The Mother of All Conflicts: Auditors and Their Clients
Kaplan, Richard L
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The Mother of All Conflicts: Auditors and Their Clients

Richard L. Kaplan*

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I. INTRODUCTION AND CONTEXT

From 1980 through 1991, I taught a semester-long course entitled "Accounting Issues for Lawyers." I dropped the course for several reasons, the most pertinent to this Conference being a concern that financial statements were so meaningless that lawyers did not really need to be all that familiar with their interpretation. This was long before "special purpose entities" became the preferred way to hide corporate debt. This was long before corporate tax shelters became so commonplace that the tax expense on a corporation's income statement bears no discernible relationship to the corporation's financial net income. This was long before related party rules were disregarded with an

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* Peer and Sarah Pedersen Professor of Law, University of Illinois at Urbana-Champaign. This Article is based on a presentation at the Conference on "Evaluation and Response to Risk in Law and Accounting: The U.S. and EU," held on April 5, 2003 at the University of Illinois. I want to thank my colleague, Richard Painter, for organizing this conference and for inviting me to participate. I also thank the participants at the Conference, especially Professor Andrew Bailey of the University of Illinois Department of Accountancy, for their comments and reactions. The customary disclaimer of responsibility applies, probably with more force than is usually the case.

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abandon that would shame a televangelist. It already seemed that financial intermediation in general, and mutual funds in particular, had largely eliminated the need to scrutinize a company's financial statements directly. If financial statements did not matter, why bother learning how to read them? The world looks very different today, but this central point seems unchanged.

Actually, my disenchantment with financial reporting began many years earlier, when I worked as a junior auditor for one of the (then) Big Eight accounting firms. In that milieu, did we actively ferret out fraud? Did we seek to bring integrity to financial statements? Did we hold management's feet to the proverbial fire on the proper accounting treatment of corporate transactions? Not as far as I could see.

My world was a series of steps grandiloquently styled an "audit program," the primary purpose of which was to generate files of audit "workpapers" that looked like last year's workpapers. Moreover, the procedures for generating these workpapers were set forth with time budgets for each discrete step, often in increments as small as half an hour. Completing the assigned tasks within the specified time budget was absolutely critical. Exceeding the time allotted meant that the audit might run behind and "bust" the budget that was formulated when the quoted audit fee was determined. In that circumstance, the accounting firm might have to "eat" the excess costs. This the firm most certainly did not want to do, and auditors were regularly admonished about the critical importance of meeting the prescribed time budgets.

In the context of these time budgets, uncovering some squirrelly accounting treatment was an unwelcome and unrewarded experience. If further research or additional checking were required to resolve a problem, the auditor in charge of the fieldwork would fret that his (in those days, it was always "his") time budget would be "blown," and that his evaluation by the manager in charge of the audit would reflect such apparently incompetent stewardship. Such an eventuality could impact the "up or out" progress of his own career.

The staff auditor's situation was similarly precarious. Spending additional time to resolve audit irregularities put an unwelcome spotlight on one's competence and diligence. Self-doubt would inevitably rise: Why do *you* think that you are seeing something that your more learned predecessors (often including the senior auditor now in charge) missed in prior years, or did not find problematic back then? The predictable response was poor evaluations by the senior auditor, and a reputation as a "budget buster." Being so labeled meant that other seniors would ask that you not be assigned to work on their audits, since an inability to meet time budgets could jeopardize their own careers. Enough such requests, and you were soon re-entering the job market, this time as damaged goods.

Given this reality, what could a conscientious auditor do? Basically, there were two options. Option One would be to work the additional hours to resolve the issue but not record the extra time spent. This practice, known informally as "ghosting," meant that the time budget would be "met" on paper but would not reflect the actual effort expended.[1] The next year's time budget, in turn, would be based on this year's recorded experience. Current-year ghosting, therefore, meant that next year's auditors would face similar time

1. Famed ghosters often earned the epithet "Casper" after a then-popular cartoon character of the same name who was portrayed as a lovable "friendly ghost."

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pressures, because their predecessors had—apparently—been able to accomplish the assigned tasks in the time allotted.

This process of working additional hours but recording only the allotted time, had an immediate and personal consequence for the staffer—namely, nonpayment of the "ghosted" hours. After so many days/weeks of working until 9:30 or 10 p.m. while turning off the compensation clock at 5 p.m., the staffer inevitably concluded that there must be a better way. That better way was Option Two: see no evil, attribute audit irregularities to one's personal inexperience or ignorance, and move on. No one had to sidle up in a trench coat and offer enticements to disregard financial statement difficulties. The forces of selective perception usually did the trick.

Yet these lowest-level auditors are the first line of defense against corporate reporting chicanery. Problems missed or disregarded at this level generally fall off the accounting firm's radar screen. If financial inconsistencies are not flagged at this point, there may be nothing to be "passed up the line" for resolution by more experienced personnel.

Even more fundamentally, the accounting firm culture held that making trouble for a client was the road to professional oblivion. After all, the audit personnel who were the subjects of praise and admiration were the ones who earned the highest epithet: "He [still always "he"] knows how to keep clients happy." Experts in the intricacies of financial accounting standards were regarded with much less awe. Indeed, their principal utility seemed to lie in formulating hypertechnical rationalizations that would provide nominal compliance with "generally accepted accounting" precepts while enabling the client to do what it intended. That, apparently, was how you kept a client "happy."

Faced with this environment, I left auditing. I make no pretense to sainthood; after all, I transferred into tax work. Pushing the proverbial edge of the envelope was a prevailing ethos there as well, but creativity and professionalism were rewarded, not punished. Time budgets were rarely employed, and the fee charged reflected the effort actually expended and the result reached. Besides, the Internal Revenue Service was always there to challenge our conclusions and police our interpretations. No such watchdog existed in the audit area. Indeed, *we* were the watchdog, according to the Supreme Court in its famous decision in *United States v. Arthur Young & Co.*[2] Some watchdog! Selected, fed, and if necessary, put down by the very client we were supposed to watch. That is the essential conflict of interest that has pervaded the corporate accounting environment from the very beginning and that continues today. You do not get ahead by biting the hand that feeds you.

In the years since I left accounting, the difficulties presented by this fundamental ethical conflict have only worsened. Fees for nonaudit services often exceed the audit fee for any given client, and audit work is increasingly viewed as a "loss leader,"a necessary evil offered to enable the accounting firm to get its foot in the corporate door. Is it any wonder, then, that audits fail to uncover financial shenanigans or that when they are discovered, accounting firms have every incentive to gloss over the problem, to make it go away, to "fix it," in the charming phrase employed by one of my former supervisors? After all, making trouble for a client jeopardized not only the ongoing stream of audit fees, but also the potential for cross-selling tax, consulting and other services, all of

2. 465 U.S. 805, 818 (1984).

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which were more profitable than auditing per se.

In addition to these positive incentives to "finesse" accounting irregularities, there is the cult of the "business oriented" auditor—the auditor who wants to be seen as the corporation's advisor, not its disciplinarian. This cult began to develop when accounting firms started to advertise their services. At that time, the critical question became what to say in these advertisements. The typical answer was that the accounting firm in question was business-oriented, pro-active, and focused on solving business problems—in short, everything other than fastidious about auditing standards or the proper accounting treatment of corporate transactions. After all, to whom is an accounting firm's advertising directed? Certainly not the shareholders or investors, whose interests lie in checking what management tells them. And certainly not the general public that the Supreme Court seems to regard as the accounting firm's ultimate client. Rather, it is corporate leadership, the executives who determine which accounting firm to hire. Naturally, therefore, accountant pliability and identification with management are significant factors in making this determination, and the accounting firms' advertising reflects this.

Further reinforcing this transformation of watchdog into lapdog is the accounting firm's culture for partners. While the major accounting firms have thousands of clients, individual audit partners usually have only a dozen major clients, often fewer. In that circumstance, the partner in charge of the audit is almost desperate to keep *all* of the clients in his/her stable. Losing one client over accounting irregularities would be very bad indeed; losing two would constitute professional suicide. In other words, it matters little that the accounting firm is huge with hundreds of large clients. The individual audit partner has only a few. As a consequence, at the level where the most important decisions are made regarding financial statement disclosures, the balance of power lies with the client. So much for auditor "independence!"

And yet auditor "independence" is the only reason to require that public corporations be audited by outsiders. Preparation of financial statements can be handled by company staff just as readily as by outside personnel. But would we trust the results? Ah, there's the rub, the mother of all conflicts: the accounting firm is supposed to monitor, validate, and correct the financial results of a corporation that can just as easily make the accounting firm go away by firing it!

Into this conundrum ventures the Sarbanes-Oxley Act of 2002 (the Act), promising to ameliorate this essential conflict. More specifically, the Sarbanes-Oxley Act responds to three major problems with the existing paradigm:

1. Auditing firms have become too cozy with corporate management to provide an "independent" check on management's abuse of corporate financial reports.

2. Auditing firms have further compromised their independence by offering nonaudit services to audit clients.

3. Audits have failed to uncover colossal frauds and major financial misstatements.

The remainder of this Article examines these three major problems and evaluates the corresponding responses of the Sarbanes-Oxley Act.

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II. Checking Management Abuse of Financial Reports

A. The Dilemma of Auditor Coziness

By its very nature, corporate management has strong tendencies to manipulate financial statements. Managers want to show the positive contribution that they have made to the corporate enterprise's operations. In more recent times, corporate management has had very substantial *personal* financial reasons to do so as well. The proliferation of managers' compensation formulae that are tied to corporate financial performance measures, exacerbated in many cases with munificent grants of options on the corporation's stock, make managers keenly interested in their corporation's financial statements. Too keenly interested, in fact, to simply let the financial chips fall where they may. Instead of standing passively by, modern managers act affirmatively to "manage" the results shown on their corporation's financial statements. Indeed, the very phrase, "to manage earnings," suggests that management is actively engaged in determining what goes into a corporation's financial reports.

Against these natural tendencies of management, public accounting firms are supposed to provide an "independent" check on attempts to manipulate a company's balance sheet and income statement. Yet, the preceding Part of this Article described some of the countervailing features of the auditing environment, not the least being the ability of corporate management to fire the auditing firm outright. This control by management over the financial status of the auditing firm is capsulized in the familiar joke about the corporate official interviewing two accounting firms and asking each of the partners, "How much is two plus two?" The first firm's partner said "four," but the second firm's partner replied, "What number did you have in mind?" The second firm won the client.

This context notwithstanding, auditing firms are charged with checking management's abusive proclivities and blowing the proverbial whistle if necessary. No less an authority than the United States Supreme Court described the role of public accounting firms as follows:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[3]

That is the charge that public accounting firms have accepted. It is certainly not an easy undertaking, but it remains the *raison d'être* of the legal requirement that public companies be audited. If the auditors are not willing to "maintain total independence from the client at all times,"[4] as the Supreme Court put it, there is no reason to have the

3. *Arthur Young*, 465 U.S. at 817-18 (emphasis in original).
4. *Id.* at 818.

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audit at all.

But as the preceding Part showed, the task of "maintain[ing] total independence from the client" faces a variety of institutional and cultural obstacles.[5] The pressure to please every client when an individual partner has only a few major clients is immense. And an accounting firm that seeks to grow will commonly try to raid other accounting firms' client lists. In doing so, it often agrees to provide the audit for an artificially reduced fee, a practice that is sometimes called "lowballing."[6] Since the audit of a new client typically entails *additional* work of a one-time nature, the auditing firm will almost certainly lose money on this audit engagement in the first year, and perhaps in later years as well. In that context, the auditing firm faces enormous economic pressure to keep the client. In effect, the firm has "invested" or sunk significant resources in the new client relationship in the form of unbilled hours, so the firm must retain this client to make this investment pay off. Woe be the partner who jeopardizes that client relationship before the written-off billings have been recovered from future years' audit fees.

Add to this economic pressure certain psychological tendencies to shade assessments in favor of a fee-paying client. As one commentary described the auditor's quandary, "When people are called upon to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self-interest."[7] Consequently, auditors are prone to bias their conclusions to best preserve the client relationship that pays their bills, hardly a ringing endorsement of the cherished "independence" concept.

Beyond these structural difficulties, the dilemma of auditor coziness is often made still more troublesome by burdens that the accounting firms willingly assume. One particularly egregious example involved the accounting firm of Ernst & Young and its audit client, PeopleSoft.[8] Ernst & Young and PeopleSoft developed and marketed a software product together. The name of this product clearly indicated the joint nature of the undertaking: "EY/GEMS for PeopleSoft." Ernst & Young even paid royalties to PeopleSoft ranging from fifteen percent to thirty percent, with a guaranteed minimum royalty of $300,000. The two companies shared customer information, leads, and "target accounts," and had links to each other's web sites. They even held themselves out as "business partners." Throughout this relationship, Ernst &Young was PeopleSoft's "independent" auditor.

Come on now! Do we really need copious pronouncements on the finer points of auditor "independence" to conclude that an explicit business joint venture is an insurmountable impediment? The Securities and Exchange Commission found a clear violation in this case, but Ernst & Young continued to maintain that its "conduct was entirely appropriate and permissible."[9] Some auditors obviously need to recalibrate their

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5. *Id.*

6. *See* Max H. Bazerma et al., *Opinion: The Impossibility of Auditor Independence*, 38 SLOAN MGMT. REV. 89, 93 (1997) (discussing the impossibility of auditors remaining objective).

7. *Id.* at 91.

8. *In re* Ernst & Young, LLP, SEC Admin. Proc. File No. 3-10933 (Nov. 13, 2002).

9. *See E&Y Faces Independence Charges Over Relationship With Audit Client*, DAILY TAX REP. (BNA), Nov. 14, 2002, at G-11 (quoting the accounting firm's statement); *see also* Cassell Bryan-Low, *SEC Blasts Ernst Case as a 'Work of Fantasy,'* WALL ST. J., July 21, 2003, at B4 (SEC likens Ernst & Young's legal defense of its involvement with PeopleSoft to a Harry Potter novel).

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giggle testometer!

B. The Act's Response

The response of the Sarbanes-Oxley Act to the dilemma of auditor coziness focuses on accounting firm partner rotation and corporate hiring restrictions.

1. Partner Rotation

Section 203 of the Act declares that:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.[10]

The Securities and Exchange Commission (the Commission) has interpreted this awkward phrasing to require that the lead and concurring partners on a client audit must change after five years, and that they must avoid involvement with that audit for at least five years, a "time out" period in the Commission's charming lexicon.[11] The Commission, moreover, has extended the rotation principle to any partner who has "significant involvement" with the client, but the time parameters are different. Instead of rotating after five years and then having a five-year "time out" period, these partners must be rotated off a client every seven years and then face a two-year "time out" period.[12]

While these rules are certainly steps in the right direction, they are only baby steps. For example, what about the staff auditor just below the partner who has been on the client's audit team for the past four years? If she is promoted to partner, may she then serve as the "lead" partner on that client's audit for the next five years? Her level of responsibility has changed, to be sure, but the problem of not getting a fresh set of eyes on the annual audit remains.

Moreover, five years (let alone seven years) is simply too long in today's fast-paced business world. A relatively unknown company can become a financial powerhouse—at least on paper—much faster than was the case previously. Five years allows a dubious accounting practice to blossom into a major disaster, as some of the more recent financial meltdowns have so painfully demonstrated. Given the increasingly significant implications for investors of all types, especially employees in self-directed pension plans,[13] early detection of financial irregularities is critical. Accordingly, rotation periods

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10. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 203, 116 Stat. 745, 773 (2002) (codified at 15 U.S.C. § 78j-1(j) (2002)).

11. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6,006, 6,046 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01(c)(6)).

12. *Id.* These rules parallel requirements adopted on October 2, 2002 by the Institute of Chartered Accountants in England and Wales to the effect that the "engagement partner"—but not the reviewing partner—must rotate after five years, and that other key audit partners must rotate after seven years. *See* Patrick Tracey, *U.K. Increases Audit Partner Rotation to Five Years to Improve Impartiality*, DAILY TAX REP. (BNA), Oct. 4, 2002, at G-3.

13. *See generally* Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ.

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should never exceed two years.

In any case, these "musical chairs"-like requirements are all implemented within the *same* accounting firm. Little new perspective is being introduced, since the newly rotated-in partners would have academic backgrounds and training experiences similar to the partners being rotated out. Whatever accounting firm culture may have contributed to an unwillingness to challenge a client's financial statement decisions in the past is unlikely to produce a different viewpoint simply because the individual players have changed positions.

Consider for a moment the position of the new partner on the audit. To a large extent, this partner will necessarily be relying on the audit work performed by the staff person immediately below the partner level, especially if the client is in an industry in which the newly rotated-in partner has had little previous experience. She will, therefore, need to be "brought up to speed," or educated in the workings of her client, by the same person who has run the important below-partner work during the previous several years. She may ask some new questions, but the tendency to defer to the explanations of experienced staffers will be substantial.

Moreover, this new partner is probably succeeding a more senior partner as lead partner on the audit engagement. In many cases, that more senior partner may be an object of intra-office respect and admiration, perhaps even veneration. That partner may be the new partner's mentor, or have served in that capacity at some point in the newly assigned partner's career. Given this context, how likely is it that the new partner will challenge the conclusions of her predecessor? How willing will she be to "rock the boat," or to challenge a client's financial reporting practices that were condoned by the accounting firm in the past? Can she now contend that these practices have somehow morphed into unacceptable or unethical representations?

If the Act really wanted a new perspective, it should have required public corporations to switch auditing *firms* every few years. Then, it would have gotten a new perspective. Then, the new partner would feel comfortable challenging the work done previously. Then, an entire new *team* of auditors, and not just the final arbiters, would be examining the corporation's financial practices and procedures. Rotating only the lead and reviewing partners within the same auditing firm gets the client some new eyes, but those new eyes are still looking through the same glasses.[14]

And if, by some chance, those new eyes do raise questions about past practices, the auditing firm may simply reassign the questioner elsewhere and put some other partner in charge of this audit. After all, a long-term client relationship is far too important to be jeopardized by one "difficult" partner. A different partner, one who "better understands" the client, will take over instead. In this manner, long-term client relationships corrode the essential detachment that "auditor independence" requires. After decades of serving

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L. REV. 53 (2004) (analyzing recent trends in U.S. pension policy that shift the risk of retirement funding to individual employees investing on their own behalf).

14. The Act directs the U.S. Comptroller General to study "the potential effects of requiring the mandatory rotation of registered public accounting firms." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 207(a), 116 Stat. 745, 775 (2002). The report of this study was released on November 21, 2003 as U.S. GEN. ACCT. OFF., GAO-04-216 PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION (2003), *available at* http://www.gao.gov/new.items/d04216.pdf (last visited Jan. 29, 2004).

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as a corporation's auditor,[15] the accounting firm identifies with the client, substitutes trust for skepticism, and brags about the client to prospective recruits. The only effective way to counter this fatal "capture" is to rotate accounting firms according to some predetermined schedule. Merely rotating partners within the same firm is inadequate.

2. *Client Hiring Restrictions*

Section 206 of the Act provides that:

> It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service . . . if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position . . . was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.[16]

This provision attempts to address one of the many human dimensions of the audit process—namely, the propensity of client corporations to hire public accounting firm personnel to staff their own financial positions.

This practice is not really new or particularly unnatural. Many corporate audits require weeks, or even months, of "field work" during which the accounting firm's employees are working in the client's physical environment alongside the client's employees. They exchange stories, occasionally share meals, and regularly interact in producing the innumerable audit workpapers and explanations of financial irregularities that constitute much of the modern audit. During this process, corporate officials get to know the auditors on a fairly personal basis, and over the course of several years a certain comfort level frequently develops. Thus, when the corporation needs to fill a key financial position, the officials in charge may instinctively think of the accountants who have worked on the company's annual audit. After all, they are already familiar with the corporation's financial activities and have accumulated a certain amount of industry experience and expertise that would have real value to that client. Plus, the interactions of the audit process have enabled the corporate officials to assess the workability or "chemistry" of the auditors over a much longer period than the typical job search allows. Thus, many senior financial positions in corporations are occupied by people who formerly audited those corporations.

The naturalness of this phenomenon notwithstanding, the coziness that it inevitably implies is seriously deleterious to the concept of auditor "independence" and its correlative notions of objectivity and impartiality. How assertive, how demanding, how noncompliant will an auditor be if that same person is potentially a job candidate at the company that the auditor is purporting to audit? The adversarial nature that the word "audit" connotes when used in the context of an "income tax audit" seems totally lost if the client is a potential employer and one's behavior and attitude are being evaluated in that context.

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15. *See* U.S. GEN. ACCT. OFF., *supra* note 14, at 6 (stating "[t]he average length of the auditor of record's tenure . . . was about 22 years for Fortune 1000 public companies").

16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 206, 116 Stat. 745, 774-75 (codified at 15 U.S.C. § 78j-1(l) (2002)).

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Given this reality, the Act's one-year waiting period is not even an entire fig-leaf. It permits the wholesale employment of accounting firm personnel by corporate clients as long as the person in question was not involved in the client's most recent audit. The comfort level and mutual interactions described above occur over the course of several annual audits, not just one. Waiting one year is, therefore, not much of a restriction. Indeed, even the lead partner on the audit could be hired as chief financial officer of the corporate client once she has been "rotated off" that assignment for one year. The career of that partner could easily have included that corporation's audit for ten years or more in different capacities at the partner and pre-partner levels. But after a single year, that person has been cleansed—apparently—and is now eligible for employment at the most sensitive level within a corporation's financial structure. This is not even a fox guarding the chickens; it is a fox playing with the other foxes!

A recent audit scandal has highlighted yet another unseemly aspect of the auditor employment pattern: the corruption of the audit process itself. The HealthSouth Corporation engaged in a massive accounting fraud over several years that overstated profits by some $4.6 billion.[17] This gigantic overstatement was accomplished by fairly simple accounting entries, nothing terribly sophisticated, but the corporation's auditors, Ernst & Young, never detected the erroneous entries. Why not? Because the company was very careful to spread the misstatements among several different accounts, rather than plowing it into a single account where the overstatement would probably attract attention.[18] Company officials also monitored these transactions to ensure that they did not exceed the dollar threshold that Ernst & Young used to check year-to-year variations. In pulling off this scheme, it obviously helped that the chief financial officer of HealthSouth had worked as an auditor at Ernst & Young, the auditing firm for HealthSouth Corporation.[19] Incidentally, that person left the accounting firm in the 1980's,[20] so the one-year waiting period that the Sarbanes-Oxley Act requires[21] would not have precluded that official's employment as chief financial officer even today.

Clearly, the practice of hiring former employees of the auditing firm is inconsistent with the concept of "auditor independence." The Act's one-year rule is no remedy to the inevitable coziness and possible corruption that corporate employment—or even *potential* corporate employment—entails. Perhaps, a corporation should not be allowed to hire *any* personnel from its auditing firm, including people who did not work on its audits but who know some of the people who did and who are familiar with the firm's auditing practices and procedures. Corporations would still have an enormous pool of financial talent that they could tap—namely, employees of *other* accounting firms, both large and small. But at the very minimum, people who worked on a company's audit should not be employable by that company in any capacity, ever!

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17. Carrick Mollenkamp, *HealthSouth Accounting Woes Grow to as Much as $4.6 Billion*, WALL ST. J., Jan. 21, 2004, at B2; *see also* Deborah Solomon et al., *HealthSouth Faked Profits, SEC Charges*, WALL ST. J., Mar. 20, 2003, at C1; Evan Perez & Ann Carrns, *Surgery Partners of HealthSouth Mull Bailing Out*, WALL ST. J., Apr. 8, 2003, at B1.

18. *See* Jonathan Weil, *Accounting Scheme Was Straightforward But Hard to Detect*, WALL ST. J., Mar. 20, 2003, at C1.

19. *Id.*

20. *Id.*

21. *See supra* note 16.

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III. NONAUDIT SERVICES

The preceding Part dealt with the inherent conflict in private-sector auditing—namely, that accounting firms are to provide an "independent" check on the same corporate management that engages and possibly discharges them. This Part explores the impact on this conflict that is presented when an auditing firm provides nonaudit services to its client while also serving as the auditor for that client.

A. Impact of Nonaudit Services

The range of nonaudit services being offered by accounting firms is huge and ever-expanding. They begin with so-called "traditional" tax return preparation and consulting services and progress to more unusual services, such as inspecting client facilities for cleanliness and physical appearance. Seriously! HealthSouth actually engaged its auditing firm, Ernst & Young, to see if the "magazines in waiting rooms were orderly, the toilets and ceilings were free of stains, and the trash receptacles all had liners."[22] And that is just what has been revealed because of accounting scandals. Who knows what other services auditing firms provide their audit clients but are "below the radar" simply because the clients involved have not yet imploded?

In any case, the provision of nonaudit services to audit clients presents a special challenge to the concept of "auditor independence." Not that this is anything new, however. Indeed, some sixteen years ago, I wrote about this problem as follows:

> Although this tension may be inescapable, it has been compounded, unnecessarily in my view, by additional pressures willingly assumed by the accounting profession. The whole panoply of "consulting services," ranging from designing the accounting systems accountants will purport to audit to recruiting financial officers for their clients, undermines the appearance, if not the fact, of independence. Rendering such managerially oriented services to clients makes it too easy for the accounting firm to be identified with management—in the minds of the accounting firm as well as the financial statement's readers. If independence, a fragile concept under the best of circumstances, is to be maintained, accounting firms must refrain from providing such advisory services to audit clients.[23]

Since that time, the situation has gotten much worse. Billings for nonaudit services frequently exceed those for the audit itself, often by several multiples.[24] As a result, auditing firms are even more loathe to alienate a client over some "technical" financial reporting dispute. After all, millions of nonaudit service revenue may be at stake, in addition to the annual audit fee. This situation was described by the U.S. Senate Committee on Governmental Affairs as follows:

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22. Jonathan Weil, *What Ernst Did for HealthSouth*, WALL ST. J., June 11, 2003, at C1.

23. Richard L. Kaplan, *Accountants' Liability and Audit Failures: When the Umpire Strikes Out*, 6 J. ACCT. & PUB. POL'Y 1, 6 (1987).

24. *See* Cassell Bryan-Low, *Accounting Firms Earn More From Consulting*, WALL ST. J., Apr. 16, 2003, at C9 (discussing the ratio between audit and nonaudit services fees paid in 2002 by major companies such as American Express Co. to accounting firms such as Ernst & Young).

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> One of the major concerns about Andersen as the auditor of Enron has been that it did not exhibit sufficient independence and objectivity in discharging its responsibilities. In 2000, Andersen earned $52 million in fees from Enron. Less than half of that amount, $25 million, was for audit work; $27 million related to consulting services . . . . [I]t is difficult to comprehend how such large consulting fees could not have created a serious conflict of interest for Andersen.[25]

Indeed it is!

B. The Act's Response

The response of the Sarbanes-Oxley Act to the problem posed by nonaudit services is two-fold. Certain nonaudit services are banned, and others are permitted only if they are pre-approved by the corporation's audit committee.

1. Prohibited Nonaudit Services

Section 201 of the Act prohibits an auditing firm from providing the following eight categories of nonaudit services to an existing audit client:

> (1) bookkeeping or other services related to the accounting records or statements of the audit client;
> (2) financial information systems design and implementation;
> (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
> (4) actuarial services;
> (5) internal audit outsourcing services;
> (6) management functions or human resources;
> (7) broker or dealer, investment adviser, or investment banking services;
> (8) legal services and expert services unrelated to the audit.[26]

In addition, other services can be added to this list if a newly constituted rule-making authority so determines.[27] That new authority is called the "Public Company Accounting Oversight Board" (PCAOB) and is analyzed in the next Part of this Article. The PCAOB may also exempt, "on a case by case basis," any particular accounting firm from this statutory prohibition, if "such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors."[28] The Securities and Exchange Commission, however, can review such exemptions,[29] thereby providing further oversight.

In any case, accounting firms are still allowed to provide the nonaudit services

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25. STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., REPORT ON FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 28 (2002), *available at* http://www.senate.gov/~govt-aff/_files/100702watchdogsreport.pdf (last visited Oct. 21, 2003).

26. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(a), 116 Stat. 745, 771-72 (2002) (codified at 15 U.S.C. § 78j-1(g) (2002)).

27. *Id.* at 772 (adding 15 U.S.C. § 78j-1(g)(9)).

28. *Id.* § 201(b), 116 Stat. 745, 772.

29. *Id.*

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specified above to companies that are not their audit clients. The Act simply declares that such services may not be offered to *current* audit clients. This is clearly a step in the right direction, but only a step.

The critical issue then becomes which nonaudit services are not on the prohibited list, and the most significant of these is tax compliance and planning. Much ink has been spilled and many trees felled on the issue of whether providing tax services to an audit client so jeopardizes an auditing firm's independence that such services should be added to the Act's list of prohibited nonaudit services.[30] This issue was considered by three tax law professors in a letter to the Securities and Exchange Commission,[31] and that letter was signed by twenty-five of their colleagues, including me.[32] The thrust of that letter was that tax compliance and planning necessarily requires an accounting firm to act as its client's advocate, thereby violating one of the core elements of auditor independence.[33]

Consider, for example, an accounting firm that advises its audit client to classify certain expenditures in a way that minimizes the client's current-year tax expense. If the Internal Revenue Service subsequently challenges this classification scheme, what role will the accounting firm then play? The corporate client will quite naturally expect the accounting firm to defend the client's actions and to explain the classification scheme to the government—to act as an advocate for the client, in other words.[34]

Moreover, what will this accounting firm advise with respect to the tax liability account on the client's balance sheet? Can this firm really provide a dispassionate analysis of the expenditure classification scheme that the client adopted because of the accounting firm's recommendation? That is, can the accounting firm that promoted this scheme now require the client to set up a "reserve" to cover the scheme's possible future disallowance? Yet, an auditor in this situation must assess the likelihood that this expenditure classification scheme will be disallowed and the client's tax exposure increased accordingly. If the auditing firm cannot really make this judgment, then the client's balance sheet liability for taxes owed will be understated, perhaps dramatically. In other words, providing tax advice to an audit client necessarily requires the accounting firm to audit its own work, thereby violating another key element of auditor independence.[35]

This very point was raised by the former chief accountant of the Securities and Exchange Commission in an interview about audits of MCI, the successor to WorldCom, a company that overstated its profits by $11 billion before becoming the largest bankruptcy filing in U.S. history: "How is an auditor, who has told you how to avoid

30. *See, e.g.*, Mark A. Oates & Daniel L. Goelzer, *Auditor Independence, Sarbanes-Oxley, and Tax Services*, 54 TAX EXECUTIVE 404 (2002); Richard Y. Roberts, *The Sarbanes-Oxley Act of 2002 Does Not Prohibit Auditors From Offering Tax Services To Audit Clients*, 54 TAX EXECUTIVE 416 (2002); James P. Fuller et al., *The SEC's Auditor Independence Regulations: Tax Services Under Sarbanes-Oxley*, 55 TAX EXECUTIVE 117 (2003); Micah W. Bloomfield & Ian S. Shainbrown, *SEC Final Auditor Independence Rules Fall Short on Tax Services*, Daily Tax Rep. (BNA), Mar. 10, 2003, at J-1.

31. *Tax Profs Urged SEC to Take Tough Stance on Auditor Independence*, 98 TAX NOTES 765 (2003).

32. *Id.* at 768.

33. *See* S. REP. NO. 107-205, at 18 (2002) (discussing the potential conflicts of interest).

34. *But see* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6,017 (2003) ("accountants would impair their independence by representing an audit client before a tax court . . .").

35. *See supra* note 33.

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state taxes and get to a tax number, still independent when it comes to saying whether the number is right or not? . . . I see little leeway for a conclusion other than the auditors are not independent."[36]

Be that as it may, the Act does *not* include tax services on the list of prohibited nonaudit services. Congress apparently believed that tax services have traditionally been part of what accounting firms provide and saw less of a need to change the firms' business model so radically. But as Professor Linda Beale shows, tax planning services have morphed recently into much more aggressive activities that little resemble the "traditional" tax services of the past.[37] On that basis, therefore, tax services deserve another look and should be added to the list of prohibited nonaudit services.[38]

2. *Permitted Nonaudit Services*

For all nonaudit services not included on the prohibited list, the Act provides that such services, specifically including tax services this time,[39] can be offered to audit clients. There is one condition, however: These services must be "approved in advance by the audit committee" of the client corporation.[40] But these audit committees are given no guidance by the Act, other than a de minimis exception for nonaudit services that aggregate no more than five percent of the client's billings from the auditing firm in a given year.[41] Beyond this parameter, the audit committees are left on their own.

These audit committees, moreover, are often much less intimidating than their title might imply. They are comprised of members of the corporation's board of directors,[42] a group that has been noticeably lax in virtually all of the recent corporate accounting scandals. The Act does require that a corporation must disclose whether or not there is at least one "financial expert" on its audit committee,[43] but it does not require that the committee *have* such an expert. In any case, that person is just one member of the audit committee. Little wonder, then, that the director of investor protection at the Consumer Federation of America commented recently that "[a]udit committees are a slender reed to withstand the weight of the responsibility placed on them."[44]

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36. Jonathan Weil, *New Concerns Raised Over Independence of Auditor for MCI*, WALL ST. J., Jan. 28, 2004, at C1 (quoting Lynn Turner).

37. *See* Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. CORP. L. 219 (2004); *see also* Cassell Bryan-Low, *Accounting Firms Face Backlash Over the Tax Shelters They Sold*, WALL ST. J., Feb. 7, 2003, at A1.

38. *See* Auditor Independence and Tax Shelters Act, S. 1767, 108th Cong. § 2 (2003) (proposal to add services "for which a significant purpose is the avoidance . . . of Federal income tax" to the list of prohibited nonaudit services).

39. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(a), 116 Stat. 745, 772 (codified at 15 U.S.C. § 78j-1(h) (2002)).

40. *Id.*

41. *Id.* § 202, 116 Stat. 745, 772 (codified at 15 U.S.C. § 78j-1(i)(1)(B)(i) (2002)).

42. *Id.* § 2(a)(3)(A), 116 Stat. at 747; *see also id.* § 301, 116 Stat. 745, 775-77 (codified at 15 U.S.C. § 78f(m)(3)(A) (2002)).

43. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407(a), 116 Stat. 790. Any corporation that does not have a "financial expert" on its audit committee must disclose the reasons for that omission. *Id.* For this purpose, a "financial expert" is a person who has an understanding of generally accepted accounting principles and experience in the "preparation or auditing of financial statements of generally comparable" corporations. *Id.* § 407(b)(2)(A), 116 Stat. 790.

44. Cassell Bryan-Low, *Keeping the Accountants From Flying High*, WALL ST. J., May 6, 2003, at C1

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This reed is weakened still further by the Sarbanes-Oxley Act itself. The Act provides that "[t]he audit committee . . . may delegate to 1 or more designated members . . . who are independent directors of the board of directors, the authority to grant preapprovals" of nonaudit services.[45] In other words, a *single* member of the audit committee, who need not necessarily be that committee's "financial expert," can unilaterally approve any request by the auditing firm to provide whatever nonaudit services are not explicitly prohibited by the Act.[46] The only external check on this mechanism comes in the Act's requirement that corporations must disclose the approval of nonaudit services by their audit committees.[47]

Taking a different approach, the Securities and Exchange Commission requires that corporations must break out the fees that they pay their auditors for (1) audit services, (2) "audit-related" services, (3) tax services, and (4) other services.[48] But what are investors to make of this data? If the nonaudit service fees exceed the audit fees, should investors disregard the audit report and treat the financial statements as essentially unaudited? Should investors distinguish between situations where the nonaudit service fees exceed the audit fees by a small amount, say twenty percent, and where they are twice as large as the audit fees? If so, how? By treating the audit report as only half as reliable rather than four-fifths reliable? In that regard, does it matter if the bulk of those nonaudit service fees are categorized as "tax services"? Either the independent auditor's report provides a validation function, or it does not. It is hard to see how categorized fee disclosures usefully inform this process.

In summary, the Sarbanes-Oxley Act allows auditing firms to continue providing nonaudit services to audit client companies, other than the eight nonaudit services that the Act explicitly prohibits. All other nonaudit services, including tax consultation, must be approved in advance, but a single member of the audit committee can fulfill that function. The resulting fees must be disclosed and broken down by broad category, but otherwise, the detrimental impact of nonaudit services on auditor independence is unabated.

A better approach would ban the provision of *all* nonaudit services by auditing firms. These services can be obtained from all sorts of nonaccounting firms, but only accounting firms can perform a financial audit. And if the particular expertise of accounting firms cannot be obtained from other suppliers, at least prohibit corporations from obtaining these services from the same accounting firm that does their audit. Sixteen years ago, I noted the appeal of hiring different accounting firms to provide audit and nonaudit services as follows:

> [S]uch arrangements could *enhance* audit quality by putting the auditor accounting firm in the position of evaluating the work of its competitor, the nonauditor accounting firm. By aligning the interests of the auditing firm in this

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(quoting Barbara Roper).

45. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 202, 116 Stat. 745, 773 (codified at 15 U.S.C. § 78j-1(i)(3) (2002)).

46. These decisions must "be presented to the full audit committee at each of its scheduled meetings." *Id.*

47. *Id.* (codified at 15 U.S.C. § 78j-1(i)(2) (2002)).

48. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6,006, 6,048 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 240.14a-101(e)). On the difficulty of differentiating among these categories, see Michael C. Durst & Thomas H. Gibson, *"Audit" vs. "Non-Audit" Tax Services under Sarbanes-Oxley*, 55 TAX EXECUTIVE 474 (2003).

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fashion with those of financial statement users, the audit function would be reinvigorated rather than compromised.[49]

Under this approach, there is no need for a corporation's audit committee, however it is constituted, to be involved with the approval of nonaudit services. Nor will financial statement users need to puzzle out the significance of disaggregated fee disclosures, because the nonaudit services would be provided by firms *other than* the company's auditors. Instead of this substantive response to the independence problem that nonaudit services present, the Sarbanes-Oxley Act opted for procedural niceties with little real bite.

IV. Inadequate Audits

Ordinary investors are largely oblivious to the coziness that has developed between many auditing firms and their corporate clients. They accept the auditor's certification of the company's financial results at face value, without a thought about rotation of partners or of firms. They are similarly indifferent to the provision of nonaudit services by accounting firms to their audit clients, despite the corrosive effect of those services on the auditing firms' vaunted "independence" and reliability. But ordinary investors *are* acutely aware and absolutely flummoxed by the problem considered in this Part—namely, the inability of certified audits to ferret out accounting fraud before a corporation collapses.

A. Audit Failures and Accounting Fraud

If there is one factor that best explains why the Sarbanes-Oxley Act was enacted, it is the failure of certified audits to detect rampant and massive accounting frauds prior to a corporation's imploding. The Enron Corporation has become emblematic of this phenomenon,[50] but it was not the only, the first, or even the biggest of these calamities. In October 2002, the U.S. General Accounting Office issued a mammoth report with the prosaic title of "Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges."[51] This Report provides in-depth analysis of a mind-numbing parade of sixteen major audit failures, beginning with Adelphia Communications Corporation[52] and continuing through Enron[53] to JDS Uniphase Corporation,[54] MicroStrategy Incorporated,[55] Rite Aid Corporation,[56] Safety-Kleen Corporation,[57] Sunbeam Corporation,[58] Waste Management, Inc.,[59] and Xerox

49. Kaplan, *supra* note 23, at 6 (emphasis in the original).

50. *See generally* REBECCA SMITH & JOHN R. EMSHWILLER, 24 DAYS (2003), *excerpted in* Rebecca Smith & John R. Emshwiller, *'24 Days': Behind Enron's Demise*, WALL ST. J., Aug. 8, 2003, at C1 (detailing the fall of Enron).

51. U.S. GEN. ACCT. OFF., GAO-03-138 FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES (2002) [hereinafter GAO REPORT].

52. *Id.* at 117-24.

53. *Id.* at 144-51.

54. *Id.* at 157-62.

55. *Id.* at 163-70.

56. GAO REPORT, *supra* note 51, at 176-86.

57. *Id.* at 187-91.

58. *Id.* at 201-06.

59. *Id.* at 214-24.

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Corporation,[60] among others. Moreover, this Report was prepared before two of the largest financial implosions—namely, WorldCom[61] and HealthSouth Corporation[62]—came to light. While the specifics vary from case to case, the bottom line was the same: the certified audit failed to prevent serious financial misstatements before they became public.

Moreover, these calamities, as dramatic as they were, represented only the most prominent of audit failures. The GAO Report found no fewer than 689 financial statement "restatements" by publicly traded companies between January 1997 and March 2002.[63] The immediate loss to shareholders of the restating companies was estimated at $100 billion in lost market capitalization.[64]

The impact of this financial unreliability was much broader still. As the GAO Report explains, "[n]ot only do restatement announcements appear to affect company stock prices, but some evidence suggests that these announcements and the questions they raise about certain corporate accounting practices may negatively impact overall investor confidence."[65] Indeed, survey evidence shows that investor confidence in June 2002, one month before the Sarbanes-Oxley Act was enacted, "was at an all-time low due to concern over corporate accounting practices (even lower than the period just after September 11, 2001)."[66] Monthly surveys showed that 91% of respondents agreed that "[a]ccounting concerns are negatively impacting the market," and 71% believed that "[a]ccounting problems are *widespread* in business."[67]

These negative sentiments, moreover, relate directly to investment patterns. As the GAO Report explained, "[i]nvestors' confidence in their ability to accurately value their equity holdings relies upon the *accuracy of the information available*. If the information provided is not accurate, the reported income stream generated from holding company shares becomes more uncertain and the stock market investment riskier."[68] In response to their lack of confidence in the "accuracy of the information available,"[69] investors withdrew funds from the market. Indeed, mutual funds experienced a net outflow—*i.e.*, sales exceeding purchases—in July 2002 that "was the largest outflow on record at the time."[70] Clearly, something was amiss.

B. The Act's Response

The response of the Sarbanes-Oxley Act to the problem of audits that fail to audit was a restructuring of the accounting regulatory system. The central feature in this new structure is the Public Company Accounting Oversight Board, or PCAOB.[71] This

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60. *Id.* at 225-35.
61. *See* Cassell Bryan-Low, *WorldCom's Auditors Took Shortcuts*, WALL ST. J., July 28, 2003, at C9.
62. *See* Solomon et al., *supra* note 17.
63. GAO REPORT, *supra* note 51, at 5.
64. *Id.*
65. *Id.* at 32.
66. *Id.*
67. GAO REPORT, *supra* note 51, at 36 (emphasis supplied).
68. *Id.* at 40 (emphasis supplied).
69. *Id.*
70. *Id.*
71. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(a), 116 Stat. 745, 750 (codified at 15 U.S.C.

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distinctly non-governmental agency[72] is charged with several major responsibilities, but they fall into two general categories: (1) regulating the accounting profession itself via registration requirements and investigations, coupled with the imposition of "appropriate sanctions;"[73] and (2) establishing standards relating to "auditing, quality control, ethics, [and] independence."[74]

1. Regulating the Accountants

The idea that someone needs to audit the auditors is not new, and the PCAOB simply succeeds an existing peer review organization that had a similar name—the Public Oversight Board. This approach has not exactly been a screaming success. As summarized by Professor Larry Ribstein, "[t]he current system of peer review . . . obviously has not filled in the gaps, as indicated by the recent corporate frauds themselves and by the fact that *no major accounting firm has failed a peer review*."[75]

This result is almost inevitable, given the enormous size of the major accounting firms. Only an organization of comparable scope can hope to seriously monitor the auditing practices of such firms. Instead, the PCAOB will inevitably be limited to a fairly broad examination of the firms in question, an approach that is unlikely to ferret out the problematic decisions that auditing firms have made. Consequently, it is difficult to see what exactly the PCAOB brings to the enforcement table, especially given the more draconian processes of civil liability awards (via private lawsuits) and criminal sanctions (by the Securities and Exchange Commission[76] and the Justice Department) that already exist.

2. Setting Auditing Standards

In contrast to its role in auditing the auditors, the PCAOB's new authority to set auditing standards could literally change the accounting landscape. How it chooses to use this authority remains to be seen, of course, but the possibility of serious reform of what audits are supposed to do certainly exists.

For far too long, auditors have focused on accounting processes rather than assuring investors that no fraud exists. The typical formulation of the audit report states that a company's records were examined in accordance with "generally accepted auditing standards," or GAAS. But who sets these standards? The auditors themselves. Now, for the first time, a body not beholden to the private auditing firms will dictate what an audit is intended to accomplish. Instead of the all-accountant group that formulated GAAS, the

§ 7201, et. seq. (2002)).

72. *Id.* § 101(b); *see also id.* § 102(f), 116 Stat. at 755 (granting authority to impose registration fees and annual fees on public accounting firms); *id.* § 109(d), 116 Stat. at 770 (granting authority to assess annual "support fees" on public corporations).

73. *Id.* § 101(c)(1), (3), (4).

74. *Id.* § 101(c)(2); *see also id.* § 103 (outlining in detail standards for auditing, quality control, and ethics).

75. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 14 (2002) (emphasis supplied).

76. *See, e.g.*, In the Matter of Richard P. Scalzo, CPA, Exchange Act Release No. 34-48,328 (Aug. 13, 2003), *available at* http://www.sec.gov/litigation/admin/34-48328.htm (last visited Oct. 22, 2003) (SEC bars a partner in the accounting firm of PricewaterhouseCoopers from performing audits for the rest of his life).

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PCAOB must have a majority of nonaccountants.[77] The Deputy Chief Accountant of the Securities and Exchange Commission described this change recently as follows: "The PCAOB is a full-time body of standard-setters, rather than a body made up of full-time auditors who are part-time standard setters, to ensure that the standards are not written in a way that makes compliance easier at the expense of quality."[78]

Perhaps, now, audits will provide the assurance that investors seek—namely, that the books have not been cooked, in the common vernacular. Until now, financial statement users have been left to wonder how an audit that complied with GAAS could somehow miss a nearly $4 billion overstatement of profits at WorldCom. How could GAAS be so beside the point that such a major fraud escapes notice?

In part, the answer seems to be that auditors have been looking in the wrong places. A study by two accounting scholars concluded that modern auditing has focused too much on the information systems that a client uses to generate financial information and too little on a direct testing of the underlying transactions.[79] This approach, the study found, is at odds with a search for fraud at the highest levels of the organization:

> Misstatements arising from fraudulent financial reporting are intentional misstatements in financial statements with the intent to deceive financial statement users. Sources of such misstatements include manipulation or falsification of accounting records, misrepresentations or intentional omissions from the financial statements, and/or intentionalmisapplication of accounting principles. Such fraudulent activities seem beyond the scope (or motivation) of lower level employees. Rather, it would seem to be *within* the domain of top level management and *beyond* the domain of the internal control system.[80]

Indeed, in their study of seventy-two separate financial statement frauds committed in 1998 and 1999, the authors found that the chief executive officer, president, or equivalent in the company was involved in seventy-one percent of those frauds.[81] Nevertheless, the attitude of auditors focused on compliance with GAAS has too often paralleled the comment of an auditor in the Cendant Corporation scandal: "We never thought (senior management of Cendant) were the type that would do (that) sort of thing."[82] Perhaps, the PCAOB can refocus auditing standards to where accounting frauds are more likely to occur.[83]

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77. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(e)(1), (2), 116 Stat. 745, 751 (codified at 15 U.S.C. § 7211(e)(1), (2) (2002)).

78. Scott A. Taub, Speech by SEC Staff: The SEC's Internal Control Report Rules and Thoughts on the Sarbanes-Oxley Act, *available at* http://www.sec.gov/news/speech/spch052903sat.htm (last visited Aug. 5, 2003).

79. *See* Charles P. Cullinan & Steve G. Sutton, *Defrauding the Public Interest: A Critical Examination of Reengineered Audit Processes and the Likelihood of Detecting Fraud*, 13 CRITICAL PERSP. ON ACCT. 297 (2002) (discussing how major public accounting firms' increased focus on systems assessment fails to further the firms' stance on fraud detection).

80. *Id.* at 304.

81. *Id.* at 300. These results are almost identical to those found in an earlier study of 204 financial statement frauds, 72% of which included involvement by the company's chief executive officer. *Id.* at 299.

82. *Id.* at 302.

83. *But see* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 103(a)(2)(A)(iii)(II)(bb), 116 Stat. 745, 756 (codified at 15 U.S.C. § 7213(a)(2)(A)(iii)(II)(bb) (2002)) (The PCAOB must require auditors to evaluate whether a corporation's internal controls "provide reasonable assurance that . . . receipts and expenditures . . .

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Deficiencies in auditing standards, however, are only half of the problem. The other half involves what the financial statements report or misreport. That domain is covered by "generally accepted accounting *principles*," or GAAP, and the PCAOB is not authorized to promulgate accounting principles. Those principles remain the province of a private group, the Financial Accounting Standards Board, that has turned GAAP into a rules-obsessed swamp that frequently mistakes the epidermis of the leaves for the forest. One of the sillier of its edicts allowed Enron to create a "special purpose entity" to finance its operations and then omit this entity's liabilities from Enron's balance sheet, as long as Enron's ownership interest in this entity was less than ninety-seven percent.[84] If GAAP can allow this blatant subterfuge, it can allow anything. And if it can allow anything, it becomes devoid of meaning. As a result, financial statements that present a corporation's financial operations "according to GAAP" become less of an assurance of quality and more of a trap for the unwary.

The Sarbanes-Oxley Act should have bestowed jurisdiction over GAAP to the new PCAOB. Many of the same complaints regarding "industry capture" in the formulation of GAAS apply with equal force to the formulation of GAAP. Professor George Mundstock recently described this process as follows:

> Accounting technicians of high principles worked mightly over the years to build an amazing artifice. But, the whole project has been misguided from the start. The accounting rules should have been built by government to protect investors, not by isolated professionals looking solely to the industry's morale and narrow principles.[85]

Instead, the Act authorizes a study of the costs and feasibility of moving to a "principles-based accounting" system.[86] And even when this study is released, it is not clear what the PCAOB is supposed to do with its findings.

V. CONCLUSION

As the preceding Parts have shown, the Sarbanes-Oxley Act presents a potpourri of largely missed opportunities regarding the relationship of auditors and their clients. Coming at a historic moment for the U.S. securities markets, it addressed important problems but adopted weak solutions. It rotates partners instead of accounting firms, it prohibits auditing firms from providing only certain nonaudit services to their clients, and it creates a new authority to set auditing standards but not accounting principles. At base, it is not clear that these half-hearted approaches will accomplish all that much.

This assessment is bolstered by a recent survey of executives at multinational corporations. Its findings include the following:

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are being made only in accordance with authorizations of *management* . . .") (emphasis supplied).

84. *See* GAO REPORT, *supra* note 51, at 145 & n.109; *see also* William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 49-54 (Feb. 1, 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport (last visited July 31, 2003). By comparison, the tax law requires only an eighty percent ownership interest for a corporation to include a subsidiary in its consolidated tax return. I.R.C. §§ 1501, 1504(a)(1)(B)(i), (2) (2000).

85. George Mundstock, *The Trouble With FASB*, 28 N.C.J. INT'L L. & COM. REG. 813, 841 (2003).

86. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108(d)(1), 116 Stat. 745, 769 (codified at 15 U.S.C. § 78j-1 (2002)).

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• Only one-third of survey respondents believe that the Act will "restore investor confidence."

• Fully half of finance chiefs and managing directors believe that the Act will have "no impact" at all.

• Only nine percent of survey respondents believe that the Act "is a good and adequate response to problems in accounting and reporting."[87]

Perhaps the next legislative effort will be better, but comprehensive opportunities to address these issues do not arise that often. If the audit process is to fulfill the high expectations that U.S. securities laws assign to it, things must improve and perhaps some day they might. Indeed,[88]

> I see a day.
> When auditors will audit,
> When skepticism will replace cronyism,
> And the word "public" in certified *public* accountant has meaning.
>
> I see a day.
> When auditors will challenge managers,
> When independence will be a fact, not just a goal,
> When auditors will correct financial statements that mislead.
>
> I see a day.
> When auditors will *look* for fraud,
> When people will know who are the crooks, and who are not.
>
> I see a day.
> When generally accepted accounting principles make sense,
> When accountants, and lenders, and investors will use the *same* language and see the *same* profits.
>
> For only then will they be able to say together:
>
> > The money is real,
> > The money is real;
> > We *now* know,
> > The money is real.

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87. *See* Janet Whitman, *Sarbanes-Oxley Begins to Take Hold*, WALL ST. J., Mar. 25, 2003, at C9 (discussing the Management Barometer Study from PricewaterhouseCoopers regarding the effects of the Sarbanes-Oxley Act).

88. With admiration and respect for one of history's greatest orations, Martin Luther King, Jr., I Have a Dream, Remarks at the Lincoln Memorial (Aug. 28, 1963), *reprinted in* THE WORLD'S GREAT SPEECHES 751-54 (Lewis Copeland & Lawrence W. Lamm eds., 3d ed. 1973); *see also* A CALL TO CONSCIENCE: THE LANDMARK SPEECHES OF DR. MARTIN LUTHER KING, JR. 81-87 (Clayborne Carson & Kris Shepard eds., 2001).

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