

SHAREHOLDER VALUE AND AUDITOR INDEPENDENCE

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ABSTRACT

This Article questions the practice of framing problems concerning auditors' professional responsibility inside a principal-agent paradigm. If professional independence is to be achieved, auditors cannot be enmeshed in agency relationships with the shareholders of their audit clients. As agents, the auditors by definition become subject to the principal's control and cannot act independently. For the same reason, auditors' duties should be neither articulated in the framework of corporate law fiduciary duty, nor conceived relationally at all. These assertions follow from an inquiry into the operative notion of the shareholder-beneficiary. The Article unpacks the notion of the shareholder and tells a particularized story about the shareholder interest. The exercise complicates the agency description, highlighting multiple and unstable shareholder demands that displace the unitary model of the shareholder usually brought to bear. This fragmented and volatile model of the shareholder provides neither a basis for articulating a coherent set of instructions respecting aggressive accounting nor for imposing conservative accounting. The Article concludes that legal positivism provides a more appropriate conceptual framework. Auditor duties should be conceived in formal rather than relational terms, with fidelity going to the rules and the system that auditors apply rather than to a client interest.

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INTRODUCTION

The stock market carried on unperturbed for almost two months after Enron's Chapter 11 filing on December 2, 2001.¹ Despite funny numbers implicated in the company's collapse,² despite repeated warnings from Arthur Levitt's Securities and Exchange Commission (SEC) about the quality of financial reports,³ despite accumulating

1. For an account of Enron's collapse, see William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1299-1332 (2002).

2. It has since turned out that 96 percent of Enron's net income for 2000 can be attributed to one or another aggressive accounting techniques. Kurt Eichenwald, *Report Details Enron's Moves To Shift Assets*, N.Y. TIMES, Mar. 6, 2003, at C1.

3. See, e.g., Arthur Levitt, *Renewing the Covenant With Investors*, Speech at the New York University Center for Law and Business (May 10, 2000), at <http://www.sec.gov/news/speech/spch370.htm> (on file with the *Duke Law Journal*) (discussing his "concern that corporate America's motivation to meet Wall Street earnings expectations could be overriding common sense business practices").

accounting restatements,⁴ and despite a growing stack of disturbing scholarly findings,⁵ Wall Street went on believing that the self-regulatory, reputation-based, highly concentrated audit system did its job. Even as the Enron scandal crossed the line that separates mere financial failure from criminality, traders shrugged off Enron's negative implications for the numbers on corporate bottom lines.⁶ Then, on January 29, 2002, the market finally got it.⁷ A fistful of shareholder value went up in smoke that day as the market lost confidence in the auditor's willingness to say no to management's self-serving and misleading accounting treatments.⁸ The market has yet to emerge from this crisis of confidence in auditor independence.⁹

4. A recent General Accounting Office report on accounting notes that public company restatements rose from 92 in 1997 to 225 in 2001. From 1997 to June 2002, there were 919 announced restatements, involving 845 companies, which came to nearly 10 percent of all those listed. U.S. GEN. ACCT. OFFICE, REPORT TO THE CHAIRMAN, COMM. ON BANKING, HOUS., AND URBAN AFFAIRS, U.S. S.: FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 15-19 (2002) [hereinafter GAO REPORT].

5. For a review of the literature, see Mark W. Nelson et al., Where Do Companies Attempt Earnings Management, and When Do Auditors Prevent It? 5-14 (Oct. 22, 2000) (unpublished manuscript, on file with the *Duke Law Journal*).

6. Stocks soared the week after Enron's bankruptcy filing. Nima Warfield et al., *Year-End Review of Markets & Finance 2001: Review of What Was News*, WALL ST. J., Jan. 2, 2002, at R12. Negative price effects of Enron's collapse were limited to firms, such as lenders, with claims against the company. Henry Sender & Richard B. Schmitt, *Enron's Woes May Ripple Out to Others*, WALL ST. J., Nov. 29, 2001, at A3.

7. Gretchen Morgenson, *Worries of More Enrons to Come Give Stock Prices a Pounding*, N.Y. TIMES, Jan. 30, 2002, at C1.

8. *Id.* But it was a hiccup and not a crash. The Dow Jones average opened at 9,865.50 and dropped as low as 9,576.70 before closing at 9,618.20. Volume was up at 18,120,000 over the previous day's 11,868,000. The value was recovered within a few days. Dow Jones Industrial Average Historical Prices, YAHOO! FINANCE, at <http://finance.yahoo.com/q/hp?s=%5EDJI&a=00&b=28&c=2002&d=00&e=31&f=2002&g=d> (last visited Oct. 12, 2003).

9. The crisis is multifaceted and covers corporate governance generally. See, e.g., Kurt Eichenwald, *In String of Corporate Troubles, Critics Focus on Board's Failings*, N.Y. TIMES, Sept. 21, 2003, at A1 (reviewing the crisis in the context of Richard Grasso's resignation as chairman of the New York Stock Exchange due to negative reactions to his undisclosed high salary). Discussion of problems concerning audits has abated as observers wait and see whether reforms under the Sarbanes-Oxley Act prove effective. See William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1026-35 (2003) (discussing the political implications of Congress's decision to address the crisis by delegating to a new agency). But flare-ups continue. In 2003, the leading scandal concerns Freddie Mac and its practice of income smoothing to disguise the risk level of its investments. See, e.g., Patrick Barta et al., *Behind Freddie Mac's Troubles: A Strategy to Take on More Risk*, WALL ST. J., Sept. 22, 2003, at A1 (unraveling the details of mortgage middleman Freddie Mac's accounting history and the multiple federal investigations now facing the company).

Most observers frame the problem in terms of a professional's failure to perform a duty to a client. Under this view, diminished confidence in audit quality caused stock price declines and turned shareholders into the victims of a classic principal-agent conflict of interest. The auditors disserved the shareholder interest they are charged to protect by pursuing lucrative consulting contracts with their audit clients, thus compromising their independence, and hence, their professional integrity. Management, violating its own duties to the shareholders, crossed the auditors' palms with silver in exchange for a free hand to manage bottom-line numbers.¹⁰ This dirty deal between managers and auditors follows from the 1990s shift to stock option compensation, which skews management's incentives toward stock market speculation.¹¹ The solution to the problem is thought to lie in redirecting the auditor-agent's loyalty to the shareholder principal. In the words of Arthur Levitt:

Independence, at its most basic level, is exercised and honored by those professionals who must abide by it, and assumed by those who must rely on it. It is a covenant between auditor and investor, and no one else; a covenant that says the auditor works in the interests of shareholders, not on behalf of management¹²

The principal-agent characterization resonates especially well in both corporate law and economics, because it cabins the problem of auditor responsibility within these fields' paradigms for describing and regulating duties within the firm. The legal paradigm is the framework of fiduciary duty,¹³ which regulates conflicts of interest and accords shareholder value enhancement a privileged place amongst

10. See John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990's* 8–13, 26–28 (Columbia Law School, The Center for Law and Economic Studies, Working Paper No. 214, 2003), at http://www.law.columbia.edu/center_program/law_economics/wp_listing_1/wp_listing/211-220#6984 (on file with the *Duke Law Journal*) (describing management's preferences for managed earnings in the 1990s and the rise of nonaudit service provision by auditors).

11. See Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1146–47 (2003) (“[T]he ramping up of executive compensation with generous stock options made CEO's and CFO's obsessed with high stock prices, which they were willing to inflate by hook or by crook.”).

12. Levitt, *supra* note 3.

13. For a discussion of management's duty to report accurately in the corporate fiduciary law framework, see Faith Stevelman Kahn, *Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure*, 34 GA. L. REV. 505, 507–18 (2000).

the firm's objectives.¹⁴ The economic paradigm is agency theory, which looks at conflicts of interest as problems of misaligned agent incentives and seeks corrective adjustments.¹⁵

This Article questions the practice of framing the problem of auditors' professional responsibility inside the principal-agent paradigm, even as it accepts the story of the dirty deal.¹⁶ The questions about the agency framework follow from an inquiry into the operative notion of the shareholder beneficiary. The Article unpacks the notion of the shareholder and tells a particularized story about the shareholder interest. The exercise complicates the agency description, which tends to assume a unitary model of the shareholder. Under this Article's analysis, multiple and unstable shareholder demands displace the unitary shareholder interest. This fragmented and volatile model of the shareholder does not provide a basis for articulating a coherent set of instructions respecting aggressive accounting and earnings management.

This Article endorses traditional notions of auditor independence even as it rejects the principal-agent paradigm and the fiduciary-beneficiary framework that accompanies it. To see the connection, let us return to Arthur Levitt and complete his sentence:

It is a covenant between auditor and investor . . . that says the auditor works in the interests of shareholders . . . a covenant that says the auditor must steer clear of having financial interests in the

14. The touchstone citation is *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

15. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 9–11, 14–15 (1991). For descriptions of auditors and auditor independence in an agency theoretical framework, see Rick Antle, *Auditor Independence*, 22 J. ACCT. RES. 1 (1984) (modeling the independence problem in terms of agency theory and focusing on auditor compensation schemes) and Rick Antle, *The Auditor as an Economic Agent*, 20 J. ACCT. RES. 503 (1982) (addressing “issues which arise when an auditor is explicitly introduced in a principal-agent framework”).

16. In addition to the headlines that triggered the crisis, the dirty deal story is well supported by academic studies showing a negative correlation between earnings quality and auditor provision of nonaudit services. See Richard M. Frankel et al., *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management* 2–3, 19–25 (MIT Sloan School, Working Paper No. 4330-02, 2002) (showing a positive association between earnings management and nonaudit fees); see also Sonda Marrakchi Chtourou et al., *Corporate Governance and Earnings Management* 20–26 (Apr. 2001) (unpublished manuscript, on file with the *Duke Law Journal*) (showing a negative correlation between earnings management and audit committee independence); April Klein, *Audit Committee, Board of Director Characteristics, and Earnings Management* 22 (Oct. 2000) (unpublished manuscript, on file with the *Duke Law Journal*) (demonstrating a negative correlation between earnings management and audit committee independence but no additional benefits from complete independence).

companies he or she audits; and a covenant that says the auditor's work stands separate and apart from their clients' business.¹⁷

The second part of Levitt's sentence sets out the traditional view, defining auditor independence in terms of a financial interest separate from the shareholders.¹⁸ Unfortunately for Levitt's covenant, the traditional view and the framework of agency fiduciary duty do not blend into a coherent whole. One cannot "stand separate and apart" from the client's business and at the same time be an agent beholden to the shareholder interest. If we want auditors to be independent, we cannot mesh them in an agency relationship with the shareholders, where by definition they become subject to the principal's control¹⁹ and cannot act independently. Nor, for the same reason, should auditors' duties be articulated in the framework of corporate law fiduciary duty. More generally, auditor responsibility should not be conceived relationally at all.

But if not an agency relationship, then what? This Article concludes that legal positivism provides a more appropriate conceptual framework. Auditor duties should be conceived in formal rather than relational terms, with fidelity going to the rules, to the texts, and to the system that auditors apply. An auditor faithful to Generally Accepted Accounting Principles (GAAP), the elaborate system of rules and standards that determines accounting treatments,²⁰ will be better equipped to serve its clients' interest than

17. Levitt, *supra* note 3.

18. To avoid financial stakes is to adhere to the basic rules of auditor independence as embedded in SEC rules dating back to 1972. See 17 C.F.R. § 210.2-01(b)–(c) (2003) (prohibiting auditors from holding client stock).

19. "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents to act." RESTATEMENT (THIRD) OF AGENCY § 1.01 (Tentative Draft No. 2, 2001).

20. GAAP has two leading sources, the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC). FASB, a nongovernmental organization, is accounting's legislature. MICHAEL A. DIAMOND ET AL., FINANCIAL ACCOUNTING: REPORTING AND ANALYSIS 12 (5th ed. 2000). But the SEC has the authority to trump FASB's treatments and impose its own treatments. See 15 U.S.C. §§ 77s(a), 78m(b)(1) (2000) (granting the SEC the power to prescribe accounting forms, details, and measures). The SEC rarely uses this authority, preferring to work cooperatively with FASB when it wants GAAP revised. DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 146 (3d ed. 2001). GAAP is mandatory for companies filing reports under the federal securities laws. See Administrative Policy on Financial Statements, Accounting Series Release No. 4, 11 Fed. Reg. 10,913 (Sept. 27, 1946) (considering those accounting statements prepared under principles not enjoying substantial authoritative support misleading).

an auditor catering to transient client demands, particularly the demand to maximize shareholder value.²¹

Part I describes finance as a world of political tension. The tension results from the fact that the present value of a share cannot be verified as fundamental value. Under this uncertainty, equity investors fragment into diverse types—speculators, investors, short-term holders, long-term holders, noise traders, fundamental value investors, dumb money, and smart money. Part I sets out a taxonomy of shareholders that divides the various types along a left-wing—right-wing political axis, with speculative, noisy shareholders on the left and conservative shareholders on the right.

Part II shows that the right-side, conservative shareholder interest tends to object to aggressive accounting, while the speculative, noisy, left-side interest takes a more equivocal view. The left accepts and approves of aggressive accounting practices on an upside price cycle, only to be at risk of injury when the cycle turns down. Aggressive accounting suited left-side shareholders particularly well during the recent period of irrational exuberance. Even as economic fundamentals ceased to contain share prices and conservative voices in the financial world rose in warning,²² left-side shareholders paid no attention.²³ Auditors helped confirm the optimistic picture by allowing aggressive accounting, serving the left-side shareholder interest even as audit quality deteriorated. Unfortunately for auditors, shareholder demand is a dynamic feature of the financial landscape. It shifts quickly from exuberance to conservatism when the market index points down. Thus, shareholder demand has shifted across the board to accounting conservatism in

21. To reject agency in favor of a positive approach to auditor duties also is to reject application of the shareholder value maximization norm. This Article accordingly joins the body of opinion that accounts for the crisis of confidence by looking to the pathologies of the bubble stock market, as well as to the agent incentive problems bound up in the dirty deal. *See, e.g.*, Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 786–836 (2002) (discussing shareholder empowerment in light of insights into behavioral economics); Coffee, *supra* note 10, at 4–7 (arguing that we should look both to changes in management incentives and the special incentive problems connected to the bubble stock market). Such an account still starts with stock option compensation and its creation of the perverse incentive to maintain the stock price by misstating results. But the skewed incentive structure of the 1990s does not have sufficiently recent origins to make for a complete account. The bubble stock market fills out the story, implying that the shareholders themselves share the blame if not the responsibility.

22. *See, e.g.*, ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 203–33 (2000) (assessing, correctly, that the market was grossly overvalued and surveying possible responses).

23. Money on the table tends to have that effect.

the last two years. But this neoconservatism remains contingent on market events. For the long term, we cannot project an enduring right-left shareholder coalition for conservative accounting.

Part III asks whether we plausibly can articulate auditor duties for the benefit of a shareholder beneficiary modeled from the conservative side. This analysis does yield a signal against aggressive treatments, but a clear set of instructions remains elusive. Conflicts with investor protection policies also arise. And even if we arrived on a set of conservative instructions, they would have to be imposed by regulation. Conservative auditing firms will not evolve by spontaneous order. Left to their own devices, managers will always prefer to keep their options open and engage an auditor with a reputation for flexibility.

Part IV concludes that auditors should be instructed to look for guidance from their own jurisprudence of GAAP rather than from their shareholder clients. A shift to this positivist concept of auditor responsibility will not by itself solve the crisis of confidence. But it will provide a superior framework within which to evaluate accounting treatments and professional reforms.²⁴ Shareholder capitalism, like freedom, should be limited for the sake of its own preservation.

I. FINANCE AS POLITICS

Lawyers and economists both tend to model a unitary shareholder whose preferences are constant in time. This simplified actor takes business risks, wants value maximized, and holds its stock for an indeterminate period. This actor also suffers an informational disadvantage relative to managers and depends on the managers for information, even as this actor possesses meaningful self-protective options such as diversifying, monitoring, and selling into the liquid market. Theorists do not disagree about the general components of the model. Rather, differences emerge only as to the relative emphasis that should be given to each component, particularly as

24. The incentive problem bound up in the fact that the client's managers pay the fee assures the persistence of independence problems. See Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* 50 (Mar. 1, 2002) (unpublished manuscript, on file with the *Duke Law Journal*) ("[T]he fundamental tension in the statutory audit system is that auditors get hired by, fired by, and must work side by side with, the corporate client . . . while legally required to take the interests of shareholders, creditors, and the public as their primary responsibility and allegiance.").

between the shareholder's dependent and self-protective aspects.²⁵ When subsets of shareholders are broken out, there tend to be only two—individual and institutional holders.²⁶

Simplicity has its advantages, and the unitary model works well much of the time. Occasionally, however the model obscures the issue on the table, as has happened with the present crisis respecting financial reports. Here, one needs to unpack the model and look through to the real world to see that there is no unitary, empirical shareholder whose preferences provide a basis for deducing a set of instructions about accounting treatments. Constructing a model shareholder beneficiary in this context means choosing among different types of shareholders. This choice is a political decision. Just as politics informs a legislative judgment when conflicting interest groups compete for regulation, politics informs the choice of instructions respecting a system of financial reporting.²⁷ Given shareholders with different preferences and expectations, such choices cannot be avoided. This is *financial* politics, not public politics, but it is still politics.

Section A shows that shareholding's political contingency follows from uncertainty about value. People buy, sell, and hold shares in pursuit of value. But, at any given moment and whatever the stock price, no one can be sure whether or to what extent value really exists. The shareholder profile as a result becomes variegated by different approaches to valuation and behavioral infirmities. Meanwhile, in a world of uncertain valuation, the one thing that is supposed to be clear and verifiable is the record of past performance. But clarity and verifiability are not so easily achieved even as to the past record. No science holds out an objectively correct means to record and report corporate transactions. Accounting principles, like

25. Compare EASTERBROOK & FISCHER, *supra* note 15, at 28–30 (insisting that shareholders look for aggregate gains and can self-protect through diversification), with Lawrence E. Mitchell, *Trust, Contract, Process*, in PROGRESSIVE CORPORATE LAW 185, 185–91, 202–09 (Lawrence E. Mitchell ed., 1995) (stressing that shareholders invest because of trust, which has social value that is enhanced through fiduciary law).

26. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 525, 578–80, 585–89 (1990) (suggesting that shareholder passivity is historically contingent, incentives to intervene will change with aggregation of holdings in institutional hands, and that regulatory barriers to larger holdings should be removed); Harry DeAngelo et al., *Special Dividends and the Evolution of Dividend Signaling*, 57 J. FIN. ECON. 309, 350–51 (2000) (suggesting that a shift in holding pattern from individual stockholders to institutional holders explains changes in payout policy that occurred between 1962 and 1995).

27. For a similar use of a political analogy, see SHILLER, *supra* note 22, at 233.

all laws, follow from their drafters' policy judgments, and reporting firms must make judgment calls in applying them. It follows that the accounting system and the audit take center stage in the politics of shareholding.

A. *The Elusive Value of a Share*

Finance is political because, at any given time, no one knows exactly how much a given share is worth. To see this, one need only refer to the simplest expression of investment value:

$$PV = \frac{A}{r}$$

Present value (*PV*) equals cash flow over time (*A*) divided by a discount or capitalization rate (*r*). *PV* is today's stock price. *A* is the checks the investor expects to get in the mail with respect to the investment. The capitalization rate *r* is the rate of return on the investment.²⁸ Most of equity valuation is an expansion of this relationship.²⁹

The fact that value can be expressed as an equation misleads people into thinking that the exercise of valuation, done with the correct methodology, yields a correct result—a *PV* that equals the intrinsic value of the stock. In fact, there is no such empirical result. There are only guesses. The reason is this: Investing entails parting with cash today with the hope of a larger cash payment to be made in the future. But, because no one knows what the future will bring, the *A* in the equation is just a projection, a guesstimate.³⁰ The more one knows about the investment, the better the guess. For investments in stable firms with established shares of quiet product markets, one can get a good handle on the future by reference to past performance.³¹ But the number of informational variables is endless even in this

28. For a more detailed presentation of valuation fundamentals, including the constant growth variation on the equation, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 62–71 (6th ed. 2000).

29. For an example of the analytical expansion on the basic equation into a series of valuation models, see ZVI BODIE ET AL., *INVESTMENTS* 532–56 (4th ed. 2000). Balance sheet valuation models are the exception to the rule.

30. *See id.* at 557 (noting that uncertainty respecting stock market forecasts is always high).

31. BENJAMIN GRAHAM ET AL., *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE* 437 (4th ed. 1962). Michael L. Wachter, *Takeover Defense when Financial Markets Are (Only) Relatively Efficient*, 151 U. PA. L. REV. 787, 793–94 (2003), suggests that, as a result, the gravamen of uncertainty in valuation lies in the ascertainment of the capitalization rate.

relatively easy case, because we are talking not only about the future of one company producing in a competitive market,³² but the future of the economy as a whole.

Constant uncertainty about value causes inconsistencies and anomalies to creep into investors' behavior.³³ The reader of *Business Week* who peruses growth projections for the economy, projections generated by financial institutions or consultants, would be unlikely to lay money on their accuracy. Yet when the same reader buys a stock, she puts her money down on a projection of a stream of cash flow that bears a close familial relation. In fact, to the extent the *Business Week* prognosticators project only for the near or an intermediate term, the projection bound up in a stock purchase is even less certain because it involves a prediction of the indefinite future.³⁴

The discount rate r also is a guess.³⁵ In theory, it reflects sensitivity to risk and is subjective to the investor.³⁶ Because people are risk averse, as A gets chancier, the discount rate r gets bigger, causing the present value to decrease: The higher the risk, the higher the r , and the higher the rate of return.³⁷ The discount rate's subjective origins imply empirical grounding.³⁸ But, to the extent they

32. See ZVI BODIE & ROBERT C. MERTON, FINANCE 260 (2000) (describing the firm-specific risks of a simple baking business).

33. See SHILLER, *supra* note 22, at 55–57 (describing emotional bases of investor behavior under uncertainty).

34. $PV=A/r$ values the firm as a perpetuity. BREALEY & MYERS, *supra* note 28, at 66. The assumption seems heroic. Under one approach to valuation practice there is no point in projecting specific payments beyond an intermediate term of around five years. See EUGENE F. BRIGHAM & LOUIS C. GAPENSKI, FINANCIAL MANAGEMENT: THEORY AND PRACTICE 241–46 (6th ed. 1991) (“Firms typically go through *life cycles*.”).

35. See BREALEY & MYERS, *supra* note 28, at 66–69, for an exposition of this point, using dividend yield on a relatively stable stock as a proxy for r , but concluding that for any stock a present estimate of r is too error-prone and subject to noise to be meaningful.

36. See BODIE ET AL., *supra* note 29, at 150–55 (describing the behavioral origins of investor risk aversion).

37. See *id.* at 127–40 (describing the relationship between risk and return). It follows that high returns on equity investments imply significant risk taking. It also follows that people who make killings in the market are not necessarily smart. Cf. JOHN KENNETH GALBRAITH, A SHORT HISTORY OF FINANCIAL EUPHORIA 78–79 (1990) (noting the “public impression that intelligence, one’s own and that of others, marches in close step with the possession of money”). They may merely be lucky, proceeding on greed and killer instinct more than on analytical prowess.

38. Financial economics’ “separation theorem” limits the subjective moment in investment to the selection of a proportion of riskless treasury securities to be mixed with investment in the market equity portfolio. But it achieves this limitation on subjectivity only on the heroic

exist at all, subjective capitalization rates do not reveal themselves in practice. There is no way to know operative values of r for a stock based on yesterday's closing price.³⁹ There are too many variables. Market results for defined periods in the past can be analyzed so as to produce empirical rates of return for those defined past periods.⁴⁰ But the verifiable numbers of the past are only so much help in valuation. Investment looks to the future, not the past. Nor can of the market prices of comparable firms bring certainty to the uncertain world of share valuation. Comparable numbers are verifiable, but they derive from real world transactions made by other actors making guesses. Such information assists the actor under uncertainty,⁴¹ but the exercise of assaying comparables does not yield figures that determine a company's "intrinsic" or "fundamental" value—the "true" value of the firm.

Despite all the foregoing, the concept of fundamental value is far from meaningless. Indeed, it is valuation's constant focal point. Although the accuracy of a price set today cannot be verified or falsified, it is verified or falsified over time; the truth wills out over time in cold hard cash.⁴²

Finally, even though investment and valuation look to the unknowable future, past results bear critically on valuation. They

assumption investors can borrow to purchase risky stocks at the risk free rate of return. JAMES H. LORIE ET AL., *THE STOCK MARKET: THEORIES AND EVIDENCE* 122–26 (2d ed. 1985).

39. See *supra* note 35. Empirical values of r can be ascertained for bonds because the projected payment stream is fixed, and thus the only variables are default and inflation risk. As these risks increase, the value of r in the equation rises; the value of r also being the yield on the bonds. One can derive that figure easily if you know the promised payment and the present market price. In fact, the *Wall Street Journal* does the derivation daily. See BODIE ET AL., *supra* note 29, at 401–05 (showing reported bond yields). With equities, the value of A is not fixed and follows from the success or failure of the company. The result is that the present values reported in the press do not communicate the discount rates brought to bear by the actors parting with their money to buy the stock. A price earnings ratio, *inter alia*, provides an indirect handle on market discount rates, but an often unreliable one. See WILLIAM W. BRATTON, *CORPORATE FINANCE: CASES AND MATERIALS* 72–73 (5th ed. 2002) (“[S]ince the market is engaged in capitalizing *future* (not past or even solely current earnings), the capitalization rate cannot be observed directly or determined precisely.”).

40. See BODIE ET AL., *supra* note 29, at 571–72, for a simple model in which empirical returns on selected stocks are regressed against those of a wider market index for a discrete period in the past.

41. See BODIE & MERTON, *supra* note 32, at 208–09 (2000) (suggesting that the “essence” of valuation lies in reference to comparable assets with known market prices, but admitting that analysts search for and can discover incorrectly valued assets in trading markets).

42. See BODIE ET AL., *supra* note 29, at 537 (asserting that price and intrinsic value converge over time).

provide a base point for future projections and, more generally, amount to all one can know for certain in an uncertain situation. The auditor enters at this point in the description: By protecting the integrity of the past numbers, the auditor protects the integrity of the entire valuation process.⁴³ The audit looms large even though A is a projection of a cash flow figure rather than a projection of an income statement bottom line to be passed on by an auditor.⁴⁴ Analysts derive A by making standard adjustments to a present income statement figure and then projecting into the future.⁴⁵ It follows that equity valuation tends to rely on audited figures, assuming them to be both empirically verifiable and duly verified.⁴⁶ It further follows that if the income statement figure cannot be trusted, the whole valuation is tainted from the start. The very suggestion of a taint means an increase in the value of r .⁴⁷ So when the post-Enron market woke up on January 29, 2002 concerned that bad accounting and auditing were widespread problems,⁴⁸ it adjusted its values of r upward because it suddenly lost confidence in the values of A on which it based its projections.⁴⁹ Present prices fell as a result. In the world of finance—where risks that cause prices to fall normally concern badly run operations or bad economies and valuations assume sound reporting institutions—that sudden, added uncertainty implies a crisis.

43. See HERWITZ & BARRETT, *supra* note 20, at 227–28 (discussing investor perceptions of audits as guarantees of accuracy and the reality that audits at best provide a reasonable assurance of the absence of material misstatements).

44. See BODIE ET AL., *supra* note 29, at 575 (discussing the importance of the net income figure); BREALEY & MYERS, *supra* note 28, at 72–77 (discussing the link between the stock price and earnings per share).

45. See BRATTON, *supra* note 39, at 45–49 (making the adjustments).

46. There is an extensive empirical literature demonstrating the relevance of accounting results for valuation. For a review of the literature, see Robert W. Holthausen & Ross L. Watts, *The Relevance of the Value-Relevance Literature for Financial Accounting Standard Setting*, 31 J. ACCT. & ECON. 3, 5–14 (2001).

47. The GAO REPORT, *supra* note 4, at 24, notes an average stock price decline of 10 percent on the trading day after the announcement of an accounting restatement. Some of these losses could reflect downward adjustments of A . Increases in r also will have figured in since a restatement taints the quality of the issuer's entire reporting system.

48. See *supra* notes 7–9 and accompanying text.

49. See Dan A. Simunic, *Auditing, Consulting, and Auditor Independence*, 22 J. ACCT. RES. 679, 680 & n.2, 699 (1984) (suggesting that investors will require compensation for a perceived increase in the probability of inaccurate reporting, causing the firms market value to decline); Siew Hong Teoh & T.J. Wong, *Perceived Auditor Quality and the Earnings Response*, 68 ACCT. REV. 346, 347–49, 364–65 (1993) (showing that perceived reductions in audit quality trigger stock price declines due to downward revision of expected earnings).

B. Modeling the Shareholder

To value a share is to get a handle on A and r , studying facts presently ascertainable about the company, the industry, and the economy, and then to take out a crystal ball. Because security prices are only projections, it comes as no surprise that financial economics has never managed to come up with a robust asset pricing model.⁵⁰ Absent such a model, which would provide a means to verify present prices, there is much room for behavioral variation and diversity of approach and opinion in the world of shareholding. And so the world of finance is as much a world of politics and politicians as it is a world of technologies and technocrats.

The eight-part typology in Table 1 captures the diverse approaches and behaviors that politicize shareholding. The eight classifications are presented as a series of opposite pairs so as to clarify the political description; there results a series of four binary alternatives for a model shareholder.⁵¹

TABLE 1

Left Side	Right Side (Financial Conservatism)
Speculation	Investment
Noise trading	Fundamental value investment
Dumb money	Smart money
Short term	Long term

To model a unitary shareholder beneficiary in order to derive a set of coherent governance instructions is to mix and match

50. See Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 771–72 (1985) (explaining why market prices cannot be proven to be allocatively efficient). Application of the leading model of asset pricing, the Capital Asset Pricing Model, cannot yield a verifiable intrinsic value because the model is based on past results. See BRATTON, *supra* note 39, at 109–11 (discussing the derivation of the variables and controversies respecting empirical tests).

51. For a contrasting binary, see Lynn A. Stout, *The Investor Confidence Game*, 68 BROOKLYN L. REV. 407, 409–20 (2002). On the left side, Stout places the trusting investor, and on the right side, she places the rational expectations investor. Many elements of Stout's description overlap elements in the description here. But the two discussions have diverging normative implications. Stout's trusting investor is a victim, to whose needs the securities markets should cater, *inter alia*, by abandoning conservative, verifiable accounting. *Id.* at 433–34, 434 n.71.

characteristics from the various rows and from either column. But a problem arises. If one includes too many characteristics from both columns at once, the model loses its coherence. To maintain a viable shareholder unit and a basis from which to deduce regulation, one must choose sides.

The observation that coherent shareholder models follow from reductive choices does not necessarily carry negative normative implications. Nor should it be taken to assert that reductive modeling is necessary in all governance contexts. The shareholder is modeled routinely in boardrooms and in corporate and securities law. The menu selections and the model's particulars vary with the context. For example, in the 1990s stock market, actual investor behavior followed extensively from the left column.⁵² Historically, securities law regulates from the perspective of the right column.⁵³ But left-column considerations have been creeping in noticeably during the last two decades.⁵⁴ Corporate law tends toward generality, modeling the shareholder beneficiary so vaguely as to elide the problem of making menu choices. This is not necessarily a failing. The governance problems on corporate law's table often do not require further inquiry into the shareholders' financial and behavioral profiles. For example, when the question is whether management should be able to line its pocket with an unfair self-dealing transaction, the law fairly may assume a universal shareholder interest in a fiduciary duty of loyalty.⁵⁵ Notably, corporate law draws selectively and opportunistically from the right column in articulating

52. See SHILLER, *supra* note 22 (describing the causes of the 1990s stock market bubble).

53. The federal securities laws mandate disclosure of fundamental information under penalty of law on the assumption that management operating in a free marketplace will have inadequate incentives so to do. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 169–93 (3d ed. 1998) (discussing the competing philosophies that underlie disclosure law). One benefit is diminished volatility in stock prices. *Id.* at 216–19.

54. The turning point occurred in 1978. Prior thereto, the SEC insisted that issuers disclose only verifiable financial information. That conservative position was much criticized. See, e.g., Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1188–91 (1970) (arguing that accountings should incorporate the values of assets rather than their costs). The SEC eventually yielded, crafting a safe harbor rule for issuer disclosures of projections, Securities Act Release No. 5993, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,757 (Nov. 7, 1978), as well as setting guidelines for projections of future performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978).

55. In the historic legal model of the corporation, the fiduciaries—board of the directors and officers—owe their duty not to the shareholders directly but to the corporate entity. The classic citation is *People ex rel. Manice v. Powell*, 94 N.E. 634, 637 (N.Y. 1911). By using the entity notion, the law in effect models a unitary shareholder.

the law of takeover defense. This controversial fiduciary construct⁵⁶ aligns the “long-term” shareholder with the manager against left-side actors so as to justify management takeover defenses.⁵⁷

The columns’ left-right organization designedly shadows the left-right split of public politics since the French Revolution.⁵⁸ There is some difficulty, however, in designating the two columns. The term “financial conservative,” implied by the left-right split, fairly can be applied to right-side shareholders.⁵⁹ But neither “liberal” nor “progressive” makes sense for the left side. “Aggressive” works better, but not well enough, for there are plenty of aggressive investors on the right side. The phrases “shareholder value maximization” and “shareholder capitalism” described many actors and events on the left side during the 1990s. Unfortunately, these phrases fail descriptively because just about everybody in both columns wants shareholder value maximized.⁶⁰ The 1960s term “go go” works well for the left side some of the time, as does Alan Greenspan’s 1996 phrase “irrational exuberance.”⁶¹ In bear markets, however, left-side investors are anything but go go or enthusiastic. “Easy money” also describes the left side, although only on the upside. So this Article will proceed referring to “left-side” and “right-side” shareholders, substituting the conservative label for the right side on occasion.

There follows a description of the eight types of shareholders and the political tensions that distinguish them.

56. Compare Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (articulating a shareholder choice model), with Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002) (arguing for management discretion respecting takeover defense to protect the long-term interest).

57. See, e.g., *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) (approving defensive tender offer on the ground of protection of long-term investment plan).

58. The practice of denoting political opinions by left and right dates from the early meetings of the French National Assembly, at which the former third estate sat to the left of the chair and the former privileged classes sat to the right. WILLIAM JAMES MURRAY, *THE RIGHT-WING PRESS IN THE FRENCH REVOLUTION: 1789–92*, 3 (1986).

59. In the interest of full disclosure, the author admits to adherence to financial conservative values in scholarship and teaching and also in the conduct of personal affairs.

60. On a rational actor model, the only equity investors who would not want common stock value maximized have additional claims against the firm in other forms, as employees, creditors, or preferred stockholders. Issues arise concerning maximization of the firm’s overall value for the benefit of these constituents and maximization of the value of the common stock. The leading intervention in favor of overall maximization is Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999).

61. SHILLER, *supra* note 22, at 3.

1. *Speculation versus Investment.* The first binary comes from the classic conservative treatise on finance and valuation, Graham and Dodd's *Security Analysis*.⁶² Graham and Dodd divide stockholders into two types. On the left side, they place those who play the market looking for quick upsides—speculators. They contrast speculators with investors, dividing investors into two subsets. In their more conservative appearance, right-side investors look for safe income streams, analyzing past performance and avoiding any forward-looking projection. The less conservative subset of right-side investors looks for capital appreciation rather than income, investing in future growth projections. They thereby resemble speculators, the difference lying in the approach taken. Investment in growth requires something “more tangible than the psychology of the purchaser.”⁶³ Specifically, it requires, as objectives, safety of principal and a satisfactory return, and, as means to the objectives' fulfillment, thorough analysis. Such analysis has to address the quality of the company, but cannot stop there. Quantity, in the sense of the relation of the stock price to the company's fundamental value, matters just as much. In the Graham and Dodd picture, the market price is not necessarily the best available evidence of the value being offered. Given a market full of speculators, it certainly will not be: the highest quality firm is just a speculative issue if speculators have bid its price to the stratosphere.⁶⁴ Meanwhile, say Graham and Dodd, investment is “good for everybody and at all times.”⁶⁵

2. *Noise Trading versus Fundamental Value Investment.* Graham and Dodd's distinction between speculation and investment

62. BENJAMIN GRAHAM & DAVID L. DODD, *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE* 33–36 (3d ed. 1951). There is nothing in the discussion that follows here that cannot be found, expressly or by implication, in Graham and Dodd's chapter 4. For a contemporary discussion of speculation, see Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225 (2001).

63. GRAHAM & DODD, *supra* note 62, at 37.

64. *Id.* at 38–39. Contemporary observers term their approach “value investing.” Warren Buffett, a Graham student, is a famously successful exemplar. See ROGER LOWENSTEIN, *BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST* 36–59 (1995) (describing Buffett's relationship with Graham).

65. GRAHAM & DODD, *supra* note 62, at 34. But speculation is not always bad, depending on who does the speculating and the prevailing conditions. Unfortunately, speculation often turns out badly: The failure properly to distinguish between the two activities, they say, brought about the disaster of 1929. *Id.*

can be updated with reference to the contemporary noise trading theory of stock market pricing.⁶⁶ The noise theorists occupy the branch of financial economics that allows itself to be influenced by behavioral psychology.⁶⁷ The traders they describe resemble Graham and Dodd's speculators. For their right-side counterparts, we can update Graham and Dodd to model a contemporary class of "fundamental value investors."⁶⁸ These actors have assimilated the lessons of valuation described above. They know that value lies in hard cash flows and they invest into those flows even as they look for growth. Their time perspectives tend to be longer. And their information sets only include facts respecting the investee and the economy—so called "fundamental value information," rather than the latest word from Wall Street. Market trends and daily noise do not impress them.

The noise traders resemble Graham and Dodd's speculators, with an overlay of psychology to thicken the description of the speculative mindset. Noise traders chase trends: When they see somebody make a killing on a rising stock, they assume that actor to be smart rather than lucky⁶⁹ and imitate the strategy.⁷⁰ They also display behavioral biases; they are overconfident in their own investment abilities.⁷¹ When the stock price is trending up, they react too favorably to good news. Once a down trend has asserted itself they react too unfavorably to bad news. In both cases they suffer from

66. See, e.g., Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP., Spring 1990, at 19, 19–20, 25–30 (reviewing "an alternative to the efficient markets approach . . . recently pursued").

67. See BRATTON, *supra* note 39, at 159.

68. Noise theorists sometimes model value investors but also employ the smart/dumb distinction. See *infra* text accompanying notes 83–92. For a leading model employing the noise versus value investor distinction, see Josef Lakonishok et al., *Contrarian Investment, Extrapolation, and Risk*, 49 J. FIN. 1541, 1542–44, 1575–76 (1994). This model divides shareholders into value investors and growth investors, and suggests that investors seeking an above-market yield should select "value" stocks because most investors make the mistake of selecting "glamour" stocks. Glamour stock investors suffer from a cognitive limitation: they overreact optimistically to the recent history of good news about those stocks, paying too much on the assumption that past earnings growth can be extrapolated into the indefinite future. At the same time, they overreact in the negative to the stocks of firms that have suffered recent reverses. Institutional investors make the same mistake, confusing investment in stocks with outstanding performance records in recent periods with "prudent" investment.

69. See GALBRAITH, *supra* note 37, at 12–13 (describing the "specious association of money and intelligence" that characterizes investor behavior).

70. See Shleifer & Summers, *supra* note 66, at 28–30 (describing positive feedback trading).

71. Robert A. Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1459–60 (2002).

the availability bias, placing too great a weight on recent events and easily available information.⁷² Availability bias also leads investors to make ill-considered risk-return projections, underweighting the importance of risks of low probability and high magnitude. Finally, at the moment when the trend turns, noise traders can be a little slow to read the handwriting on the wall.⁷³ This cognitive dissonance follows from hindsight bias—overweighting past events that actually occurred rather than those that might have occurred.⁷⁴ It also follows from confirmation bias—the tendency to confirm earlier decisions regardless of their intrinsic soundness.⁷⁵ Noise traders get embedded notions about their strategies and shut out information. The list goes on.⁷⁶

Trends dominate the resulting picture of market pricing.⁷⁷ When the market trends up, too much is made of good news and bad news is filtered out.⁷⁸ Indeed, market information may influence the price as much as, or even more than, fundamental value information. This happens in a bubble, when a feedback loop takes over as one stock price increase feeds the next increase.⁷⁹ The trend only turns some time after information about fundamental value has ceased to justify

72. See Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1127–28 (1974) (describing availability biases that arise when “people assess the frequency of a class or the probability of an event by the ease with which instances or occurrences can be brought to mind”).

73. See Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 659–61 (1996) (describing how brokers can disguise bad investment advice, causing investors to make decisions at a slower pace).

74. See Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 104 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 288, 297 (1975) (“Finding out that an outcome has occurred increases its perceived likelihood. . . . Thus, Judges tend to believe that this relative inevitability was largely apparent in foresight, without the benefit of knowledge what happened.”).

75. See Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOCIAL PSYCHOL. 2098, 2099, 2108 (1979) (“[T]here is considerable evidence that people tend to interpret subsequent evidence so as to maintain their initial beliefs.”).

76. See generally Cunningham, *supra* note 21, at 780–86 (surveying the field); Langevoort, *supra* note 73, at 634–41 (describing behavioral distortions that lead to excessive risk taking).

77. For models, see, e.g., Nicholas C. Barberis et al., *A Model of Investor Sentiment*, 49 J. FIN. ECON. 307, 318–32 (1998); Kent D. Daniel et al., *Investor Psychology and Security Market Under- and Overreactions*, 53 J. FIN. 1839, 1845–55 (1998).

78. See Barberis et al., *supra* note 77, at 310–13 (summarizing evidence of price underreaction to good news and momentum in stock prices).

79. SHILLER, *supra* note 22, at 44–68.

the price.⁸⁰ Eventually the accumulation of bad news causes investors to substitute a new, negative model.⁸¹ Then the trend turns downward, with investors thereafter tending to underweight good news.⁸²

Restating in less formal terms, swings of mood characterize the behavior of left-side investors. We have seen of late that the mood swings can be quite extreme. Uncertainty is the ultimate cause.

3. *Dumb Money Versus Smart Money.* The next binary, dumb money versus smart money, complicates the division between noise traders and fundamental value investors. The dumb money includes the noise traders, but could also include a fundamental value investor who still has a lot to learn and who does something really ill-advised, like investing based on the recommendation of a stockbroker. The smart money similarly includes the better-informed fundamental value investors, but the category should encompass other actors as well. Graham and Dodd find practical utility in a distinction between “unintelligent speculation” and “intelligent speculation”—the difference between uninformed risk-taking and risk-taking upon study and consideration.⁸³ Making reference to the noise trading model, we can update the “intelligent speculator” into the smart money investor. Some smart money will combine fundamental and market value information, watching the noise traders and the market trend. When the noise traders go on an upside tear, bidding up stocks in a feedback loop where an uptick is good news that triggers another uptick, smart money certainly can ride along. There is, after all, money to be made as prices rise. But the smart money knows when fundamentals do not support the market price and, being (relatively) free of behavioral biases, will be the first to bail out when the trend turns. The same insights invite the smart money to profit by bucking the trend. When fundamental value does not support the market price, the price inevitably will fall. Accordingly, money can be made shorting the stock (or the whole market) or buying puts. Either way,

80. See Barberis et al., *supra* note 77, at 307–08 (describing how over one to twelve-month periods “security prices underreact to news”).

81. ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* 113–14 (2000); Lakonishok et al., *supra* note 68, at 1542.

82. SHLEIFER, *supra* note 81, at 113–14. “[O]ut-of-favor (or value) stocks have been underpriced relative to their risk and return characteristics, and investing in them has indeed earned abnormal returns.” Lakonishok et al., *supra* note 68, at 1574.

83. GRAHAM & DODD, *supra* note 62, at 43.

the smart money bets that the stock (or the market) will fall. More generally, given a lot of noise, smart money is likely to be contrarian.

In this contrarian posture, the smart money plays the most heroic role in all of financial economics. The second branch of the field—the orthodox one that averts its eyes from behavioral psychology—adheres to the famous efficient market hypothesis (EMH). The EMH asserts that the market price is the best reflection of fundamental value and that new fundamental value information gets into the stock price almost immediately.⁸⁴ The EMH asserts these points even as it accepts the existence of dumb money and noise trading.⁸⁵ It is able to do both at once because it asserts that smart money trumps dumb money. Dumb money goes off in every direction, canceling itself out in the random error term. Smart money goes consistently in the direction of fundamental value, keeping stock prices correctly aligned with fundamentals.⁸⁶

The EMH remains a good story,⁸⁷ but the contrasting noise trading description of the market became ascendant at some point during the last decade. Recent stock market behavior confirms the shift. Under the present consensus view, the stock market is a place where noisy supply and demand intermix with fundamental value because there is not enough smart money to trump the dumb money in the short term.⁸⁸ Contrarian investment is just too risky. In the long term, however, fundamental value always prevails.

Indeed, fundamental value information remains highly relevant even in a bubble stock market. A rational, fundamental value story

84. BREALEY & MYERS, *supra* note 28, at 354–62.

85. SHLEIFER, *supra* note 81, at 2–3.

86. *Id.* Under the EMH it follows that supply and demand do not determine stock prices. What is an offer in the stock market is money in the future and the demand for money is consistently high. The valuation questions go only to the amount of money, the time of payment, and the quantum of risk—questions answered by fundamental value information. Since demand is a constant, the only thing that can cause a price to change is new fundamental value information. Noise traders, meanwhile, always get wiped out in the long run. *Id.* at 3–5.

87. For a recent defense of the story, see Eugene F. Fama, *Market Efficiency, Long Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283, 285–88 (1998).

88. See, e.g., Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35, 49–54 (1997) (“[A]rbitrage opportunities are harder to identify in stock markets than in bond and foreign exchange markets.”). It is argued that the introduction of single stock futures contracts will make it less costly to take contrarian positions, permitting the smart money to do the price corrective job hypothesized in the EMH. See Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733, 743 (2002) (“[U]nless regulators gum up the works, [investors] should be able to go short in future markets by posting cash margin, but without the need to borrow shares.”). Time will tell.

supported the noisiest of recent markets—the dot-com bubble of the late 1990s. The Internet was new, people were shifting their attention to it in large numbers, and the number of customers was expected to increase. According to the story, that meant there were going to be fantastic profits for a handful of winners who got in early with attractive websites and gained market share.⁸⁹ Without such a fundamental value story there would have been no dot-com boom. The problem was that the story, although rational, was also highly probabilistic. Worse, it became exaggerated in the telling, in the interpretation, and in the wake of actual stock price increases. When the market puts present money on the table, the connection between that market value and the supporting fundamental value story can be very attenuated.⁹⁰ But even at the crest of tulipmania, there was an operative fundamental value story.⁹¹

All of this implies that for a stockholder, whether a noise trader or a fundamental value investor, nothing is more important than news about fundamental value. Of all fundamental value information, earnings information is the most important subset: $PV = A/r$. Every time new earnings reports appear, people adjust their projections of A to account for the news.⁹² Adjustment occurs whether the investor is smart or dumb, or trades on noise or fundamental value. The protection of the integrity of this information is the auditor's task.

4. *Short Term Versus Long Term.* In the preceding three pictures of shareholders and stock prices, the left-side interest has been prone to a short-term time horizon, with the right side looking to the long term. This follows from the respective investors' characteristics. The market information that drives the left-side interest bears primarily on the near term. The fundamental value that drives the right side tends to have meaning only over the intermediate

89. Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1125–26 (2003).

90. GALBRAITH, *supra* note 37, at 12–15.

91. “Tulipmania” was a bubble in the price of tulip bulbs in seventeenth century Holland. See Peter M. Garber, *Tulipmania*, 97 J. POL. ECON. 535, 555–57 (1989). Garber argues that a rational story supported the high prices in that rare bulbs because they had a high fundamental value due to the sales of their offshoots. *Id.* at 555–57.

92. Differences of opinion of the effect of fundamental value go to whether the market reacts correctly, underreacts, or overreacts. See SHLEIFER, *supra* note 81, at 112–13 (stipulating that generally “security prices underreact to news such as earnings announcements,” but that “over longer horizons of perhaps three to five years, security prices overreact to consistent patterns of news pointing in the same direction”).

or long term. Today, the appellations “short term” and “long term” have come to stand in for Graham and Dodd’s terms speculation and investment. The reference to time horizons avoids the pejorative implication of Graham and Dodd’s label for the left-side investor.⁹³ This makes sense in a world where “shareholder value maximization” keyed to today’s stock price has taken on a positive normative connotation.⁹⁴

Under the shareholder value norm in circulation during the 1990s, the shareholders’ division according to time horizons has no negative connotations for productivity. Present value theory brings all time horizons together into today’s market price.⁹⁵ If the EMH is right, and the price reflects fundamental value, then directing management to maximize present value holds out no risk of perverse effects. To maximize fundamental value is to maximize today’s price. Therefore, management confidently can invest for the long term without having to worry about being punished by the left-side interest in the stock market.⁹⁶

In the 1980s, in contrast, shareholder value maximization practice seemed more of a threat to management’s freedom to invest.⁹⁷ The leveraged restructuring movement, which was likewise predicated on the theory of shareholder value maximization, denuded management of investment discretion, even as it produced large,

93. Graham and Dodd pointed out that there is no clear line separating the short and long terms and that one can “invest” short term and “speculate” long term. GRAHAM & DODD, *supra* note 62, at 35–36.

94. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1278–87 (1999).

95. See Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 288–90 (1990) (describing idealized conditions wherein “shareholder wealth maximization is nevertheless still beneficial to all shareholders,” regardless of their levels of risk aversion).

96. Provided, of course, that management credibly can communicate its proprietary information about future prospects to actors in the market. If it cannot, then a market tendency to rely on short-term performance numbers can have perverse effects. See William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT’L L. 213, 223 (1999) (providing that management is averse to making long-term investments because of the challenge in conveying “investment policy and the firm’s prospects” to market traders).

97. See Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry*, in STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN, AND EUROPE 5–6 (Donald H. Chew ed., 1997) (“The U.S. system of capital allocation creates a divergence of interests between owners and corporations that interferes with the flow of capital to those corporate investments that offer the highest long-run payoffs.”).

present payments in the form of tribute to shareholders long starved of cash returns.⁹⁸ The defenders of restructuring asserted the transactions had the beneficial effect of constraining management's tendency to invest equity capital suboptimally, even as the transactions had the effect of taking the subject firms private, thereby insulating them from left-side shareholder influences.⁹⁹ The transactions' opponents claimed that high leverage entailed excessive agency costs and choked off new investment.¹⁰⁰ Eventually, history defused the issue by consigning high leverage restructuring to its scrap heap. Leveraged restructuring came to be seen as shock therapy incurred in the normative transition from post-war managerialism to the superior shareholder value regime of the 1990s,¹⁰¹ under which managers invested for the long term even as they adhered to a norm of present shareholder value maximization.¹⁰²

The present crisis of confidence brings the left-side, short-term shareholder interest back to the top of the list of corporate policy problems. If the dirty deal story is accurate, observers in the 1990s deluded themselves into thinking that stock option plans productively had aligned management incentives with a unitary shareholder interest. Management emerges in the story with a short-term, left-side shareholding interest that triggers a perverse incentive to falsify performance numbers, externalizing risks of enterprise on shareholders with a long-term horizon.¹⁰³ The shareholder of the shareholder value maximization norm fragments accordingly.

98. William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 167-68.

99. See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 65-72 ("[D]ebt is crucial to management discipline and resolving the conflict over free cash flow.").

100. Bratton, *supra* note 98, at 162-65.

101. See Bengt R. Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, J. ECON. PERSP., Spring 2001, at 121, 127-37 (describing the beneficial effects of leveraged restructuring and the shift toward a shareholder value perspective).

102. See Merton H. Miller, *Is American Corporate Governance Fatally Flawed?*, in STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS, *supra* note 97, at 38, 41-45 (rejecting "any permanent or systematic bias for U.S. firms in the aggregate toward myopia or hyperopia, toward underinvestment or overinvestment relative either to the shareholders' or to society's best interests").

103. See Coffee, *supra* note 10, at 10-13 ("[T]he 1990's was the decade in which senior executive compensation shifted from being primarily cash-based to being primarily stock-based. With this change, management became focused . . . on the likely future performance of their firm's stock over the short-run.").

C. Summary

The liquid, faceless trading market reacts daily to the varying perspectives of left-side and right-side shareholders, aggregating and resolving their differences in a single stock price. When the impact of the differences is limited to the market floor, no political implications need be discussed. But in the 1990s, shareholder demands, particularly left-side shareholder demands, reached outward to influence reporting practices. Earnings became something to be managed before being reported, and auditors cooperated with the practice. Pricing distortions resulted and, eventually, confidence suffered. This Article's next Part describes the link between the left-right politics of shareholding and 1990s earnings management.

II. MANAGED EARNINGS AND THE SHAREHOLDER INTEREST

All observers agree on the overriding importance of the audit, regardless of their left- or right- side postures or their positions on controversial topics like the EMH and the correctness of stock prices. Equity valuation extrapolates from the earnings statement, and all investors rely on its accuracy. The fact that this is one of the few points of complete agreement in all of finance makes a crisis about the numbers all the more disturbing.

Descriptions of the crisis concentrate on the audit failures themselves,¹⁰⁴ and on the incentives of the managers and auditors responsible.¹⁰⁵ This Part supplements those accounts, looking at 1990s accounting through the different lenses of left- and right-side shareholders. It shows that the right side, while disapproving of aggressive accounting, also tends to be able to cope with it. And, being conservative, it can survive on the downside as well as prosper on the upside. The volatility comes from the left side, not only in stock prices but in the view of reporting numbers. Accounting treatments now widely condemned were viewed with favor or indifference by left-side actors only a short time ago. Indeed, in the late 1990s, the accounting industry even cited shareholder complacency as a justification for the dirty deal. If the threat to independence due to provision of nonaudit consulting services did not

104. See GAO Report, *supra* note 4, at 17–24 (describing the increasing number of large companies being forced to restate their financial statements).

105. See generally Coffee, *supra* note 10, at 7 (relating “managerial and gatekeeper compensation over the last two decades” to audit crises).

upset the shareholders, then regulators should not intervene to impose their more conservative views of the matter.¹⁰⁶ And it worked both ways: In the late 1990s, the supply-demand dynamic respecting audit services operated to make auditors sensitive to the left-side shareholder interest.¹⁰⁷ Unfortunately for the auditors, stock market reverses have a way of turning left-side shareholders into advocates of conservative financial values. Declining stock prices triggered a shift in shareholder demand from the left to the right side. Much of today's condemnation of aggressive accounting follows from the shift.

The same left to right shift occurred after 1929, with conservatism prevailing for decades thereafter;¹⁰⁸ but a left-side demand for aggression eventually returned during the bull markets of the 1960s and early 1970s.¹⁰⁹ One can expect a similar cyclical return to left-side perspectives at some point in the future.¹¹⁰ When that occurs, the supply-demand signal respecting accounting treatments could shift back as well. On this analysis, audit reform addressed only to perverse incentives bound up in nonaudit consulting may not provide a complete and enduring solution to the auditor incentive problem.¹¹¹ The incentive problem also stems from the corporate governance system's evolutionary assimilation of a norm of shareholder responsiveness.¹¹²

106. RICK ANTLE ET AL., AN ECONOMIC ANALYSIS OF AUDITOR INDEPENDENCE FOR A MULTI-CLIENT, MULTI-SERVICE PUBLIC ACCOUNTING FIRM, LAW & ECONOMICS CONSULTING GROUP, INC. REPORT FOR AICPA 25–26 (1997), cited in Frankel et al., *supra* note 16, at 8–9. The industry's advocates also pointed to informational advantages and the adequacy of legal liability constraints. *Id.* at 21–25.

107. See Bratton, *supra* note 1, at 1357–58 (“The accounting profession has drifted into the role of friendly service provider, lured by management bribes characterized as consultancy fees.”).

108. See GALBRAITH, *supra* note 37, at 65 (stating that after the crash of 1929, “markets were generally orderly and dull”).

109. See *id.* at 68–70 (describing the mood during this time as optimistic and “speculative”).

110. See *id.* at 12–19 (proffering that speculative excess is cyclical and will reemerge in the future).

111. Significant consulting is still permitted. Section 201 of the Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 78j-1(g) (West Supp. 2003), largely repeats the substance of antecedent regulations, falling well short of absolute prohibition. For a detailed comparison, see Bratton, *supra* note 1, at 1030–35.

112. See Eisenberg, *supra* note 94, at 1278–87 (describing institutional investors' increasing level of activity). See also Bratton, *supra* note 1, at 1358–61 (explaining the connection between the Enron failure and the shareholder value maximization norm).

A. *Exaggerated Reserves*

Why, prior to 2002, were shareholders impervious to consulting's threat to independence and to aggressive accounting more generally?

To begin to answer this question, take a simple, relatively benign example of 1990s earnings management—the cookie jar reserve. In one version of this ploy, the issuer takes an extraordinary loss in a given quarter respecting an unsuccessful line of business. The stock price effect of the bad news is muted because the loss is a one-time-only affair. Given, say, a \$15 billion company, the market will not be overly concerned as between a write off of \$1.5 billion or \$1.75 billion.¹¹³ So the company, which expects actual write offs over time to total \$1.5 billion, tops up the present deduction from earnings to \$1.75 billion. The extra \$250 million goes to the cookie jar. In a later quarter when the earnings are coming in a tad less than what was expected for that quarter, management conveniently revisits the loss reserve and reduces it. The released sum supports earnings in the later quarter.¹¹⁴ A cookie jar stash also can derive from any overestimated cost; for example, unrealistically high estimates of any of sales returns, loan losses, or warranty costs all can serve the function.¹¹⁵

Management can offer a couple of justifications for the manipulation. First, and foremost, investors prefer a series of

113. This is because analysts are concerned only about earnings from continuing operations and filter out extraordinary gains and losses. BODIE ET AL., *supra* note 29, at 588.

114. The use of a “big bath” write-off to increase cookie jar reserves is constrained for business exits commenced after December 31, 2002. Under ACCOUNTING FOR COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES, Statement of Financial Accounting Standards No. 146 (Financial Accounting Standards Bd. 2002), liabilities incurred in respect of closures are to be recognized upon incurrence and not in advance.

115. See Arthur Levitt, The “Numbers Game,” Address at the NYU Center for Law and Business (Sept. 28, 1998), at www.sec.gov/news/speech/speecharchive/1998/spch220.txt (on file with the *Duke Law Journal*) (“A third illusion played by some companies is using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs.”). The accounting crisis that engulfed Freddie Mac in June 2003 concerned this sort of accounting. The very existence of a scandal triggered by an earnings understatement demonstrates the degree to which the investment community has completely reversed its demands respecting reporting practice. One result of the restatement of Freddie Mac's books is worry among analysts of value decreasing volatility in the stock. See, e.g., Patrick Barta & John D. McKinnon, *Freddie May Have Understated Profits By Up to \$4.5 Billion*, WALL ST. J., June 26, 2003, at C1 (describing Freddie May's accounting disclosures, which “suggest the company was seeking to smooth the volatility of its earnings perhaps to impress investors who prefer steady, predictable results”); Ken Brown, *Heard on the Street: Bargain Hunters Hesitate with Freddie Mac*, WALL ST. J., July 2, 2003, at C1 (“Investors say their most basic concern is the company's accounting.”).

smoothly increasing income figures.¹¹⁶ The draw-downs from the cookie jar let management construct that steadily rising line of earnings. The alternative option—reporting volatile earnings numbers—will result in a higher value of r over time, and that hurts the stock price.¹¹⁷ Such income smoothing does not necessarily corrupt the trend, even as it beneficially reduces volatility. And since the trend determines the long-run value, any misrepresentation is not material.

Alternatively, management can argue that noise traders hype every piece of news about fundamental value to such a degree that some earnings management serves a higher shareholder interest.¹¹⁸ To take an example, perhaps apocryphal, from the later 1990s, if the firm misses its expected quarterly earnings number by one cent and the overheated market as a result punishes the stock by bidding it down 10 percent, then a reserve that holds out the missing penny benefits the shareholders.¹¹⁹ It allows management to anticipate and counteract the left side's behavioral shortcomings, protecting the stock price from short-term market mood swings.

Shareholder responses to these explanations depend on the state of the market and the politics of the particular shareholder.

To begin on the right side, the fundamental value investor will oppose any manipulation of earnings figures through loss reserves. Since this investor only cares about cash flows in the future, it wants an unvarnished present report. Management advocacy that results in smoother numbers makes it harder to work through to the most accurate valuation. Since greater volatility means a higher r , the appraiser needs accurate information about volatility so as to make the adjustment. Indeed, this investor will question the whole practice of setting aside the reserve. Better to expense the costs stemming

116. See Mary E. Barth et al., *Market Rewards Associated with Patterns of Increasing Earnings*, 37 J. ACCT. RES. 387, 398–412 (1999) (showing that firms with patterns of higher earnings have higher price/earnings ratios, controlling for other factors).

117. The rate of return r is a volatility measure. See BREALEY & MYERS, *supra* note 28, at 160–65 (demonstrating how r is calculated).

118. See Joseph B. Fuller & Michael C. Jensen, *Just Say No to Wall Street*, 14 J. APPLIED CORP. FIN. 41, 42–43 (2002), for a description of quarter-to-quarter earnings pressures in the late 1990s.

119. A 10 percent decline based on a one cent shortfall can be explained as rational. If stock traders are skeptical about earnings figures and assume that management accounts aggressively, then the one cent shortfall signals that management's cookie jars have run out and all other aggressive gimmicks have been used to the maximum. Given this read, the one cent shortfall signals very bad news. Management, moreover, has no choice but to account aggressively.

from closure of a line of business as they are incurred, not in advance, thereby giving an unvarnished set of earnings numbers from period to period.¹²⁰

The smart money and long-term investors will nod in agreement, but there will be differences in their profiles. The smart money sees through the ruse to the periodic cash flows, at least so long as the published reports give it an adequate basis for doing so. It is only hurt by cost of the analysis; but, because it is smart, it will do the analysis anyway. For example, from a smart money point of view, there arguably would have been nothing wrong with Enron's practice of pumping up its earnings numbers with results from sham transactions with Special Purpose Entities (SPEs), so long as Enron fully disclosed the transactions in the footnotes to its financials.¹²¹

The long-term investor, once situated in a stock, presumably will not be destabilized when management falls a couple of cents short of expectations in the current quarter. At the same time, earnings management, pursued in moderation, will not inflict any significant injury on this investor. In the long run, the empirical cash flow absolutely controls, and the long-run question is whether the company produces competitively. Therefore, the long-term investor would profess indifference to earnings management that manipulates earnings figures to suit the short-term interest.

Now cross over to the left side and assume a shareholder who buys a stock on a trend-chasing basis. The trend is that earnings are rising. The holding period is short or intermediate without a definite termination date. Given this profile, anything that might be hyped as bad news could be destabilizing, causing this shareholder to sell, thereby incurring tax and transaction costs. It follows that a little finagling to avoid the firm being short on its earnings projections will not be objectionable. Just by arranging the numbers, management protects the shareholder from herself and the manic nature of the market. A liquidity seller will be especially grateful for the income smoothing.

But, unfortunately, earnings management holds out some problems for left-side investors, even as they are its nominal beneficiaries. It works well only so long as management massages the

120. For a fuller explication of this point of view, see *infra* note 174 and accompanying text.

121. For a description of the Enron fraud, see Bratton, *supra* note 1, at 1314–34. The most shocking thing was that there was so little smart money. Basic points signaling distortions in Enron's financial presentation were in plain view. *Id.* at 1324–25.

numbers to protect an upward trend that responds by staying on trajectory for at least the intermediate term. Suppose that the upward trend stalls, causing management to draw down from the cookie jar to protect the slope of the line. There will be some shareholders who are influenced to hold who might otherwise have sold because of the stall. As to these investors, the income smoothing may or may not be beneficial. It will certainly turn out to be detrimental if events make clear that the upward trend stopped before the income smoothing. Once the trend turns down, the manipulation undertaken protectively becomes injurious. Indeed, all left-side investors' interests then presumptively lie in getting out in the first wave. Where the unvarnished truth prompts that sale, income smoothing injures the holder. The injury is even worse for the holder buying in reliance on the manipulated numbers at or after the turning point in the trend.

With earnings management, then, the left-side investor, to which management caters, could turn out to be an injured party. But the risk of injury becomes hard to see in a bull market.

B. Revenues, Costs, Aggressive Accounting, and the Incentives of Shareholders and Auditors

Cookie jar ruses lie on the benign end of aggressive accounting. In fact, the stock prices of companies announcing restatements respecting loss reserves have been known to go up when the restatement entails an increase in present earnings.¹²² Manipulations respecting revenue recognition and the taking of costs bear more directly on the quality of the earnings statement. Revenue overstatements make up the largest category of recent restatements, at 38 percent, with cost understatements coming in second at 16 percent.¹²³ These cases suggest a starker conflict between management and shareholder interests. The misstating manager looks more culpable, particularly given stock option exercises and stock sales prior to the restatement. At the same time, the restatement holds out more severe consequences for the shareholders: In the three-day period surrounding the restatement, an average of 10 percent of the restating company's market capitalization disappears.¹²⁴

122. GAO REPORT, *supra* note 4, at 23–24. The Report also shows that these restatements make up only a small percentage of the total from 1997 to 2002.

123. *Id.* at 19–20.

124. *Id.* at 24.

But even here, in the core territory of aggressive accounting and audit failure, the shareholder interest, viewed over time, does not unite against management and aggressive accounting. The manipulation need not even imply a cruel day of reckoning. A manager wanting to make her numbers for a quarter might do a little “channel stuffing”—loading up customers’ inventories with the company’s widgets to boost sales and earnings figures, inducing the stepped-up widget sales with discounts or easy credit.¹²⁵ The stuffing robs the later period of sales revenues. But there need be no day of reckoning if the next period’s sales growth suffices to make up for the stuffed sales. So long as moderation is exercised, then, this revenue enhancement device only smoothes the income trend. More extreme manipulations do hold out a day of reckoning, of course. This happened with WorldCom’s practice of capitalizing significant sums that should have been expensed.¹²⁶ Even with WorldCom, however, legions of shareholders who sold in advance of the date of full disclosure benefited mightily.¹²⁷

From the left-side point of view, then, aggressive accounting is problematic but not necessarily destructive. Even in extreme cases, the benefits and detriments depend on who is left holding the stock on the day of reckoning.

Consider a second statistic respecting restatements from 1997 to 2002: While 10 percent of listed companies announced restatements, causing each company on average a contemporaneous loss of market value of 10 percent, total losses due to restatements during the period only amounted to 0.02 percent of the market’s total capitalization.¹²⁸ Assuming that all aggressive treatments applied by companies from 1997 to 2002 will not be triggering later value-destructive

125. ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW 163 (2002).

126. WorldCom’s bankruptcy was triggered by the announcement that \$3.9 billion of costs of leasing other company’s networks had been capitalized rather than expensed. The (bogus) theory of justification was that the unused capacity under the leases was incurred in anticipation of future business. Jonathan Krim, *Fast and Loose at WorldCom; Lack of Controls, Pressure to Grow Set Stage for Financial Deceptions*, WASH. POST, Aug. 29, 2002, at A1. If we take WorldCom’s justification seriously, we get an innovative example of the new fair value accounting: The treatment entails estimating future cash flows and discounting them to a present value figure.

127. When a fraud maintains a stock price at an artificially high level over a period of time, the fraud benefits all shareholders who sell prior to its discovery, whatever their motivations as sellers.

128. GAO REPORT, *supra* note 4, at 26.

restatements, then, from a left-side point of view, the bottom line could be that the risks and returns of aggression vary with the case. Restating the point, a strategic cost-benefit analysis is more appropriate than a norm that prohibits aggressive accounting. Recall in this regard the most famous fraud of all—the sham swaps between Enron and its SPEs, entered into to paper over \$1 billion of income statement deductions stemming from portfolio losses.¹²⁹ A reader of the *Powers Report*, the product prepared by Enron's special committee investigation by independent directors, will see that the transaction structures failed because stock market reverses in 2001 exceeded the parameters of extensive stress tests run by Enron's experts.¹³⁰ Enron's cost-benefit calculation went wrong only because the market plummeted for unrelated, fundamental value reasons. Had the market performed according to expectations, however, the transaction structures need never have been the occasion for an accounting restatement. The scandal-triggering treatment, then, easily could have turned out a cost-benefit success. The wild card in these calculations is left-side shareholder demand, which follows the state of the market. Cost-benefit calculations accordingly shifted across the board after the market turned down in 2001, and the downside risks of aggression increased in magnitude.

This picture of risk-return tradeoffs also fits the auditing firms of the late 1990s. The firms, emboldened by decreasing risks of liability, reappraised the downside risk of audit failure.¹³¹ They acted out the relationship $PV = A/r$, stepping out of the low return modes of independence and conservatism and riding with the rising market. When a nonaudit consultant sells earnings management services, the transactional economics differ from those attending the sale of the same advice by the firm's auditor. The nonaudit consultant takes no formal responsibility for the consequences of its advice, and can walk away in the event of ex post scrutiny (subject to such derivative liability as the system attaches).¹³² The auditor, in contrast, makes a

129. See Bratton, *supra* note 1, at 1305–20, for a description of the transactions.

130. WILLIAM C. POWERS, JR. ET AL, REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 98, 103–04 (2002); Bratton, *supra* note 1, at 1316–18.

131. Coffee, *supra* note 10, at 25–30. For a description of the mindset of reporting managers, see Langevoort, *supra* note 11, at 1146–51.

132. Cases on investment banker opinions issued in connection with mergers assay the liability question. *Compare In re Shoe-Town, Inc. Stockholders Litig.*, C.A. No. 9483, 1990 Del. Ch. LEXIS 14, at *17–22 (Feb. 12, 1990) (holding that the special committee's investment

formal pronouncement on the firm's numbers, performing a necessary compliance function and staking its reputational capital on the numbers' quality.¹³³ Its gatekeeper role adds value to its consulting services. The accounting firms turned consulting into a premium business because they credibly could tie the consulting services to the audit endorsement.¹³⁴ Such a premium, high-return service, carried an appropriately high risk for the auditor's reputational capital.

Viewed retrospectively, the cost-benefit appraisal may seem ill-advised, at least for Enron's auditor, the ill-fated Arthur Andersen firm. But *ex ante* things looked different. Andersen, acting in the left-side frame of mind of the 1990s, presumably appraised the risk with a view to the sky high market capitalizations of Enron and other clients. Like a left-side investor, it mistook that market value for fundamental value, no doubt telling itself new economy stories and other left-side claptrap then in circulation.¹³⁵ The prestige of the EMH also may have skewed the risk-return appraisal. If the market price reflects fundamental value, then one has little reason to factor heavily a downside projection of a marketplace full of left-side investors, market regulators, reporters, and prosecutors, acting out the unpleasant, vindictive behavior pattern that accompanies a rough downside shift. If fundamental value is there in the price, no collapse can occur. Meanwhile, the Final Four accounting firms pick up Andersen's clients even as they confront litigation and enforcement costs due to their own audit failures.¹³⁶ For these four firms, it is too soon to know whether the tradeoff of the 1990s proves detrimental or beneficial in the long run.¹³⁷

banker is not an agent of the shareholders), *with Wells v. Shearson Lehman/American Express, Inc.*, 514 N.Y.S.2d 1 (App. Div. 1987), *rev'd on other grounds*, 526 N.E.2d 8 (N.Y. 1988) (refusing to dismiss a complaint based on an agency theory).

133. HERWITZ & BARRETT, *supra* note 20, at 231–40.

134. Coffee, *supra* note 10, at 27–30.

135. For a summary, see BRATTON, *supra* note 39, at 168–70.

136. See Cassell Bryan-Low, *Who Are Winners at Andersen's Yard Sale?*, WALL ST. J., May 30, 2002, at C1 (“[O]ther firms are taking the risk that hiring lots of Andersen partners could end up bogging them down in legal-liability issues stemming from Andersen's botched audits of Enron Corp.”).

137. In cases where audit failure coincides with the collapse of the business, the left-side stockholder victims, who also believed that the fundamental value really was there, tend to see it two ways. Either they have been robbed or someone has defrauded them. In the case of Enron it was indeed the latter, but only to some extent. At Enron and across the exchange, much of the fundamental value never was there in the first place and the stock price eventually was going to collapse whether or not overstated earnings figures propped it up for extra time. The crisis of confidence accordingly is mostly a left-side crisis stemming from price declines due

C. Summary

On the upside, earnings management works beautifully and presently favorable market results have a way of validating business practices. In a bear market, however, left-side investors overreact to the bad news. They also do an about-face on earnings management, suddenly demanding unvarnished truth. What the left side approved, accepted, or did not question on the upside, it has excoriated since January 28, 2002. For a particularly stark example of this born-again conservatism, we can look not to an investor but to an economic theorist, Professor Michael Jensen. In 1978, Professor Jensen stated that “there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis.”¹³⁸ He went on to provide critical theoretical justification for the leveraged restructurings of the 1980s.¹³⁹ Then he put the 1990s on track with a famous argument for the productivity advantages of stock option compensation.¹⁴⁰ All three interventions found their way into the deep structure of theoretical support for the short-termism of the late 1990s. In 2002, Professor Jensen’s line changed abruptly:

Managers must be forthright and promise only those results they have a legitimate prospect of delivering, and they must be clear about the risks and uncertainties involved. They must dispel any air of unreality that settles over their stock and highlight what they cannot do as readily as they trumpet their prospects

Managers must recognize that an overvalued stock can be damaging to the long-run health of the company¹⁴¹

Graham and Dodd could not have put it better.

to the absence of fundamental value. See GAO Report, *supra* note 4, at 26–30 (discussing surveys of investor confidence). Audit quality is a secondary matter.

138. Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978).

139. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323–25 (1986). (“[G]oing private and leveraged buyout (LBO) transactions . . . are creating a new organizational form that competes successfully with the open corporate form because of advantages in controlling the agency costs of free cash flow.”). *Id.* at 325.

140. Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 261–62 (1990) (showing that executive pay is insufficiently sensitive to performance).

141. Fuller & Jensen, *supra* note 118, at 45.

III. THE SHAREHOLDER BENEFICIARY AND THE CHOICE OF TREATMENT

All sides now join in the call for a return to probity in reporting and audit practice. The job of bringing this about and reforming the auditor-client relationship goes to the new Public Company Accounting Oversight Board (PCAOB) established by the Sarbanes-Oxley Act,¹⁴² along with the audit committees of the various boards of directors.¹⁴³ This Part considers whether the PCAOB and the audit committees feasibly can make normative choices about accounting treatments and audit practice by reference to a shareholder beneficiary.

Section A poses a hypothetical choice between three different accounting treatments and searches for a shareholder model that provides a point of reference for a gatekeeper charged with determining the correct accounting treatment. Four alternative models are proposed: the smart money shareholder, a firm-specific composite shareholder, a constituency model, and the fundamental value investor. None proves adequate taken alone; conflicts with investor protection policies also arise. But a plausible composite model emerges from the combination of the fundamental value investor, with its preference for conservative treatments, and the dumb money investor, with its need for paternal protection. Such a model would receive general approval in the present political context. Section B asks whether a continuing basis of support can be projected for this model, answering in the negative. So long as shareholder capitalism prevails, managers will remain vulnerable to left-side demands. Management will always prefer an auditor with a reputation for flexibility respecting aggressive treatments and avoid an auditor with a reputation for conservative probity. It follows that even if we could derive a set of conservative instructions, it would have to be imposed by regulation.

142. See Sarbanes-Oxley Act of 2002 § 103(c), 15 U.S.C.A. § 7213(c) (West Supp. 2003) (“The Board shall cooperate on an ongoing basis with professional groups of accountants . . . and advisory groups . . . in the examination of the need for changes in any standards subject to its authority . . .”).

143. See *id.* § 301, 15 U.S.C.A. § 78j-1 (mandating audit committees made up of independent directors and with power to engage independent outside advisors).

A. *Modeling the Auditor's Shareholder Beneficiary*

Hypothesize a firm with a choice of three accounting treatments: Under Number 1, this year's earnings are \$1,000,000,000; under Number 2, earnings will be \$1,050,000,000; and under Number 3, earnings will be \$950,000,000. All are either clearly GAAP or can be defended in good faith as GAAP.¹⁴⁴ Where do management and the auditor go for a norm or rule that instructs them as to the choice among the three treatments?

Three alternatives present themselves in short order. First, GAAP has a norm that signals treatment Number 3¹⁴⁵—an accounting convention termed “conservatism.”¹⁴⁶ For present purposes, the conservatism convention sends a simple message: when in doubt, understate. To the extent one understates when in doubt, there remains little room for aggressive accounting. The convention, however, is not mandatory.¹⁴⁷ Absent a clear instruction from GAAP, the second alternative must be considered: to leave the choice among the treatments in the envelope of management's business judgment. But if one lacks confidence in management's incentives respecting the choice, and one does in 2003,¹⁴⁸ then one turns to a third alternative: return to GAAP and revise it so as to narrow the range of choices.

The question is whether the shareholder interest holds out a fourth alternative: Can one look to the interests of a shareholder

144. It is not unrealistic to hypothesize \$100,000,000 of running room. Under audit practice in the 1990s, management got an automatic 5 percent leeway under a rule-like application of GAAP's materiality principle. Arthur Levitt objected. Levitt, *supra* note 115, at 4–6. He had a good point. If being one cent short on one's numbers meant a 10 percent stock decline, then a *per se* 5 percent noncompliance allowance was likely to have manipulative results. The SEC intervened. See Securities and Exchange Commission, Staff Accounting Bulletin No. 99, 17 C.F.R. pt. 211, subpart B (2003) (amended Aug. 12, 1999) (“[P]rovid[ing] guidance in applying materiality thresholds to the preparation of financial statements filed with the Commission and the performance of audits of those financial statements.”).

145. Assuming that the choice among the three treatments implicates no issues of balance sheet conservatism. See *infra* notes 173–176 and accompanying text.

146. HERWITZ & BARRETT, *supra* note 20, at 67–71, term this a “modifying convention[,]” distinguishing it from accounting's collection of seven more fundamental principles. Conservatism is summed up in the accountants' adage: “[A]nticipate no profits but anticipate all losses.” Sudipta Basu, *The Conservatism Principle and the Asymmetric Timeliness of Earnings*, 24 J. ACCT. & ECON. 3, 7 (1997) (quoting JAMES H. BLISS, *MANAGEMENT THROUGH ACCOUNTS* (1924)).

147. HERWITZ & BARRETT, *supra* note 20, at 71, describe conservatism as a “practical consideration[.]” to be drawn on in interpreting and applying accounting principles.

148. For a thorough presentation of incentive problems leading managers to favor inaccurate treatments, see Lucian Ayre Bebchuk & Oren Bar-Gill, *Misreporting Corporate Performance* 7–33 (June 2003) (unpublished manuscript, on file with the *Duke Law Journal*).

beneficiary for instructions as to the choice among Numbers 1, 2 and 3? To answer the question in the affirmative is to model the auditor's professional duties in the framework of an agency relationship. But, depending on how one models the shareholder, the firm, and the stock price, one can elicit at least four possible sets of instructions.

1. *Irrelevance: The Smart Money as Beneficiary.* The EMH holds out a distinct notion of the shareholder when it asserts that right-side, smart money shareholders determine the market price.¹⁴⁹ From this point of view, the choice of treatment is irrelevant so long as management discloses enough information to make the preparation of the books transparent to the smart money. With full disclosure, the smart money can translate the accounting numbers back into appropriate net cash flow projections. It follows that under these conditions accounting treatments never result in market manipulation.¹⁵⁰

This irrelevance story becomes less persuasive as one looks at the left-side interest and interpolates noise into the picture of the market price. With noise in the price, the choice of treatment does have market value implications (if not necessarily long-run fundamental value implications). As a backstop, the EMH proponent can assert an intermediate view that admits the noisiness of prices but nonetheless suggests that one structure market regulation *as if* the story told in orthodox financial economics was true. The notion is that noise traders will in the long run be pushed toward rationality if the regulatory structure treats them as if they were well-informed rational actors. Restating, even though the markets are like jungles, they are better left unregulated. Paternalism only protects the dumb money unproductively. Better to let it learn its lesson and smarten up or be ground under by the heel of history.

To accept this view is to dismiss Sarbanes-Oxley's PCAOB and rely on a long-term market corrective. Even if one does that, this "as if" heuristic does not hold out instructions as to the choice among treatments. It merely returns one to the EMH position, which

149. See *supra* notes 84–86 and accompanying text.

150. This point of view was once taken very seriously. See, e.g., Ray Ball & Philip R. Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. ACCT. RES. 159, 174–76 (1968) (arguing that the market anticipates the bulk of annual accounting numbers); Eugene E. Comiskey, *Market Response to Changes in Depreciation Accounting*, 46 ACCT. REV. 279, 284 (1971) (showing higher earnings due to rule change did not move stock prices).

instructs that the decision is irrelevant so long as the smart money can see it.¹⁵¹

2. *The Real World Shareholder as Beneficiary.* Alternatively, under a sociological approach, a profile of the real-world shareholder would be derived, firm by firm.¹⁵² Management (and by extension the auditor) would do a survey of the shareholder population to find out the kind of clientele attracted by the firm. A high-water dot-com presumably would have a clientele of volatile noise traders looking for easy money, whereas a boring but solid company like Proctor & Gamble would have a more fundamental-value-oriented group of holders. But this approach suffers from intrinsic limitations. By modeling the beneficiary on the mean investor you leave out the outliers. Alternatively, some companies could have bipolar groups. Even if one derived a profile, the makeup of the group could change over time. Or, more likely, with today's complicated holding patterns, an investor profile will be hard to ascertain in the first place. On consideration, then, this approach does not seem helpful.¹⁵³

But if the inquiry is redirected to the firm and away from the investor, there emerges a sharper notion of the role for regulation. Now the idea is that each firm makes disclosures about its financial reporting philosophy and operative policies in advance and hews to the profile over time. Conservative and aggressive firms thus separate themselves by profile and auditors sign off annually on the accuracy of the description. The shareholders then sort themselves out as they may.¹⁵⁴ To the extent the particular holder deems a particular reporting approach material, she adjusts her portfolio accordingly.

151. It is noted that the EMH model of the shareholder dovetails with a strong reputational model of auditor incentives. This view has informed case law to the effect that auditors are highly unlikely to participate in client frauds. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (“An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work.”).

152. For an example of thinking along these lines, see HAROLD BIERMAN, JR. & SEYMOUR SMIDT, *THE CAPITAL BUDGETING DECISION: ECONOMIC ANALYSIS AND FINANCING OF INVESTMENT PROJECTS* 290–93 (3d ed. 1966).

153. The point follows from the economists’ view that shareholder preferences should not influence investment policy. For a summary of the literature, see Hu, *supra* note 95, at 287–88.

154. For analogous suggestions, see Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 108–29 (1980) (discussing disclosure of dividend policy). See also Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 992–98 (1991) (suggesting that corporations disclose their policies of “corporate speech” in advance).

The SEC's current proposal for disclosure of critical accounting policies follows this approach.¹⁵⁵

To the extent this approach enhances transparency, it results in a disclosure system better equipped for the EMH perspective described above. But the clientele theory articulated here differs significantly because it brings left-side shareholders within the group of actors to be protected by regulation.¹⁵⁶

3. *All Constituents as Beneficiaries.* A clear instruction could follow from the reconstruction of the fiduciary model to encompass all parties in interest in the firm. This entails replacing the shareholder value paradigm with a model that includes multiple beneficiaries—creditors, other contract counterparties, and employees as well as shareholders. This is a route to a conservative set of instructions. Lenders, having a limited or no chance for capital appreciation, do negative analyses looking to default risk.¹⁵⁷ On the downside, they look to hard asset values.¹⁵⁸ Firm application of the conservatism convention accordingly suits their informational interest.¹⁵⁹ In the standard picture, the employees are similarly risk averse. An ethical point of view, centered on avoidance of injury, also favors this approach.¹⁶⁰

155. See generally Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies, Securities Act Release No. 8098, Exchange Act Release No. 45,907, [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,638 (May 10, 2002) (to be codified at 17 C.F.R. pts. 228–29, 249) (covering assumptions behind highly uncertain estimates and disclosure of reasons behind the selection of treatments).

156. The new Regulation G, which requires issuers disclosing *pro forma* results to reconcile those results with GAAP numbers, is an example of this. The smart money takes the *pro forma* results for what they are worth; the dumb money gets fooled and needs protection. See generally Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8176, Exchange Act Release No. 47,226, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,816 (Jan. 22, 2003) (to be codified at 17 C.F.R. pts. 228–29, 244, 249).

157. GRAHAM ET AL., *supra* note 31, at 315–23.

158. *Id.* at 353.

159. Conservatism in accounting has been attributed to the bankers' interest. See QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Concepts No. 2, § 94 (Financial Accounting Standards Bd. 1980) (“Once the practice of providing information about periodic income as well as balance sheets became common . . . it also became evident that understated assets frequently led to overstated income in later periods.”).

160. Interestingly, the Supreme Court has approved this approach. In *United States v. Arthur Young & Co.*, 465 U.S. 805, (1984), it said: “The independent public accountant performing this special [public] function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.” *Id.* at 817–18. The Court held that the auditor may not claim an evidentiary privilege for workpapers. *Id.*

Unfortunately, this constituent-based conservatism is not politically correct as a matter of corporate law, nor, one suspects, in the view of many economists.¹⁶¹ Nor is it correct as a matter of contemporary securities law policy, which is moving away from accounting conservatism.

This move from conservatism follows from dissatisfaction with the historical cost principle, which exalts verifiability over real-world verisimilitude. When an asset is booked at historical cost, the original purchase price provides a verifiable source for its reported value.¹⁶² The problem comes years later when the verifiable figure understates the asset's economic value. Fair value accounting, in contrast, contemplates a later upward restatement of the asset's book value to reflect the higher market value, even where the higher market value has not been verified by a closing price in a trading market. Conservatism favors cost accounting over fair value accounting because fair value sacrifices verification, and verification is conservatism's bedrock. Indeed, the accounting literature describes conservatism as the requirement of a higher level of verification for good news to be booked as gain than for bad news to be booked as loss.¹⁶³

Contemporary opinion in the world of securities policy welcomes GAAP's steps in the direction of fair value treatments—most famously the acceptance of mark to market treatments respecting derivatives¹⁶⁴ and accounting for mergers.¹⁶⁵ In the case of derivatives, the booked amounts come from computer programs; in the case of mergers, the reporting company commissions a periodic appraisal. The theory in both cases is that fair value treatments produce more meaningful numbers because they follow from concepts and

161. Unsurprisingly, the leading statement of the shareholder primacy position in the legal literature was made by an economist. Oliver E. Williamson, *Corporate Governance*, 93 *YALE L.J.* 1197, 1207–15 (1984). There is a view in the accounting literature that conservatism is an efficient contracting technology, with verifiability being the key to the efficiency effect. See generally Ross L. Watts, *Conservatism in Accounting* (Dec. 16, 2002) (unpublished manuscript, on file with the *Duke Law Journal*), for a description and a literature summary.

162. HERWITZ & BARRETT, *supra* note 20, at 67–68, 70.

163. Basu, *supra* note 146, at 4, 7.

164. ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998).

165. GOODWILL AND OTHER INTANGIBLE ASSETS, Statement of Financial Accounting Standards No. 142 (Financial Accounting Standards Bd. 2001).

techniques of valuation practice.¹⁶⁶ The intended beneficiary is the left-side shareholder.¹⁶⁷ Because the exercise of translating accounting numbers to valuation numbers takes sophistication or, alternatively, resources, the move to fair value has a democratizing effect. But it also comes at a cost. The shift to fair value puts the whole system on a track away from conservatism and toward soft reported figures that build in management advocacy. Valuation, after all, is inherently uncertain. It remains to be seen whether the crisis of confidence chills further movement down this track on the ground that the risk of self-serving misstatement outweighs the benefits to left-side shareholders.¹⁶⁸

4. *The Fundamental Value Investor as Beneficiary.* Finally, the shareholder can be modeled as a right-side fundamental value shareholder.¹⁶⁹ This approach abandons the quest for a real-world shareholder model in the wake of a normative decision to seek guidance from financial conservatism.

But, having gone that far, some choices remain to be made. A question arises as to whether to model a fundamental value investor with a long-term time horizon, or to leave the time horizon open. Strong opinions can be expected to be heard on the matter. According to one school of thought, the shareholder value maximization norm dictates that no time horizon be mentioned,¹⁷⁰ leaving open a door for disinvestment and 1980s-style restructurings. An opposing school of thought argues for the long-term horizon so as to encourage capital investment.¹⁷¹

166. See Stanley Siegel, *The Coming Revolution in Accounting: The Emergence of Fair Value as the Fundamental Principle of GAAP*, 42 WAYNE L. REV. 1839, 1846–49 (1996) (discussing benefits and dangers of fair value treatments).

167. The smart money does its own valuations.

168. The SEC's post-Sarbanes-Oxley rules address the problem by requiring disclosure of assumptions in Management's Discussion and Analysis. About the Application of Critical Accounting Policies, Securities Act Release No. 8098, Exchange Act Release No. 45,907, [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,638 (May 10, 2002) (to be codified at 17 C.F.R. pts. 228–29, 249). For the argument that the audit crisis implies a let up in the movement to fair value, see Bratton, *supra* note 1, at 1352–58.

169. For a discussion along these lines, see Hu, *supra* note 95, at 290–91.

170. See *id.* at 355 (“[U]nder appropriate assumptions and in an idealized world, publicly held corporations can arrive at investment decisions which all shareholders would prefer without determining or taking into account the particular time or risk preferences of individual shareholders.”).

171. See Porter, *supra* note 97, at 7–8 (“Sustained private investment can not only improve the skills of employees, increase the capabilities of supporting industries, or upgrade the

The stakes change if one restricts the inquiry to the audit context. In the post-bubble environment, the short-term time horizon has a deservedly bad name in respect to reporting incentives due to the spectacle of managers hiding behind aggressive accounting while selling stock in advance of collapse.¹⁷² At present, therefore, most observers can be expected to opt for the long-term perspective concerning the fundamental value audit beneficiary.

Another decision that needs to be made concerns the inclusion in the beneficiary model of the smart money investor. Recall that the smart money seeks full disclosure only. To the extent the analysis behind the treatment is disclosed, the smart money can protect itself and need not worry much about the way the treatments impact the bottom line. In contrast, the dumb money will be bottom-line oriented, and thus, the choice of treatment matters a great deal to this shareholder. Thus, for purposes of overall confidence, it is better to address financial reports to both sides of the dumb-smart binary. Speaking roughly, this is the approach that informs the securities laws.

What signal is yielded by this combination of the long-term fundamental value perspective with protection of the dumb money? As to conservatism versus aggression on matters of revenue and cost recognition, one gets a strong conservative signal.

Two important caveats need to be entered, however. The first concerns fair value treatments. One can expect right-side interests to take verifiability more seriously than do contemporary securities regulators. A policy dispute therefore arises in respect to this accommodation of the dumb money.

The second caveat concerns cases where the conservatism bound up in the long-term fundamental value perspective comes into conflict with conservative accounting. Such conflicts arise when balance-sheet understatement means a sacrifice in income-statement accuracy. The conservative shareholder looks to an accurate income statement. A prominent line of accounting conservatism (and the creditor interest) opts for understatement of the balance sheet.¹⁷³ The loss reserves

sophistication of consumer demand, but also generates local 'externalities' . . . [which] play a crucial role in building competitiveness.").

172. Lawrence A. Cunningham, *The Sarbanes Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 934 (2003).

173. The classic case concerns cost accounting for assets. The cost cap means depreciation deductions are lower over the life of the asset. By implication, earnings are overstated. See

discussed in Part II provide an example of this conflict. The balance-sheet conservative anticipates the loss and creates the reserve, writing down the assets. As a result, losses are taken before their actual realization.¹⁷⁴ The income-statement conservative objects to this—to get an accurate picture of the income stream, the advance write-down treatment will need to be unwound and the losses recognized only upon incurrence. But this ongoing policy dispute amounts to a conservative family quarrel. Its outcomes imply tradeoffs rather than right or wrong answers¹⁷⁵ and entail no fundamental challenge to the conservative norm.

B. Market Correction versus Regulation

One emerges from the foregoing discussion positing a shareholder modeled from the right side and moving to conservative treatments. How deep and enduring is investor support for this approach?

Right-side shareholder support can be assumed. Left-side voices and management can be expected to resist this approach much of the time. But, given today's crisis of confidence, conservatism looks more welcome than usual to the left side. There should follow a shift of demand respecting audit practice, a shift bearing on current audits. Because shareholding entails a dynamic politics, however, the duration of this tilt toward conservatism needs to be projected.

A long-term projection would be risky. To see why, recall Arthur Andersen as it flailed in crisis. To regain a reputation for probity, it brought in Paul Volcker, a renowned financial conservative, as a sort of constitutional monarch.¹⁷⁶ Volcker surprised everybody by announcing that he was going to turn Andersen into the one conservative auditing firm.¹⁷⁷ Had Andersen's other problems not

AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 2 (1939).

174. See Watts, *supra* note 161, at 1 (“[T]he greater the difference in degree of verification required for gains versus losses, the greater the conservatism.”).

175. At present, income statement accuracy has gained the upper hand. See ACCOUNTING FOR COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES, Statement of Financial Accounting Standards No. 146 (Financial Accounting Standards Bd. 2002) (limiting loss reserves).

176. Janet Whitman, *Questioning the Books: Volcker Announces Members of Board to Study Andersen*, WALL ST. J., Feb. 28, 2002, at A4.

177. See, e.g., Devon Spurgeon & Cassell Bryan-Low, *Can Andersen Partners Keep Their Firm Alive?*, WALL ST. J., Mar. 29, 2002, at C1 (“[U]nder [Volcker’s plan] . . . the firm would

overwhelmed it, could it have prospered as a self-defined conservative firm? At first blush, one would think so. There is a right-side investor interest out there; no doubt there even are right-side managers. By hiring the auditor that always says no to aggression, conservative firms can send a credible signal to the markets about the reliability of their bottom lines and raise their stock prices. It has been argued that there is a market for such a firm, but that industry concentration precludes its emergence.¹⁷⁸ If there existed twelve or fifteen firms with the resources to audit large capitalization companies, rather than only four, things would be different.

Despite the concentration argument's strong logic, the auditor-client incentive structure supports a contrary picture. It is instructive to return to Andersen and Volcker and take a look at the reaction of the other four accounting firms. Until Volcker's announcement, they had stood in solidarity with Andersen. But when Volcker announced a conservative profile, they immediately and publicly separated themselves from Andersen.¹⁷⁹ Fear of loss of business to a reinvigorated Andersen does not appear to have been responsible. The other firms manifestly viewed the conservative strategy as a defection from a norm held among the group. Consulting rents provide the primary explanation, as usual; but the management interest may also be wielding a stick here, in addition to holding out the carrot of consulting rents.

Return to the shareholders in their left-right differentiation. Contemporary managers worry about the stock price. They have done so ever since the takeover battles of the 1980s destabilized the security of tenure they enjoyed during the postwar period.¹⁸⁰ Today, of course, management worries less that a low stock price means a takeover than it worries that a low stock price creates frictions in its relations with the institutional investors who have become empowered actors in corporate politics. The institutions want results and have tools to register public disapproval when results are not

shed all of its nonauditing businesses, among other steps to avoid any future conflicts of interest that would undermine audit integrity.”).

178. See John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1414 (2002) (“[I]n a market this concentrated, implicit collusion develops easily.”).

179. Michael Schroeder & Greg Hitt, *Questioning the Books: Big Accounting Firms Break Ties with Andersen to Resist Charges*, WALL ST. J., Mar. 4, 2002, at A10.

180. William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1517–25 (1989).

forthcoming. Any such expression of public disapproval by a significant voice in the financial community destabilizes the institutional environment of the CEO and the top team.¹⁸¹ These shareholder value opinion-makers may be well educated in the difference between noise and fundamental value and otherwise fit the right-side profile. Yet recent experience suggests that they can tip the political scales to the left.¹⁸² Many agents in the world of investment institutions worry about their quarterly bottom lines and having their portfolios judged against those of comparable funds.¹⁸³ They must watch what moves the market, as opposed to watching long-term fundamentals. This puts them in the thick of the noise.

Now return to the hypothetical's treatments Number 1, 2, and 3. In an unstable institutional environment, it makes no sense for management to engage an audit firm possessing a powerful reputational incentive to refuse to give its opinion when management chooses Number 2, overstating its earnings. The \$100,000,000 spread at issue could figure importantly in respect to the top team's reputation amongst the institutions. Managers, even managers conservatively disposed, will want the flexibility to cater to the left side. In the hypothetical, since all the treatments are GAAP, managers can cater to the left with aggressive earnings accounting without a risk of audit failure and restatement.¹⁸⁴

A risk of audit failure easily can be introduced by changing the facts of the hypothetical. Now Number 2 is an innovative, aggressive treatment that follows from a highly constructed theory of revenue recognition.¹⁸⁵ Number 2's adoption in 2003 seems unlikely. But the left-side preference as between conservatism and aggression will be

181. William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1911–14 (1995).

182. SHLEIFER, *supra* note 81, at 181–83. *See also* Lakonishok et al., *supra* note 68, at 1575–76 (demonstrating “the preference of both individual and institutional investors for glamour strategies and . . . avoidance of value strategies”).

183. SHLEIFER, *supra* note 81, at 181–83.

184. Presumably, a manager rationally would opt for low audit quality even if the market penalizes the stock price so long as the penalty is lower than the cost to management of hiring a conservative auditor. Empirical studies show strongly that the big accounting firms produce higher quality audits. *See, e.g.*, Connie L. Becker et al., *The Effect of Audit Quality on Earnings Management*, 15 CONTEMP. ACCT. RES. 1, 5–8 (1998) (summarizing the literature). The proposition here is that no incentives operate to push any one of the big firms to a higher level within the group.

185. *See supra* note 126 (describing WorldCom).

dynamic in time. So it still makes no sense to box oneself in with an inflexible, conservative auditor.

Expanding shareholder empowerment, supposedly the great governance achievement of this era, implies that the management will always want an auditor with a reputation for flexibility. Even if conservatism makes sense this year, it may be the last thing management wants next year to the extent the choice of treatment follows shareholder demands. There results a problem for the flexible auditor in the form of a risk of audit failure. That presumably is why the Final Four audit firms feared the contrast a conservative Andersen would have afforded and why they have lobbied for PCAOB to pursue a cooperative, rather than adversarial, regulatory strategy.¹⁸⁶

From a fundamental value and long-term point of view, it follows that the PCAOB should be aggressive in its review of accounting treatments.¹⁸⁷ Management's zone of discretion in applying GAAP needs to be contained. Auditors who fail to impose appropriate treatments need to be disciplined. This Article's Conclusion considers the conceptual framework in which these constraints will be imposed, suggesting that leaving the shareholder beneficiary out of the framework will make for a smoother road going forward.

Before considering the regulatory framework, a deregulatory, spontaneous-order argument should be noted. It is said that accounting has become consistently more conservative across the twentieth century, primarily as the result of pressure from contract counterparties needing verifiable financial information. Empirical studies support the assertion.¹⁸⁸ The problem for the resulting deregulatory argument is that the long-term trend toward conservatism appears to have ceased in the face of the vigorous shareholder interest of the 1990s. Other studies in the same literature show marked increases in conservatism resulting from increases in the

186. See Bratton, *supra* note 9, at 1033–34 (describing the scandal surrounding Harvey Pitt's naming of William Webster as PCAOB chair).

187. Alternatively, the structure of auditor engagement could be changed radically. Under the leading proposal, companies would purchase insurance against losses due to accounting failure and publicize the terms of the insurance; the carrier would then engage the auditor. Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited*, 8 STAN. J.L. BUS. & FIN. 39, 48–53 (2002).

188. The presence of conservative practice has been documented extensively. See, e.g., Basu, *supra* note 146, at 11–31 (showing reports to be more sensitive to bad news).

scope of auditor liability.¹⁸⁹ Given the present crisis, this literature accordingly has no compelling negative implications for regulatory policy.¹⁹⁰

IV. CONCLUSION

To the extent that auditors, audit committees, and the PCAOB must model a shareholder beneficiary, they should by all means model a long-term fundamental value investor, or, depending on the issue, model dumb money in need of the protection of a conservative authority figure. But it is not clear that the occasion for modeling need arise at all. Consider these sentences from Chief Justice Burger's opinion in *United States v. Arthur Young*:¹⁹¹

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 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.¹⁹²

If the auditor's public responsibility transcends its client relationship, it follows that reference to a shareholder beneficiary holds out a constant possibility of compromising independence.

A positive law approach that dispenses with the model of the beneficiary and takes the auditor out of an agency role provides an alternative. Under this approach, the auditor comes to the client as an independent contractor under a legally mandated contract,¹⁹³ and the auditor comes to the mandated contract as the representative of the accounting system. Its professionalism derives from the system rather

189. For both the theory and a summary of the empirical literature, see Watts, *supra* note 161, at 1–3, 15–26. The institutional history of the accounting profession and of regulation of the profession also should be cited. O'Connor, *supra* note 24, at 6–9, shows that federal securities laws are responsible in significant part for the profession's growth and consolidation.

190. It also should be noted that the assertion here—that management will want to keep its options open and will hire an accommodating auditor—is not inconsistent with the proposition that marketplace demands can mean an increase in conservatism over time.

191. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

192. *Id.* at 817–18.

193. See Securities Act of 1933 sched. A, item 25, 15 U.S.C. § 77aa (2000) (requiring an independent public or certified accountant to file a detailed balance sheet of the issuer); Securities and Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1 (2000) (outlining the procedures an independent public accountant must follow when auditing an issuer in order to properly investigate and report illegal activities).

than from the client relation. Its fidelity also goes to the system—to the rulebook—rather than to the shareholders. Firms are managed for their shareholders. Numbers can be reported for their own sake.

This positivist approach puts an academic gloss on the most basic rule in the auditing profession's ethical canon: The auditor is not to hold the client's stock.¹⁹⁴ Even so, it can be questioned under a line of criticism currently circulating respecting GAAP. The critics charge that GAAP has failed as a jurisprudence because it relies too heavily on rules. The rules, it is said, are manipulated by managers, auditors, and consultants toward the end of reports that misstate economic reality. A principles-based system, as presently offered in International Accounting Standards, would be superior because it would be less manipulable.¹⁹⁵ This criticism prompted section 108(d) of the Sarbanes-Oxley Act, which orders a study of principles-based accounting.¹⁹⁶ If the criticism is well taken then a positivist framework for articulating auditors' duties makes little sense and only exacerbates the problem.

There can be no denying that practitioners often take advantage of GAAP's rule structures when they design aggressive treatments. Regulatory arbitrage—the practice of structuring an inappropriate transaction so it stays just within the bounds set by a rule¹⁹⁷—clearly has been widespread. But these rule-based aggressive treatments, which tend to involve structured finance, leases, and (until recently) pooled mergers, do not show up in large numbers on the list of recent restatements.¹⁹⁸ The reason is that the rules make the treatments compliant with GAAP, even as many observers disapprove of the

194. 17 C.F.R. § 210.2(c)(1) (2003).

195. For a summary of the debate, see Bratton, *supra* note 9, at 1045–47.

196. Sarbanes-Oxley Act of 2002 § 108(d), 15 U.S.C.A. § 7218(d) (West Supp. 2003). The study, which has been released is broadly supportive of GAAP, even as it suggests that rules should not be articulated too finely and accounting principles can be better drafted. See generally OFFICE OF THE CHIEF ACCOUNTANT & OFFICE OF ECONOMIC ANALYSIS, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (2003), at <http://www.sec.gov/news/studies/principlesbasedstand.htm> (on file with the *Duke Law Journal*) (stating that imperfections arise when financial standards rely solely on principles or rules and recommending an improved system merely based on principles or objectives). This Article adds an additional point: However well drafted GAAP's rules and standards, they are likely to be misapplied by accountants beholden to the interests of managers and left-side shareholders.

197. Timothy F. Malloy, Regulation and the Compliance Norm 29–30 (Jan. 29, 2003) (unpublished manuscript, on file with the *Duke Law Journal*).

198. Nelson et al., *supra* note 5, at 30–31.

treatments.¹⁹⁹ Issues still arise for the Financial Accounting Standards Board (FASB), accounting's legislature.²⁰⁰ But the indicated course of action appears to be amendment of the rules to adjust their categories to yield reporting results that follow from the rules' operative principles.²⁰¹ A more fundamental jurisprudential issue concerning the relative desirability of rules and standards is not necessarily implicated. GAAP, moreover, operates in the very territory where a rule-based approach is most strongly justified: GAAP governs homogenous, recurrent situations where the actors need *ex ante* instructions and have incentives to invest in compliance.²⁰² An across-the-board shift to standards would make sense only if the costs of constant revision of the rules to keep up with unintended applications due to faulty drafting and regulatory arbitrage outweighed the benefits of advance specification. GAAP does not appear to lie anywhere near that level of dysfunction.

The restatements follow less from regulatory arbitrage than from strategic noncompliance—action under an interpretation of the law in conflict with the stated interpretation of the regulator.²⁰³ Neither rules nor standards prevent such conduct, and, as between the two, rules could even have the advantage in deterring it. Meanwhile, in every case of a restatement, GAAP by definition has proved adequate to the job of identifying the misstatement and providing corrective instructions. Under this analysis, the drafters of Sarbanes-Oxley were right in thinking that the absence of principles has contributed to the crisis but wrong in diagnosing the problem as legislative. This is not for the most part a problem concerning the relative merits of rules and standards in the drafting of statutes. It is instead a problem of professional practice in a regulatory system made up of both. It is the auditors who need to get back to principles, taking seriously

199. *Id.*

200. See HERWITZ & BARRETT, *supra* note 20, at 152–59 (explaining that the FASB continues to establish financial accounting standards and due process procedures for the entire economic community, not just public accountants).

201. The rule might be overinclusive; that is, it might bring inappropriate transactions into a given zone of treatment. A rule also might be underinclusive; that is, it might allow a transaction that should be included in a treatment category to be structured so as not to be included. Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 995 (1995).

202. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 571–77 (1992) (“[T]he greater the frequency with which a legal command will apply, the more desirable rules tend to be relative to standards.”).

203. Malloy, *supra* note 197, at 29–31.

principles already governing the reporting system and eschewing the interests of agency beneficiaries.

GAAP, despite the derisory story currently circulating, is not comprised solely of rules. It is a set of rules backed by a collection of general standards.²⁰⁴ Together, these make up a body of law that is as adequate for answering regulatory questions as any jurisprudence applied by the legal profession. But the two professions play very different roles when they apply law to fact. Where lawyers advocate for their clients, auditors in theory act more like the police and judiciary, applying the law to constrain their clients. Law-to-fact applications accordingly bear critically on their professionalism. Any departure from, or unprincipled application of, the rules in the interest of advocacy compromises the mission. It follows that the PCAOB will need to address the quality of the law-to-fact determinations auditors make in their reviews of management's treatments. In so doing, the PCAOB will face a difficult task of drawing a line between responsible applications of principles and irresponsible advocacy. If it is to succeed at this, the PCAOB too will have to take seriously the substance of GAAP.

A positivist concept of auditor responsibility does not hold out a silver bullet that solves the problem of audit failure. Cognitive limitations can impair audit quality even if the auditor has not been captured by the client's interest, whether conceived as the managers or the shareholders.²⁰⁵ An auditor believing herself to be true to the system can still be swayed by relational concerns.²⁰⁶ The point instead is that as between an agency model and the system, the latter provides the superior reference point for the pursuit of audit quality and the analysis of audit failure. With the system as that professional focal point, it is hoped that the professional accountability mechanism

204. For a survey of the general standards, see HERWITZ & BARRETT, *supra* note 20, at 67–72. For discussion of the rules–standards interplay, see Ronen, *supra* note 187, at 62–64.

205. Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 143–63 (2000).

206. For a discussion of self serving bias in auditors, see Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 96, 97 (2002).

indirectly triggers constraints on the discretion managers exercise in the choice of treatment.²⁰⁷ The shareholder will still have to be modeled, but by the system's legislature rather than its practitioners.

207. For a stronger variation on this theme, see Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375, 417–19, 424–30 (1975) (arguing that either accounting principles must be drafted so narrowly as to denude management of significant discretion in selection or the auditor should make the selection).