement of the FASB). Despite the good intentions behind the EITF, it still suffers from inadequate independent authority. The EITF typically refers approximately half of the issues it discusses to the FASB or the AICPA for additional review and deliberation. *Id.* at 498 (statement of Chairman Shad).

Keith Wishon, Senior Manager in the New York office of Price Waterhouse, has noted that the EITF “is the closest thing to an ‘accounting court’ that currently exists.” Wishon, *Plugging the Gaps in the GAAP: The FASB’s Emerging Issues Task Force*, J. Acct., June 1986, at 96, 105. By promoting this function of the EITF as a solution to the opinion shopping problem, he lends credence to the desirability of the Inquiry Center concept proposed in Part III C of this Note.

142. See *Hearings, supra* note 3, at 8 (testimony of Robert Chatov in which he wonders whether it is even realistic to expect anyone to establish comprehensive accounting rules); *id.* at 109 (statement of Abraham J. Briloff that if the FASB persists in attempting to promulgate standards for all the gray areas, “it will invariably find itself confronted with new shades of gray, some lighter, others darker, to which it will be constrained to respond”); *id.* at 229 (statement of the FASB citing SEC Staff Accounting Bulletin No. 57: “The authoritative accounting literature cannot specifically address all the novel and complex business transactions into which registrants might enter.”); *id.* at 276 (testimony of Donald J. Kirk responding to the criticism that the FASB is to the point of enunciating a “standard of the month” because the accounting environment is one in which there is a “new transaction of the month”); *id.* at 389 (statement by the FASB: “Broad standards often are not enough [to ensure comparable financial results], given the complexity of many transactions, innovative arrangements, and complicated instruments in existence today. . . . Disagreements about the proper application of existing standards may be the result of honest differences of professional opinion”); see also Serlin, *supra* note 14, at 78 (companies may face complex accounting issues “for which the proper accounting is still evolving” and for which its auditors may have had only limited experience).

143. Of course there are those who, like Dr. Briloff, assert that accountants do not need more standards, that this sort of exercise of professional judgment is what account-

likely to be uniform from one accountant to another. What is needed is some means of achieving this consistency without sacrificing the ability to reflect accurately the uniqueness of individual transactions.

C. A Proposal

This Note proposes the creation of regional Accounting Issue Inquiry Centers (AIICs) across the country.¹⁴⁴ Mandated and regulated by the SEC,¹⁴⁵ these Inquiry Centers would hear and decide specific accounting issues as presented in fact-specific contexts.¹⁴⁶ The Centers would issue rulings analogous to Internal Revenue Service (IRS) letter rulings used in the tax area. These rulings would become part of the public record but, like IRS letter rulings, would have no binding precedential value in future situations.¹⁴⁷ Rulings could be changed by the Centers as enlightened experience might dictate. These rulings would serve two important functions: (1) they would protect submitting auditors from any liability for relying on them in preparing audit

ants should be doing all the time. "Ironically, my colleagues lack faith in our own competence and professional expertise. Instead, they are looking for someone to give them a dictionary and a book of rules, or a computer program." *Hearings, supra* note 3, at 79 (testimony of Abraham J. Briloff).

144. The initial impetus for this Inquiry Center concept must be credited to Robert J. Sack. *See Sack, supra* note 42, at 128.

145. This would be done pursuant to the SEC's authority to prescribe the detail and content of financial statements and its power to prescribe the form in which required information is to be set forth. *See, e.g., Securities Act of 1933*, 15 U.S.C. § 77aa, Schedule A, Items 25-27 (1982); *Securities Exchange Act of 1934*, 15 U.S.C. §§ 78l(b)(1)(J)-(L), 78m(a)-(b) (1982 & Supp. IV 1986); *Public Utility Holding Company Act of 1935*, 15 U.S.C. §§ 79n, 79t(a) (1982); *Investment Company Act of 1940*, 15 U.S.C. § 80a-29(e) (1982); *see also Hearings, supra* note 3, at 1048-59 (memorandum from the General Counsel of the SEC regarding "The Commission's Authority To Regulate Accountants Who Practice Before the Commission").

Although some have questioned the extent of the SEC's authority, *e.g., Karmel, supra* note 2, some members of Congress believe that the SEC has been negligent in not using its authority to its full extent:

Finally, we must inquire about the performance of the Securities and Exchange Commission in meeting its auditing and accounting responsibilities. The SEC has ample statutory authority at this moment to address problems in standard-setting and audit enforcement. Yet, the Commission seems to take great pride in its reluctance to use the powers granted it by Congress.

Hearings, supra note 3, at 3 (statement of Rep. John D. Dingell, presiding).

146. The Centers would be free to consider factors unique to a particular company or industry to determine the appropriate accounting treatment.

147. *See, e.g., Rev. Proc. 80-20*, § 17, 1980-1 C.B. 633, 644 (regarding precedential value of IRS letter rulings).

opinions,¹⁴⁸ and (2) they would serve as valuable guides to other auditors, especially once a body of opinions began to form a consistent pattern over time.¹⁴⁹ The opinions of the Centers would, of course, be binding on the particular clients involved. As a consequence, the auditor should have considerably less fear of being replaced, as any alternative accounting treatment would now be considered improper regardless of who rendered the opinion.

These Inquiry Centers would serve functions very different from those of the Financial Accounting Standards Board. First, the opinions rendered by the Centers would be fact-specific, rather than in the form of general pronouncements. They would be written to resolve accounting disputes in individual situations, with no particular attempt to anticipate related issues.¹⁵⁰ Second, the opinions would not be etched in stone: the Centers

148. The SEC would have to declare that compliance with an Inquiry Center's ruling would constitute prima facie evidence of conformance with GAAP. This declaration would effectively preclude any action for negligence or fraud based on an improper accounting disclosure, assuming all relevant information had been supplied to the Center.

149. Dr. Briloff even envisioned the possibility of periodic "Restatements" of proper accounting practice, similar to that found in the field of law. *Hearings, supra* note 3, at 164. It appears that some companies already attempt to substantiate their choice of accounting treatment by looking for comparable situations in the financial statements of other companies. Serlin, *supra* note 14, at 78. It is interesting to note that the SEC, in adopting the SAS 50 Performance and Reporting Standards, expressly condones and, in fact, encourages the sort of comparison analysis that could be performed quite ideally by the Inquiry Centers:

The performance standards indicate that the reporting accountant should consider the requestor of the accountant's report, the circumstances under which the request is made, the purpose of the request and the intended use of the report. SAS 50 also indicates that the accountant, in forming its judgment, should obtain an understanding of the form and substance of the transaction[s]; review applicable GAAP; if appropriate, *consult with other professionals or experts; if appropriate, perform research or other procedures to ascertain and consider the existence of credible precedents or analogies*; and, when evaluating the application of GAAP to a specific transaction or to a specific entity's financial statements, consult with the continuing accountant for that entity.

Disclosure Amendments (proposed), *supra* note 86, at 24,021 (emphasis added).

150. This is in contrast to the function and purpose of accounting "standards," which will remain within the purview of the FASB. This proposal, however, envisions the FASB's return to a more traditional concept of "standards" as enunciated by Professors William A. Paton and A.C. Littleton in their classic work:

Standards should deal more with fundamental conceptions and general approaches to the presentation of accounting facts than with questions of precise captions, degrees of subdivision, and detailed methods of estimating

. . . .

. . . It should be possible to state accounting standards in such a way that they will be useful guides to procedures over a wide area of application. Whereas rules would be made to afford a basis for conformity, standards are conceived as gauges by which to measure departures, when and if departure is necessary and clearly justifiable. Standards, therefore, should not prescribe procedures or rig-

would not be bound to follow earlier decisions, although doing so certainly would not be inappropriate. Third, the emphasis would be on speedy resolution of accounting problems as they arose. Turnaround time would be measured in days or weeks, not months or years.¹⁵¹ The Financial Accounting Standards Board would continue to operate as it presently does; the Inquiry Centers would, of course, be expected to honor all present and future FASB releases.¹⁵²

The Inquiry Centers would be organized regionally, perhaps by state. Each Center would consist of both part-time and full-time members appointed by the state accounting association. Representation might also be mandated from a variety of other constituencies: the SEC; the banking industry; academia; and the investment-research profession.¹⁵³ The relative amount of auditing activity occurring within a region would determine the size of each Center. Each Center would further divide its manpower into operational teams of approximately four to five members who would be assigned specific issues as submitted. Operating funds could be provided by a combination of special accounting association dues and through an appropriate filing fee schedule.¹⁵⁴ Ideally, these resources would be sufficient to permit the Centers to offer salaries that would attract the highest caliber of professional talent. Members would be expected to serve for two-year terms.¹⁵⁵

idly confine practices; rather standards should serve as guideposts to the best in accounting reports.

W. PATON & A. LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 5-6 (1940).

151. See *supra* note 140 and accompanying text.

152. The burden on the FASB would be lessened, of course. Presumably, it would no longer feel the need to enunciate "standards" at the rate it has in the past. See *supra* note 150 and accompanying text.

153. Although not crucial to the success of the program, such diversity in membership ideally would make the Centers' rulings both better informed and more responsive to user needs.

154. This method of financing was thought preferable to a system where major accounting firms and corporations make sizeable contributions, an approach that has at times brought criticism on the FASB. See, e.g., *Hearings, supra* note 3, at 2, 3 (introductory remarks by Rep. John D. Dingell, presiding).

155. For comparison, each of the five members of the FASB serves for five years, although some may be reappointed to a second five-year term. *Id.* at 178 (testimony of Donald J. Kirk). Two years is short enough to attract those with concerns over the extent of their commitment and is, at the same time, long enough to enable members to become familiar with the Center's internal procedures and to have a significant input into a wide range of accounting issues.

D. Advantages of the Plan

A number of significant advantages would be achieved under this proposal. First, as a fact-specific process, the plan avoids the legalistic and formalistic problems of general pronouncements.¹⁵⁶ The Centers would be free, within existing FASB releases, to concentrate on the most economically accurate portrayal of the financial situation at hand.¹⁵⁷ The plan provides a much more flexible arrangement than the current system.¹⁵⁸

Second, the proposed system would make use of and encourage interfirm and interdisciplinary consultation.¹⁵⁹ Difficult judgmental decisions would no longer rest on the shoulders of one accountant or one accounting firm.¹⁶⁰ The Inquiry Centers would permit the use of a broad range of experience and talent in their deliberations.¹⁶¹ In addition, the teams would be comfortably removed from the day-to-day pressures of the typical practitioner, including client-retention concerns, and would be

156. See Newman, *supra* note 68, at 82 (attributing the current legalistic approach towards GAAP to "all the financial accounting rules that have been promulgated," so that the temptation is to select the most favorable treatment "and ignore the economic substance of the matter"); see also *supra* note 142 and accompanying text.

157. This result comports more closely with the FASB's own declaration that "decision usefulness" is the most important qualitative characteristic of accounting information. See Stanger & Gunther, *supra* note 1, at 1214 (citing QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2, §§ 32-110, 133-144 (Fin. Accounting Standards Bd. 1980)).

158. Indeed, even Donald J. Kirk, Chairman of the FASB, implicitly acknowledges this need for flexibility:

The problems [that FASB] is asked to deal with generally are those on which reasonable and informed people differ.

. . . [I]n making decisions, the Board must weigh conflicting factors, such as having too many versus too few standards, or broad versus detailed standards.

Apart from self interest, reasonable people may differ as to how that balance should be struck.

Hearings, supra note 3, at 179-80.

The FASB itself reiterated this comment in a statement to the Congressional Committee: "However, sometimes significant operational and environmental differences among companies in different industries, among companies within a particular industry, or even within a single company make different accounting appropriate in order to reflect the substance of different circumstances." *Id.* at 214.

159. A task force created by the SEC Practice Section of the AICPA identified a general belief among accountants that "there needs to be more consultation within firms and more communication between them on accounting and auditing matters." Pearlman, *supra* note 43, at 85. As another author put it, "It is desirable to permit maximum consultation because business transactions are sometimes extremely complex, and such transactions frequently also lead to accounting problems." Newman, *supra* note 68, at 82.

160. See *supra* note 143 and accompanying text.

161. See *supra* note 153 and accompanying text.

able to devote their full attention to the problem at hand.¹⁶² Perhaps even more significant, however, is the potential for improved communication between the preparers of financial information and the users of that information.¹⁶³ This ultimately should result in more useful and valuable information.

Third, this approach would highlight the types of accounting issues being raised in practice.¹⁶⁴ Not only would this assist the FASB in directing its attention to problem areas, but it would also engender appropriate discussion in the profession's seminars and scholarly literature.¹⁶⁵

Finally, this proposal retains the emphasis on self-regulation that the profession so highly values.¹⁶⁶ Although the SEC would have ultimate responsibility for the Centers, it would undoubtedly work with the profession in implementing the system. Public accountants would, moreover, certainly have substantial representation in the membership of these Centers. This proposal also preserves the important roles of the FASB and the POB.

162. Because the teams would consist of a significant number of non-accountants, they would be less susceptible to the threat of an individual accountant abusing his position on a team to approve an accounting approach that will benefit his clients when he returns to private practice.

163. See *supra* note 157 and accompanying text.

164. This proposal would probably make redundant some of the activities of FASB's Emerging Issues Task Force. The role of the EITF would have to be either modified or perhaps eliminated under this proposal.

165. "As with any body of knowledge which is continuously evolving, e.g., medicine, law, economics, there should be an active, continuous dialectic process involving the groves of academe and practice. A free and open dialogue should be encouraged." *Hearings, supra* note 3, at 164 (statement of Abraham J. Briloff).

166. Professor Robert K. Mautz articulated the benefits of accountant self-regulation as follows:

Generally, self-regulation is perceived as more equitable than public regulation because the standards to be met are established and enforced by fellow practitioners whose experience provides an understanding of the environment, the risks, the pressures and the possibilities of service that laymen neither comprehend nor understand. Self-regulation, if performed properly, also assures better service to the public because its emphasis is on remedy and improvement and because it is in closer touch with practice, more aware of changing needs, and more responsive to the wants of those who use the service than any other form of regulation can be.

Mautz, *Self-Regulation—Perils and Problems*, J. Acct., May 1983, at 76, 78; see also *Hearings, supra* note 3, at 798 (statement of Eli Mason, Chairman of the National Conference of CPA Practitioners, identifying three reasons for retaining the standard-setting process in the private sector).

E. Criticisms of the Plan

This proposal is bound to encounter a number of criticisms. One potential problem is that accountants, or their clients, might be reluctant to submit issues to the Center for fear of an adverse ruling.¹⁶⁷ Where an accounting treatment is at all likely to be controversial, however, the accountant may be assuming a considerable professional liability risk for failing to submit the question to the Center for its approval.¹⁶⁸ This alone should provide sufficient incentive. If not, then it may be desirable to impose civil liability by statute on both the auditor and the client firm for failing to submit issues that, according to their peers in the profession, clearly ought to have been submitted. Accountants will realize that they can no longer hide behind the cloak of professional judgment.¹⁶⁹ Here the SEC, perhaps through an entity such as the POB, would play a key supervisory and investigative role.

A second criticism might be that auditors will submit too many issues, simply overburdening the system. A number of responses can be made. First, the filing fee should be substantial enough to discourage frivolous filings. Second, the Center may, in its discretion, simply refuse to hear certain requests in the same way that other jurisdictional bodies decline to hear certain cases. The individual auditor would then be free to apply her own best judgment to the situation. But third, and perhaps most persuasively, over time there should be enough rulings on the record to provide accountants with sufficient guidance so that they often would not need to submit an inquiry themselves.¹⁷⁰ This should help reduce the caseload appreciably as the plan matures.

A third criticism may be that different Centers could give different opinions to similar factual situations.¹⁷¹ Decisions issued by one Center, however, will presumably be read by the others; where conflicts still exist, scholarly critique should highlight these conflicts and bring appropriate discussion to bear on

167. The rulings would be binding in each individual case.

168. The accountant may be opening himself to a tort action for the negligent failure to exercise due care or proper professional responsibility.

169. See *supra* note 113 and accompanying text.

170. Even if the actual volume of inquiries does not subside, the efficiency of the Centers themselves should improve as the resolution of more and more issues are expedited by reference to previous rulings.

171. This problem is a possibility in our judicial system as well.

them.¹⁷² Perhaps this conflict and discussion will prompt the FASB to take appropriate action. On the other hand, differing approaches by separate Centers might be beneficial.¹⁷³ By permitting alternative accounting treatments, the profession is, in a sense, conducting a form of laboratory experiment. After the passage of time, the profession can stand back and, on the basis of experience, select the approach it finds most appropriate. It may, in fact, find that both approaches were valid after all.¹⁷⁴

Finally, some will assert that this proposal creates an expensive, bureaucratic nightmare. While it is true that this system will add costs to the overall auditing process, such costs need not be prohibitive. For one thing, the profession would self-administer the plan. Unlike some government programs, there is no incentive on the part of the Center members to build empires. Presumably, the profession has some self-interest in keeping these costs to a reasonable level. Second, one must always view the cost of something in light of the value received. Truly useful information is rarely a free commodity. When one adds the value represented by increased investor confidence in financial information, the costs of the Inquiry Center proposal seem meager indeed.

CONCLUSION

This Note demonstrates how the recent increase in auditor changes is symptomatic of the larger problem of pressure on auditor independence. In a competitive environment for audit services, where auditors can be replaced virtually on the whim of the client, the auditor today inevitably feels some compulsion to apply accounting standards in such a way as to keep the paying client satisfied. To the extent that accountants succumb to these pressures, financial information is less reliable than it otherwise could be. But even where the profession has been able to withstand this sort of client pressure, the appearance of indepen-

172. It may be necessary to live with conflicting interpretations for a while. This often occurs under the present system. See, e.g., *supra* note 141 and accompanying text.

173. *But see Hearings, supra* note 3, at 386 (FASB Response to Written Questions) (indicating that in 1976 the Senate Subcommittee on Reports, Accounting, and Management issued a report that severely criticized the FASB for tolerating the existence of up to 42 different "alternative accounting methods").

174. Note that this clearly has not been the approach taken by the FASB. See *id.* at 214-17 (statement of the FASB regarding the Comparability of Accounting Information); *id.* at 386 (statement of the FASB identifying the very few remaining areas where any alternative accounting methods exist).

dence in the eyes of the investing public may have been tarnished. When this occurs, investors and other financial statement users price-protect themselves, and financial markets are damaged irrespective of the true quality of the underlying information.

The best solution is to separate the client-retention aspect from the underlying accounting-treatment issue. This Note has proposed the creation of regional Accounting Issue Inquiry Centers to render prompt, fact-specific opinions on the legitimacy of various accounting treatments. The responsibility for choice of treatment on close issues would belong to the Center, not the auditor. Where the Center rejects a particular treatment, the auditor need not fear being replaced; the proposed treatment would be improper regardless of who rendered the opinion. Upon approval of a treatment, the auditor would be able to render an unqualified opinion without fear of liability—and with a much clearer conscience than he otherwise might have had. Overall, society would win through the establishment of a more efficient information market. Difficult accounting issues would be brought into the open, and investors would have the assurance of knowing that issues had been resolved by experts free from the biased self-interest that a client's fee might have imposed.