

Lawyers Keep Out:
Why Attorneys Should Not Participate in Negotiating
Critical Financial Numbers Reported by
Public Company Clients

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ABSTRACT

In response to the financial scandals at the turn of the century, Sarbanes-Oxley and related reforms radically changed the relationship between accountants and the companies they audit. As a result, auditors exert greater power in the negotiations with management that produce critical numbers in company financial statements. That power provides auditors with newfound ability to resist pressure to certify financial statements that are overly favorable to company stock prices.

With the best of intentions, some now urge that company attorneys should expand their efforts to police clients' financial statements. But the introduction of lawyers into the bargaining between management and an auditor would likely reverse the benefits of the recent reforms. Attorneys today suffer from the very biases in favor of management that plagued auditors before the reforms. Lawyers' client-focused ethos reinforces that bias. Their necessarily meager accounting knowledge, and the absence of any systematic review of lawyers' input to such negotiations, mean that attorney bias will have free rein. Adding lawyers to the mix will therefore more likely hinder financial reporting than help.

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I. INTRODUCTION.....	1503
II. ATTORNEYS WANTED FOR ACCOUNTING WORK	1505
III. SOFT NUMBERS FROM HARD BARGAINING	1508
A. The Soft Numbers.....	1508
B. The Hard Bargaining	1510
IV. INSIDE THE NEGOTIATIONS	1514
A. The Essential Contrast Between Management and Auditor	1514
B. Bargaining Before the Reforms: Auditors Polluted and Weak	1518
1. Auditor incentive to bow to management's desires.....	1518
2. Weak professional review that provided no counterweight.....	1522
3. Passive audit committees that did not affect the negotiations	1522
4. How the pre-reform milieu advantaged management in audit negotiations.....	1524
C. Bargaining After the Reforms: Auditors Cleansed and Strengthened.....	1525
1. Removal of auditor bias.....	1525
2. A new system of auditor review	1527
3. A more active audit committee.....	1530
4. How the reforms advantage the auditor in negotiations	1534
V. ADDING ATTORNEYS TO AUDITOR/MANAGEMENT NEGOTIATIONS—A BAD IDEA	1539
A. Attorney Structural Bias	1540
B. Lawyer Ethos and Ethics That May Aggravate the Bias	1543
C. Attorney Accounting Ignorance	1547
D. No Systematic Review of Lawyer Participation in Accounting	1550
E. Adding Lawyers Could Advantage Management in Negotiations, Undoing Benefits of the Reforms	1551
VI. CONCLUSION: THE LARGER QUESTIONS	1553

I. INTRODUCTION

Lawyers live to help. When clients sing out in need, attorneys stand to for action. Indeed, when clients seem threatened—as by the wave of financial improprieties that crested with Enron and WorldCom—counsel may not wait for client calls, but volunteer assistance, even telling themselves that “helping” is a professional imperative. Law professors encourage such attitudes.

And so, the academy and the bar now cry out for attorneys to participate more fully in the production of the audited financial statements that public corporations produce. Those statements having proved opaque, who better than attorneys to improve transparency? Surely, it would help to add the attorneys’ critical and highly trained minds to the efforts of company accountants and outside auditors. Even if not in every case, the lawyers should help in most. At least, their participation couldn’t hurt. Or could it?

The brief answer is that the lawyers could hurt. In fact, their increased participation would likely do more harm than good.

It turns out that financial statements derive not only from adding numbers but also—and significantly—from negotiation. Each of many key figures can, consistent with generally accepted accounting principles (“GAAP”), fall within a permissible range—even though some numbers within the range better reflect company finances than other figures also falling within the acceptable continuum. For years, management and outside auditors have bargained back and forth to reach the final numbers. They still do.

There is today, however, a critical difference. Before the reforms centering on the Sarbanes-Oxley Act of 2002 (“SOX” or “Sarbanes-Oxley”),¹ the negotiations favored management, and management suffered a bias in favor of numbers that put more money into executive pockets, even when those numbers did not best inform the investing public. As a check on this management bias, the auditors

1. This Article uses “the reforms” to encompass the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, 29 U.S.C.), the rules and regulations that the Securities and Exchange Commission (“SEC”) issued to implement SOX, and the changes that the NYSE and NASDAQ adopted in 2002 and 2003 to revise the corporate governance requirements for issuers listing their stocks on those exchanges. See 1 JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK §§ 10:1.1–:3.2, 10:4–:5, 11:4–:5 (2009) [hereinafter BOSTELMAN, SOX DESKBOOK], for a description of the new listing standards. “The reforms” also include some related rules adopted before Enron’s public decline, see *infra* note 73, and after Sarbanes-Oxley passed, see *infra* note 77.

proved weak—weak because they suffered from economic dependence on management, weak because they were not effectively policed as a profession, and weak because they had no effective ally in the negotiations.

The reforms change all that. The reforms deprive management of a lucrative carrot it had held before auditors to sway their judgment in management's favor. The reforms subject the auditors to a far more extensive professional critique, a stick that checks what remaining pro-executive bias auditors may have. And the reforms create an ally for the auditors—vitalized company audit committees that themselves play a real role in producing financial statements, particularly when the auditor and management disagree. Today, for all these reasons, auditors much more effectively combat management efforts to select, from GAAP-compliant ranges, numbers that will serve management's self-interest. This is a happy result.

Having successfully addressed auditor issues, reformers now turn to another prominent corporate governance actor—the lawyer. Hortatory writings uncritically advocate that attorneys involve themselves to an ever-greater extent in the preparation of client financial statements. This Article pushes back against that near-consensus. Addressing particularly those numbers that emerge from management/auditor negotiation, this Article demonstrates that introducing attorneys into the carefully rebalanced bargaining is likely to send us backward, adding to the negotiations professionals who will not only fail to check the avaricious impulse of corporate captains but who will likely advocate management's self-interested position. When it comes to the negotiated numbers, we will be better saying “lawyers keep out” than “lawyers welcome.”

To explain why we must say one or the other, Part II catalogs the calls for a larger attorney role in financial reporting. To understand why negotiation occupies a central place in that reporting, Part III explains that critical financial statement numbers constitute no more than estimates or judgments—for each of which management supplies the first number, the auditor (should it disagree) provides an alternate number, and resulting negotiation produces the final number. To explain why the negotiation now favors the auditor, Part IV analyzes the pre-reform weakness of the auditor and the manner in which the reforms strengthen the auditor's hand. To explain why adding attorneys is a bad idea, Part V

demonstrates that (i) attorneys suffer from the same principal weakness that plagued the pre-reform auditors, (ii) neither ethics nor organized critique nor lawyers' accounting knowledge check that weakness, (iii) the ethos of the legal profession aggravates that weakness, and (iv) encouraging attorneys to participate in management/auditor negotiations is therefore likely to click the "undo" button on the hard-won benefits from the reforms.

II. ATTORNEYS WANTED FOR ACCOUNTING WORK

We know well the stories of Enron and WorldCom, particularly how they admitted to spectacular accounting misstatements and then promptly sank into bankruptcy.² Finger-pointing in the aftermath extended accusing digits towards the "gatekeepers."³ As the principal gatekeeper for financial statements, the auditors took a terrific shellacking.⁴ But law professors applied the corded whip to themselves, and their brothers and sisters too,⁵ with one academic expressing perhaps the prevailing view that "We lawyers are guilty."⁶

The denunciations of counsel focused at first on opinions that Enron's lawyers provided for complicated transactions.⁷ But the dialogue morphed into a more general examination of the lawyers'

2. Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Admits to Overstating Profits by About \$600 Million*, N.Y. TIMES (Late Ed.), Nov. 9, 2001, at C1; Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES (Late Ed.), Dec. 3, 2001, at A1; Simon Romero & Alex Berenson, *WorldCom Says It Hid Expenses, Inflating Cash Flow \$3.8 Billion*, N.Y. TIMES (Late Ed.), June 26, 2002, at A1; Simon Romero & Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES (Nat. Ed.), July 22, 2002, at A1.

3. See, perhaps most famously, John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002) [hereinafter Coffee, *About the Gatekeepers*].

4. See *infra* Part IV.B.1.

5. See, e.g., Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1422, 1430 (2002) [hereinafter Cunningham, *Sharing Accounting's Burden*] (stating generally that "lawyers play a significant role when accounting fraud occurs" and that, "[i]n Enron's case, lawyers played a central role in the formation, structuring, and reporting of various partnerships treated as off-balance sheet to Enron and involving related parties. . . . [W]ith Enron in this perspective, prudence suggests that . . . active professionals should be required to beef up their accounting skills").

6. Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1239 (2003).

7. See Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1 (2005); John C. Coffee, Jr., *Can Lawyers Wear Blinders? Gatekeepers and Third-Party Opinions*, 84 TEX. L. REV. 59 (2005) (responding to Schwarcz).

role in public company scandals.⁸ As a result, law professors called for more attorney involvement in financial reporting.⁹ So did part of the organized profession.¹⁰ Since involvement assumed knowledge, calls for more law school and lawyer accounting education rang out as well, with one professor decrying the decline in full-time law faculty offering accounting courses, the drop in the number of new accounting texts for law students, and even the slumping page counts in books teaching accounting for lawyers.¹¹ Programs and literature to keep attorneys abreast of financial statement rules won admiration¹² and flourish today.¹³

8. Both the American Bar Association and the Association of the Bar of the City of New York produced reports. See REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY, reprinted in 59 BUS. LAW. 145, 155-57, 162-77 (2003) [hereinafter ABA REP. ON CORPORATE RESPONSIBILITY] (addressing the role of all the principal actors in corporate governance); NEW YORK CITY BAR, REPORT OF THE TASK FORCE ON THE LAWYER'S ROLE IN CORPORATE GOVERNANCE (2006) [hereinafter NYC BAR REP. ON THE LAWYER'S ROLE] (addressing specifically the lawyer's role).

9. Professor Coffee, for example, suggests that, while auditors should continue to certify financial statements in SEC filings, attorneys should certify textual disclosures, including those in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") (required by Item 7 of Form 10-K and Item 2 in Part I of Form 10-Q, both of which cross-reference Item 303 of Regulation S-K at 17 C.F.R. § 229.303 (2010)). John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1312-15 (2003) [hereinafter Coffee, *Attorney as Gatekeeper*]. The textual disclosures in MD&A include a wealth of financial matters, such as liquidity, capital resources, unusual events that affected reported results, known trends and uncertainties that the issuer reasonably expects to have a material effect on revenues and income going forward, and off-balance-sheet financial arrangements. See 17 C.F.R. § 229.303(a) (2010) (describing disclosures); SEC Form 10-K, Part II, Item 7 (requiring disclosures); SEC Form 10-Q, Part I, Item 2 (requiring disclosures).

10. The New York City Bar concluded that "[i]t is vital that lawyers be actively consulted on matters of financial disclosure." NYC BAR REP. ON THE LAWYER'S ROLE, *supra* note 8, at 129. The City Bar cautioned against "any rigid separation between a company's legal and accounting functions," and, tellingly for this Article, opined that "[l]awyers functioning in the disclosure area, albeit not primarily responsible for a company's financial disclosures, should not distance themselves from the process used to prepare such disclosures." *Id.*

11. Cunningham, *Sharing Accounting's Burden*, *supra* note 5, at 1439, 1440, 1442-43. He concluded that "it is incumbent upon the legal professorate to assure it provides adequate teaching" in the subject. *Id.* at 1449.

12. See *id.* at 1456 ("[L]awyers should make it a professional habit to stay abreast of the top handful of hot topics of debate within the accounting profession . . ."); *id.* at 1457 ("Business lawyers should get on the mailing list of leading accounting firms that periodically prepare and distribute newsletters on current topics of interest."); *id.* (advocating "attending bar meetings and lectures concerning law and accounting, attending panels where business lawyers or SEC representatives discuss accounting, subscribing to professional literature addressing the subject, and so on"); *id.* (suggesting that firms should train their lawyers in "accounting basics and . . . how they arise in the firm's practice," and should also provide

To be sure, some voice skepticism. Notably, Steven Schwarcz argues that lawyers should play a reactive role, rather than a proactive role, in monitoring client financial reporting.¹⁴ But most have been swept away, one commentator even opining that lawyers should make their own judgments—independent of the company's auditor—on matters as fine-grained as a client's bad-debt and product-return reserves.¹⁵

In sum, from academics to the practicing bar, calls abound for greater attorney involvement in the preparation of public company financial disclosures. To evaluate this enthusiasm, we need to understand the process by which those companies produce their financial reports. In particular, we need to understand the process by

special "training seminars" "[w]hen particular [accounting] issues percolate in a firm's practice areas"); Damaris Rosich-Schwartz, *Accounting Expertise and Attorney Compliance with the Sarbanes-Oxley Act of 2002*, 24 T.M. COOLEY L. REV. 533, 565 (2007) [hereinafter Rosich-Schwartz, *Accounting Expertise*] ("[E]very corporate attorney should at least take as many [continuing legal education] or business courses as he can in these disciplines [accounting and finance], for them [sic] to be able to, in the least, make a better determination as to the company's compliance with the securities laws.").

13. As an example, each year the ABA's Annual Review of Federal Securities Regulation includes a section on accounting developments, containing detailed descriptions of specific accounting pronouncements. See Subcommittee on Annual Review, American Bar Association, *Annual Review of Federal Securities Regulation*, 64 BUS. LAW. 833, 837-47 (2009); Subcommittee on Annual Review, American Bar Association, *Annual Review of Federal Securities Regulation*, 63 BUS. LAW. 929, 955-67 (2008); Subcommittee on Annual Review, American Bar Association, *Annual Review of Federal Securities Regulation*, 62 BUS. LAW. 1065, 1102-15 (2007); Subcommittee on Annual Review, American Bar Association, *Annual Review of Federal Securities Regulation*, 61 BUS. LAW. 1235, 1272-82 (2006); Subcommittee on Annual Review, American Bar Association, *Annual Review of Federal Securities Regulation*, 60 BUS. LAW. 1069, 1289-1302 (2005). To provide a taste of the detail, the 2009 annual review discusses Financial Accounting Standards Board ("FASB") Statement No. 161, 64 BUS. LAW. 833, at 837-39; FASB Statement No. 163, *id.* at 839-40; FASB Staff Position No. FAS 157-3, *id.* at 841-42; FASB Staff Position No. FAS 133-1 and FASB Interpretation FIN 45-4, *id.* at 842-44; FASB Staff Position No. APB 14-1, *id.* at 844-46; and Emerging Issues Task Force ("EITF") EITF Issue No. 08-5, *id.* at 847. In each case, the review provides a specific discussion, footnoted to particular paragraphs in the accounting pronouncement.

14. Steven L. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 J. CORP. L. 1097 (2006) [hereinafter Schwarcz, *Financial Information Failure*].

15. Rosich-Schwartz, *Accounting Expertise*, *supra* note 12, at 540-42 (assuming in the hypothetical driving the analysis that a NASDAQ-traded client's management judged that the two reserves, together, should comprise 3% of outstanding receivables instead of the 8% used in the past because the company had corrected the problem that created the older, higher nonpayment rate); *id.* at 542 (further assuming that the outside auditor "deliver[ed] a letter confirming and agreeing with [management's] opinion that using a 3% . . . rate to calculate the loss reserve is reasonable"); *id.* at 553 (stating that the associate general counsel for the company "must [among other things] . . . determine whether the revenue recognition is in compliance with [generally accepted accounting principles]").

which companies produce their most important accounting reports—their audited annual financial statements. Even more particularly, we need to appreciate that negotiation between a management and an outside auditor constitutes a vitally important part of that process—producing, for example, numbers like the bad debt reserves to which the one commentator pointed. For the question driving this Article is whether attorney involvement in *that* kind of negotiation—producing *that* kind of number—makes sense.

III. SOFT NUMBERS FROM HARD BARGAINING

Financial statements appear straightforward. They include numbers, and numbers look like hard facts produced by unambiguous counting. This is not so. Many of the numbers that appear on audited financial statements are estimates or judgments. As such, they are soft, not hard. And, as this Article will now show, they emerge not from physical observation, but from bargaining.

A. *The Soft Numbers*

Consider a reserve for product returns. A company may know that some products will be returned. But it will not know how many or when. To determine the dollar figure for the reserve, the company will have to estimate future returns, with the estimate based on assumptions and the assumptions derived from such data as the company's historical experience with returns and the industry's experience with returns—adjusted as appropriate to take account of the particular circumstances that the company and its products face now. Obviously, a change in the assumptions on which the estimate is based will change the estimate, and, just as obviously, there is no single "right" estimate but a range of reasonable estimates. Generally accepted accounting principles permit the company to report a reserve anywhere within that reasonable range.

The courts and the Securities and Exchange Commission ("SEC" or "Commission") recognize that reserves for product returns—as well as estimates of warranty obligations—provide some of the many examples of numbers that can be properly reported at any of the figures within the relevant, reasonable spectrum.¹⁶ Asset

16. Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies, 67 Fed. Reg. 35,620, 35,631–32 (proposed May 20, 2002) [hereinafter Critical Accounting Policies Proposal].

valuations, when not based on cost, provide another example.¹⁷ So does revenue recorded on a percentage-of-completion basis—with the estimate of the percentage of a contract completed at the end of a given accounting period a matter of judgment, not certainty, and any number within a reasonable range permissible for accounting purposes.¹⁸

Recognizing the variability inherent in such numbers, the SEC in December 2001 warned that financial numbers “often imply a degree of precision” that they do not have and that companies should therefore disclose their “critical accounting policies”—those that “are both most important to the portrayal of the company’s financial condition and results, and . . . require management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.”¹⁹ The Commission thereafter proposed rules for the disclosure of those policies.²⁰ Although it did not ultimately adopt those rules, the Commission later referred to them when providing guidance to companies for periodic filings.²¹

The language that the Commission employed when describing “critical accounting policies” nicely illustrates the elasticity of important accounting numbers that companies disclose. It said that “critical accounting policies” include the policies underlying estimates that are based on “highly uncertain” assumptions under conditions where “different estimates that [the company] reasonably could have used . . . [would] have a material impact on the presentation of [the company’s] financial condition, changes in financial condition or results of operations.”²² The proposed rules would have specifically referred to “*the upper end and the lower end of*

17. See, e.g., *Ind. Elec. Workers’ Pension Trust Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 536 (5th Cir. 2008) (“Valuations of assets . . . as well as the application of sophisticated accounting standards like ‘fair value,’ leave broad scope for judgment and informed estimation; this is another way of saying that determinations on such matters can differ reasonably and sizably.”)

18. Critical Accounting Policies Proposal, *supra* note 16, at 35,626 n.53.

19. Accounting Policies; Cautionary Advice Regarding Disclosure, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001).

20. Critical Accounting Policies Proposal, *supra* note 16.

21. Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, 68 Fed. Reg. 75,056, 75,064–65 (Dec. 29, 2003) (referring to proposal); I BOSTELMAN, SOX DESKBOOK, *supra* note 1, § 6:5.

22. Critical Accounting Policies Proposal, *supra* note 16, at 35,621. Somewhat confusingly, the SEC also referred to “critical accounting estimates.” *Id.*

the range of reasonable possibilities determined by the [company] in the course of formulating its recorded estimate."²³

B. The Hard Bargaining

A company prepares its own financial statements.²⁴ If the company is subject to the reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act" or "34 Act") it publicly files its financial statements after the end of each quarter of its fiscal year.²⁵ The securities laws require that the statements for the full year—those filed after the fourth quarter—be audited.²⁶ The audit must be performed by an independent outside accounting firm.²⁷ The audit ends with an opinion from the accounting firm, hopefully (from the company's point of view) with a "clean" or "unqualified" opinion saying that the company's financial statements—after any adjustments made in the course of the audit—"present, in all material respects, [the] financial position, results of operations, and . . . cash flows [of the company] in conformity with generally accepted accounting principles."²⁸

But the opinion, of course, comes at the end. During the audit, the outside accounting firm will conduct tests to check numbers that the company has assembled; as to those numbers that represent estimates, the firm will consider whether they are supported by the underlying data and assumptions.²⁹

23. *Id.* at 35,650 (proposed 17 C.F.R. § 229.303(c)(3)(iii)(A)) (emphasis added).

24. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 110.03 (2010) [hereinafter CODIFIED AUDITING STANDARDS] ("The financial statements are management's responsibility.").

25. SEC Form 10-Q, Part I, Item 1; SEC Form 10-K, Part II, Item 8.

26. SEC Form 10-K, Part II, Item 8 (referencing, among others, 17 C.F.R. §§ 210.3-01(a), 210.3-02(a) (2010)).

27. 17 C.F.R. § 210.1-02(d) (2010) (defining "audit" as "an examination of the financial statements by an independent accountant"); *id.* §§ 210.2-01(b), (c) (defining independence).

28. CODIFIED AUDITING STANDARDS, *supra* note 24, § 110.01.

29. For example, an auditor must evaluate "the reasonableness of an estimate," *id.* § 342.09, such as the amount recorded as the "net realizable value[] of inventory . . . revenues from contracts accounted for by the percentage-of-completion method, and pension and warranty expenses," *id.* § 342.02, by "concentrat[ing] on key factors and assumptions that are . . . [s]ignificant to the . . . estimate," *id.* § 342.09. As another example, an auditor will test whether the assumptions that management uses to determine the fair value of an asset "are reasonable and reflect, or are not inconsistent with, market information." *Id.* § 328.26(a).

When the auditor disagrees with a number that the company has put into the financial statements, the auditor and company management discuss the difference. Often, that discussion turns into bargaining. When the account at issue is one for which the reported figure can—consistent with accounting rules—fall within a range, the bargaining will often produce a figure between the two numbers the contending parties advocate, a number that is acceptable to management (though not management's preferred number) and that the auditor can stomach and for which the auditor can still provide a clean opinion (though not the auditor's preferred number).

Theory predicts, and surveys confirm, that exactly such bargaining occurs. Rick Antle and Barry Nalebuff posited such negotiations in a 1991 article that challenged the "traditional view" that, after the audit, the auditor faced a simple binary choice between convincing management to accept the auditor's number for each account on which the auditor and management disagreed, or refusing to provide an unqualified opinion.³⁰ The two academics argued that, instead,

[f]inancial statements should be read as a *joint* statement from the auditor and manager. The statement becomes a joint venture if the auditor is unwilling to provide an unqualified opinion on management's [numbers]. At that point, the auditor and client begin negotiations in which the auditor may offer a revised statement. The client may threaten to dismiss him and find one more accepting of its views. Or they may decide to extend the audit to obtain more facts. In the end, *compromises are usually found*, statements are revised, and the auditor issues an unqualified opinion on the revised [financial] statements.³¹

Later empirical work supports this view. One study distributed 132 questionnaires to partners in the Canadian offices of six international accounting firms and received responses from ninety-three partners: *67% of these partners stated that they had negotiated with at least 50% of their clients.*³² When asked to choose one instance of a negotiation

30. Rick Antle & Barry Nalebuff, *Conservatism and Auditor-Client Negotiations*, 29 J. ACCT. RES. 31, 35 (Supp. 1991).

31. *Id.* at 31 (second emphasis added).

32. Michael Gibbins et al., *Evidence About Auditor-Client Management Negotiation Concerning Client's Financial Reporting*, 39 J. ACCT. RES., 535, 544, 545 tbl.1 (2001). While the article does not say when the researchers distributed the questionnaires, the first page states that the journal received the article in December 1996. *Id.* at 535.

and describe it in depth,³³ 75% of the ninety-three reported that the negotiation carried primary implications for income measurement, and 71% reported that the negotiation carried implications for balance sheet valuation.³⁴ A tabulation of the responses showed that “[t]he most common outcome (41%) of the sample negotiations was agreement on a position between the original positions of the auditor and client management. . . . 96% of the clients received an unqualified opinion and the auditor was reappointed 83% of the time”³⁵

Researchers have also studied the range within which auditor/company negotiation takes place. One study, conducted in the spring and summer of 2002, presented a hypothetical case to thirty-three auditors at national accounting firms in the United States and to thirty-eight financial managers.³⁶ The fact pattern involved “revenue recognition for long-term contracts in the pharmaceutical and biotechnology industries.”³⁷ Participants received a table showing six possible gross profit figures that the hypothetical company might recognize from the contract—ranging from \$0 to \$3,745,000.³⁸ The researchers asked auditors and managers for (i) the figures they would prefer to report and (ii) their limit figure (for auditors the highest number that the company could report while still receiving an unqualified opinion and for managers the lowest figure the company could report before the manager would fire the auditor).³⁹ The average figure that the auditors wanted to report was \$1,230,000 and the average auditor limit was \$1,850,000 (a range of \$620,000), while the average figure that the managers wanted to report was \$2,349,000 and their average limit was \$1,025,000 (a range of \$1,324,000).⁴⁰ These figures implied that the negotiation between management and the auditors would yield a reported number within the overlap of the two ranges.

33. *Id.* at 543.

34. *Id.* at 547 tbl.2.

35. *Id.* at 546–47.

36. Charles W. Bame-Aldred & Thomas Kida, *A Comparison of Auditor and Client Initial Negotiation Positions and Tactics*, 32 ACCT., ORG. & SOC'Y 497, 501–02, 501 n.5 (2007) (providing date of survey).

37. *Id.* at 502.

38. *Id.* at 502–03.

39. *Id.* at 503.

40. *Id.* at 504 tbl.1.

Articles on such management/auditor negotiations abound.⁴¹ The literature addresses virtually all aspects of those negotiations.⁴²

The understanding that management and the auditor *negotiate* numbers quite important to financial statements is beyond just interesting. Even if the negotiation produces a number that is within a reasonable range—and so satisfies accounting rules—some numbers within the range are likely to be more reasonable, or more informative to investors, than others. For example, one estimate of future product returns may be more likely to prove accurate than another, even though accounting rules permit a company to report either estimate, regardless of which one is the best. The resulting concern is that management will bargain during the negotiations for a reported estimate that will fall within the permissible range, yet contribute to “managed” earnings that serve executives’ self-interested purposes rather than best reflect their company’s economic reality. As then SEC Chairman Arthur Levitt put it in a 1998 address, such “earnings management” occurs in a “gray area between legitimacy and outright fraud” where “the accounting is being perverted” so that “earnings reports reflect the desires of [executives] rather than . . . underlying financial performance.”⁴³

41. See, e.g., Michael Gibbins et al., *The Auditor’s Strategy Selection for Negotiation with Management: Flexibility of Initial Accounting Position and Nature of the Relationship*, 35 ACCT., ORG. & SOC’Y 579 (2010); Richard C. Hatfield et al., *The Effect of Magnitude of Audit Difference and Prior Client Concessions on Negotiations of Proposed Adjustments*, 85 ACCT. REV. 1647 (2010); Richard C. Hatfield et al., *Client Characteristics and the Negotiation Tactics of Auditors: Implications for Financial Reporting*, 46 J. ACCT. RES. 1183 (2008); Susan McCracken et al., *Auditor-Client Management Relationships and Roles in Negotiating Financial Reporting*, 33 ACCT., ORG. & SOC’Y 362 (2008); Maria H. Sanchez et al., *The Effect of Auditors’ Use of a Reciprocity-Based Strategy on Auditor-Client Negotiations*, 82 ACCT. REV. 241 (2007); Ken T. Trotman et al., *An Examination of the Effects of Auditor Rank on Pre-Negotiation Judgments*, 28 AUDITING: J. PRAC. & THEORY 191 (2009); Ken T. Trotman et al., *Auditor Negotiations: An Examination of the Efficacy of Intervention Methods*, 80 ACCT. REV. 349 (2005).

42. Helen L. Brown & Arnold M. Wright, *Negotiation Research in Auditing*, 22 ACCT. HORIZONS 91 (2008) [hereinafter Brown, *Negotiation Research*] (summarizing the literature). As-yet unpublished manuscripts add to the research. See, e.g., Helen L. Brown-Liburd et al., *Effects of earnings forecasts and heightened professional skepticism on the outcomes of client-auditor negotiation*, (June 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1521551; Stephen Perreault & Thomas Kida, *The Relative Effectiveness of Persuasion Tactics in Auditor-Client Negotiations* (Nov. 22, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1511286.

43. Arthur Levitt, Chairman, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, The “Numbers Game,” Remarks at NYU Center for Law and Business (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt> [hereinafter Levitt, Numbers Game].

IV. INSIDE THE NEGOTIATIONS

Whether or not management/auditor negotiations create the dark world of which Chairman Levitt warned depends on *who* participates in the negotiations, what their *motivations* are, and their relative *strengths*. As set out below, reforms in recent years changed all these variables—for the better. Comparing the world of these negotiations before the reforms to that world as it exists today makes this point. Only after completing that comparison can we intelligently consider whether adding the attorneys to the negotiations—with *their* motivations—will strengthen the party that ought to have the upper hand.

A. The Essential Contrast Between Management and Auditor

Management typically owns equity in the company it runs.⁴⁴ The company's stock price directly affects the value of that equity, and the stock price, in turn, responds to the company's reported financial results.⁴⁵ The stock price may increase if the reported earnings or other closely watched metrics meet or beat stock analyst expectations; the stock price may decrease if the reported results fall below analyst predictions.⁴⁶ Moreover, management frequently receives cash bonuses that depend in part on earnings.⁴⁷

44. The median total value of equity holdings for CEOs at 200 public companies, that had filed their proxy statements by March 27, 2009 and that had revenues of at least \$6.3 billion, exceeded \$16.5 million at the end of 2008. *C.E.O. Pay: The Tables*, N.Y. TIMES (Wash. Ed.), Apr. 5, 2009, SundayBusiness, at 11 (using numbers compiled by Equilar, *How the Pay Figures Were Calculated*, N.Y. TIMES (Wash. Ed.), Apr. 5, 2009, SundayBusiness, at 9). Top executives obtain such large holdings because their compensation includes equity. *Id.* (showing, for the CEOs, that the median value of 2008 stock awards was \$2,688,141 and the median value of stock options was \$2,106,520).

45. Even small changes in stock prices can produce large-dollar wealth changes for top managers. See, e.g., Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 42, 52 tbl.3 (2006) (finding that, for CEOs at 215 firms that restated financial results during 1995–2002, the average (median) change in CEO wealth per 1% change in stock price during misreported years was \$567,802 (\$132,367) for options held and \$745,352 (\$62,274) for stock owned outright; comparable changes in CEO wealth per 1% change in stock price at those and other firms during years for which financials were not restated were \$263,595 (\$79,998) and \$586,526 (\$43,168)); Shane A. Johnson et al., *Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter*, 13 REV. FIN. 115, 130 tbl.III (Panel B) (2009).

46. As the chair of the SEC put it in 1998:

[C]ompanies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. . . . I recently read of

Executives therefore have a keen self-interest in the accounting numbers their companies report. Executives sometimes advance that interest by “managing” earnings so that the *reported* figures are close to or exceed consensus market expectations, equal or beat year-before quarterly results, and report positive as opposed to negative earnings.⁴⁸ Empirical research shows that such “earnings

one major U.S. company, that failed to meet its so-called “numbers” by one penny [of earnings per share], and lost more than six percent of its stock value in one day. Levitt, *Numbers Game*, *supra* note 43. Academic work confirms such anecdotal evidence. Researchers studying market reaction to stocks in the period 1986–93 found that the incremental market-adjusted returns for meeting or beating analyst expectations in the first, second, and third consecutive years of doing so were, respectively, about 8%, 5%, and 3%, while failing to meet expectations in the current year after meeting forecasts in the prior year produced a -3% to -5% incremental adjusted return on average. Ron Kasznik & Maureen F. McNichols, *Does Meeting Earnings Expectations Matter? Evidence from Analyst Forecast Revisions and Share Prices*, 40 J. ACCT. RES. 727, 740, 746, 750 (2002). A more recent study reports that, in the period from the first quarter 2003 through the second quarter 2006, the “market has . . . stopped rewarding” companies that meet or just beat (by one cent per share or less) the last analyst estimate at least three days before reported earnings. Kevin Koh et al., *Meeting or Beating Analyst Expectations in the Post-Scandals World: Changes in Stock Market Rewards and Managerial Actions*, 25 CONTEMP. ACCT. RES. 1067, 1071, 1073, 1075 (2008) [hereinafter Koh, *Meeting or Beating Analyst Expectations*]. But, while they have fallen, the abnormal returns for beating estimates by more than a penny per share and the penalties for missing estimates (both by a penny or less and by more than a penny) still remain. *Id.* at 1075, 1077.

47. A review of survey data on compensation at 177 public companies collected in 1996–97 found that, while companies used a wide variety of performance measures to determine bonuses, 91% “use[d] at least one measure of accounting profits in their annual bonus plans.” Kevin J. Murphy, *Performance Standards in Incentive Contracts*, 30 J. ACCT. & ECON. 245, 249–50 (2001). One study of CEO and Chief Financial Officer (“CFO”) compensation at 1,180 firms concluded that, in the period 2002 through 2005, a 1% increase in earnings boosted bonus payments by \$38,000. Mary Ellen Carter et al., *Changes in Bonus Contracts in the Post-Sarbanes-Oxley Era*, 14 REV. ACCT. STUD. 480, 486, 493–94 (2009).

48. See, e.g., Francois Degorge et al., *Earnings Management To Exceed Thresholds*, 72 J. BUS. 1 (1999). This study examined reported quarterly earnings by companies in the years 1974–96, *id.* at 15, and, for each analysis described below, the researchers used the “middle 80% of the sample,” when arranged by price per share, *id.* at 18. A histogram displaying reported earnings per share (“eps”) compared to analyst forecasts showed the highest number of reports exactly at the analyst forecast, with the second highest number just one penny above, “[c]onsistent with the notion that ‘making the forecast’ is an important threshold for managers.” *Id.* at 20. Similar analyses supported the conclusions that executives manage earnings to meet or surpass the eps for the same quarter in the prior year, *id.* at 19, and to report a profit (e.g., at least one cent eps) or at least break-even results, instead of a loss, *id.* at 22.

See also Patricia M. Dechow & Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators*, 14 ACCT. HORIZONS 235, 242–44 (2000) [hereinafter Dechow, *Earnings Management: Reconciling the Views*] for a summary of such studies, as well as work showing that missing analyst estimates can lead to stock price drops. Data from 1988 to 2006 confirms “a greater tendency to exactly

management” increases with the equity that the top executive holds in the company.⁴⁹

As one technique to manage the reported earnings, executives select—in accounts for which there is no single “right” figure but rather a range of acceptable figures under the applicable accounting rules—numbers that will move earnings in the direction that will increase the company’s stock price.⁵⁰ And that earnings management by selection of permissible numbers from discretionary ranges (precisely the “soft” numbers on which this Article focuses) increases with stock options and stock ownership that top executives accumulate through equity compensation.⁵¹ Thus, in the bargaining

meet or beat [the consensus analyst eps estimate] by one cent, relative to what would be expected by chance.” Sanjeev Bhojraj et al., *Making Sense of Cents: An Examination of Firms That Marginally Miss or Beat Analyst Forecasts*, 64 J. FIN. 2361, 2364, 2366, 2367 fig.2 (2009).

49. See, e.g., Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 ACCT. REV. 441 (2005). The authors studied companies other than financial institutions and utilities during the period 1993–2000. *Id.* at 448. After controlling for company size and growth, the researchers found:

[B]oth unexercisable options and [stock] ownership exhibit significant positive effects on the probability of meeting or just beating analysts’ forecasts. For example, a one standard deviation increase in unexercisable options increases by 16.3 percent the odds of meeting or just beating analysts’ forecasts, while a one standard deviation increase in ownership increases by 30.5 percent the odds of meeting or just beating analysts’ forecasts.

Id. at 455 (footnote omitted).

50. Executives can manage reported earnings by (i) selecting the level at which their company will record accruals, which “involves within[-GAAP] accounting choices that try to ‘obscure’ or ‘mask’ true economic performance”; or (ii) so-called “real activities manipulation,” which involves increasing or decreasing such expenses as research and development in a particular financial reporting period or timing the sale of fixed assets so that the gain or loss falls into a particular period. Katherine Gunny, *The Relation Between Earnings Management Using Real Activities Manipulation and Future Performance: Evidence from Meeting Earnings Benchmarks*, 27 CONTEMP. ACCT. RES. 855, 855, 858 (2010).

For this Article, the first method is the most important. “Accruals,” for purpose of the earnings management studies concentrating on that first technique, constitute the difference between income and cash flow. See Daniel Bergstresser & Thomas Philippon, *CEO Incentives and Earnings Management*, 80 J. FIN. ECON. 511, 512 (2006) [hereinafter Bergstresser, *CEO Incentives and Earnings Management*]. Accruals can be affected by the bargaining on which this Article focuses. Thus, for example, choosing a low number in the permissible range for a bad-debt provision could increase earnings in a given accounting period, in order to reach a benchmark such as the consensus analyst forecast for eps, while leaving cash flow unchanged. See Dechow, *Earnings Management: Reconciling the Views*, *supra* note 48, at 239.

51. See, e.g., Bergstresser, *CEO Incentives and Earnings Management*, *supra* note 50, at 519, 521–24 (finding a positive relationship between accruals and the amount of stock and options held by a CEO relative to the CEO’s annual salary and bonus).

over the soft numbers, a management following its financial self-interest will fight to keep the agreed-upon final number as close as possible to the number that will best serve management's self-interest.

The auditor's motivation is different. *So long as the auditor has no self-interested reason to curry favor with management or so long as any such self-interest is muted by some other factor* (and, as we will see, these are critically important caveats), the auditor has nothing to gain by providing a clean opinion on financial statements that contain less than transparent numbers. Doing so enough times will, in fact, harm the auditor's reputation. It is that reputation that permits the auditor to charge for its work.⁵² Therefore, *unless otherwise disinclined to do so by financial or other incentives that are not effectively checked*, the auditor—after reviewing and disagreeing with management's choice of a number within a permissible spectrum—should, simply in the auditing firm's and individual auditor's own self-interest,⁵³ propose a figure that the auditor believes most accurately represents the company's condition and results.⁵⁴ And the auditor should fight, during the negotiations which follow, to keep the agreed-upon number as close as possible to that ideal figure.

Assuming that all this is true and that the bargaining between management and an auditor represents, in some way, a contest between good and evil, why should good not win? Don't the auditors hold the trump card? After all, management wants the clean opinion. Why won't the auditor simply announce that, unless the company agrees to the number that the auditor wants, the auditor will withhold that opinion? Why won't that work every time?

52. See, e.g., Coffee, *About the Gatekeepers*, *supra* note 3, at 1405 (explaining that a gatekeeper rents its "reputational capital" to clients).

53. Of course, auditors may propose and fight for the number that they believe is most appropriate for other reasons as well—e.g., because, as institutions, as morally sentient individuals, and as participants in a profession, they are committed to transparent financial disclosure.

54. Clarity requires that I state here a normative preference for the auditor's number. For the reasons set out in the text, I conclude that—when management and the auditor disagree—the auditor's number usually will be "better" than management's number in the sense that the auditor's number will more accurately present the company's financial condition or results, as the case may be. Of course, this will not be true in every case. But it should be so in most.

Life is not so simple. Perhaps it is in the nature of human beings to compromise on judgment calls such as selecting a number from a permissible band. Perhaps brutal insistence on winning *every* such call might damage relations with management to the point that conducting an audit would become so adversarial as to greatly increase costs and time. Whatever the reason may be, empirical research shows that bargaining occurs, and that the bargaining yields compromises.⁵⁵ The significance of the caveat above—that the auditor have no financial reason to cave in to management or, if it does, that the incentive be effectively checked—lies not in affecting the existence of negotiations, but in whether, during the inevitable bargaining, the auditors try hard to prevail. The question is whether the bargaining over the “soft” numbers will indeed be “hard.”

B. Bargaining Before the Reforms: Auditors Polluted and Weak

Unfortunately, before the reforms, the auditors suffered from a disabling economic incentive. And it was unchecked. The auditors bargained, but not nearly hard enough.

1. Auditor incentive to bow to management's desires

In the decade before Enron and WorldCom became words of shame, the major accounting firms—the ones that audited the large public companies—radically altered the mix of services they provided. Whereas auditing and accounting work had dominated that mix before, now management consulting provided the largest slice of total revenue.⁵⁶ By the late 1990s and early 2000s, many a

55. See *supra* notes 32–42 and accompanying text.

56. The legislative history of the Sarbanes-Oxley Act of 2002 includes a report by the Senate Banking Committee on Senate Bill 2673, which became the bill that a conference committee—without itself producing a report—changed into SOX. See I BOSTELMAN, SOX DESKBOOK, *supra* note 1, §§ 2.4, 2.6, particularly 2.6.2 and 2.6.3, for a brief summary of the lawmaking. That Senate Banking Committee report highlighted the growing auditor dependence on consulting revenue:

According to the SEC, 55 percent of the average revenue of the big five accounting firms came from accounting and auditing services in 1988. Twenty-two percent of the average revenue came from management consulting services. By 1999, those figures had fallen to 31 percent for accounting and auditing services, and risen to 50 percent for management consulting services. Recent data reported to the SEC showed on average public accounting firms' non-audit fees comprised 73 percent of their total fees, or \$2.69 in non-audit fees for every \$1.00 in audit fees.

S. Rep. No. 107-205, at 14–15 (2002) [hereinafter Senate Report on SOX].

public company paid its auditor more for non-audit consulting work than for the audit itself.⁵⁷ Moreover, consulting contracts were often more profitable than the audit work.⁵⁸

Since *management* hired an accounting firm for the consulting work, the threat that the accounting firm might lose lucrative consulting business, or fail to gain such business, could reduce the skepticism and neutrality that the accounting firm might otherwise bring to its work of auditing the financial statements that management initially created.⁵⁹ The issue was personal as well as

57. *Accounting Reform and Investor Protection: Hearing on S. 2673 Before the S. Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. 725, 733 (2d. Sess. 2002) [hereinafter *S. Banking Comm. SOX Hrg. II*] (statement of Lee J. Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditors' Responsibilities, Managing Director Emeritus, Bear Stearns) [hereinafter *Seidler Stmt. to Senate Comm.*] ("The [Panel on Audit Effectiveness of the Public Oversight Board] reported that the ratio of auditing revenues to consulting revenues from SEC clients went from 6:1 in 1990 to 1.5:1 in 1999."). It was "reported that in the year 2000 Andersen was paid [by Enron] audit fees of approximately \$25 million and nonaudit fees of approximately \$27 million." *Accounting Reform and Investor Protection: Hearing on S. 2673 Before the S. Comm. On Banking, Hous., and Urban Affairs*, 107th Cong. 69, 70 (2d. Sess. 2002) [hereinafter *S. Banking Comm. SOX Hrg. I*] (statement of David S. Ruder, Chairman, United States Securities and Exchange Commission, 1987 to 1989) (also stating: "Comparisons of the amounts of audit fees to nonaudit fees for a range of companies and auditors have revealed ratios of nonaudit to audit fees ranging as high as nine to one. The expressed general concern is that an audit cannot be objective if the auditor is receiving substantial nonaudit fees.").

58. *Seidler Stmt. to Senate Comm.*, *supra* note 57, at 734 ("Some audit firm partners to whom I have spoken believe that audits are often offered as 'loss leaders,' in other words, *as entry for sales of consulting services*. In my capacity as an Audit Committee Chairman soliciting proposals for new independent auditors[,] I witnessed substantial price competition and the submission of bids that were clearly well below normal billing rates. Virtually every audit partner tries, at one time or another, to sell consulting services to audit clients.").

59. Senate Report on SOX, *supra* note 56, at 15-16 ("The key reason why awarding consulting contracts and other non-audit work to the audit firm is troubling is because it results in conflicting loyalties. While the board's audit committee is formally responsible for hiring and firing the outside auditor, *management* controls virtually all the other types of non-audit work the audit firm may do for the company. Those contracts with *management* blur the reporting relationship—it is difficult to believe that auditors do not feel pressure for the overall success of their firm with the client." (quoting Letter from John H. Biggs, Chairman, President, and CEO, Teachers' Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), to Paul S. Sarbanes, Chairman, Senate Banking, Housing, and Urban Affairs Committee (June 28, 2002) (emphasis added))).

Academic work provides mixed evidence on the relationship of consulting fees to audit failure. Compare Mukesh Bajaj et al., *Auditor Compensation and Audit Failure: An Empirical Analysis* 19, 20 & tbl.9 (Feb. 27, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387902 (finding, for companies in the sample that (i) had been sued in private investor actions for accounting errors and (ii) had suffered the largest decline in market value, that "the nonaudit component of the total fees [paid to the accounting firm performing the audit] was significantly higher th[a]n [paid to]

institutional, as auditing partners at accounting firms in at least some cases received extra compensation for “cross-selling” consulting work to audit clients.⁶⁰ What accounting firm partner would fight hard in the morning over a number to include in a financial statement with the same management to whom that partner planned to “cross-sell” consulting services in the afternoon, where a successful “cross-sale” would put money in his or her own pocket? What accounting firm would not excuse such softer bargaining if the cross-sale would land a lucrative consulting contract contributing to

comparable firms even after controlling for other known determinants of auditor compensation”), with William R. Kinney Jr. et al., *Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right?*, 42 J. ACCT. RES. 561, 569–70, 584–85 (2004) (finding “no statistically significant positive association between fees for [financial information system design and implementation] or internal audit services and restatements” (at 584), but finding a positive association between restatements and the amount a company paid for nonaudit services that were not described by type in company proxy statements (at 584–85)).

The controversy over the relationship between nonaudit fees paid to auditors and bad accounting generated another set of studies in which the researchers (i) created a model to predict the accruals (see definition in note 50, *supra*) that an audit client would have if accruals were determined purely by the relationship between certain financial values (such as change in revenues minus change in receivables), (ii) used the model to predict accruals for each firm in a sample, (iii) subtracted the predicted accruals from actual accruals to find “discretionary accruals” and then (iv), on the assumption that more discretionary accruals meant worse accounting, sought a relationship between the amount of discretionary accruals and various measures of nonaudit fees (e.g., the ratio of nonaudit fees to total fees). One early study found a positive relationship between nonaudit fees, on the one hand, and, on the other hand, discretionary accruals and reported financial results at or just above market expectations. Richard M. Frankel et al., *The Relation Between Auditors’ Fees for Nonaudit Services and Earnings Management*, 77 ACCT. REV. 71, 82–83, 89, 91, 94, 98–100 (Supp. 2002). But other, later studies found no such statistically significant relationship and criticized the Frankel work. See, e.g., Hollis Ashbaugh et al., *Do Nonaudit Services Compromise Auditor Independence? Further Evidence*, 78 ACCT. REV. 611, 630, 634 (2003); Hyeesoo Chung & Sanjay Kallapur, *Client Importance, Nonaudit Services, and Abnormal Accruals*, 78 ACCT. REV. 931, 933 (2003).

A review of the academic studies highlights the inconsistent results and suggests that providing non-audit services may weaken auditor independence and contribute to earnings management, not generally, but in “particular types of firms and circumstances.” Arnold Schneider et al., *Non-Audit Services and Auditor Independence: A Review of the Literature*, 25 J. ACCT. LITERATURE 169, 196–98 (2006).

60. One witness before the Senate Committee referred to the SEC’s proceedings against Arthur Andersen for its audits of Waste Management, noting that (i) Robert Allgyer was Arthur Andersen’s engagement partner for the Waste Management Account, (ii) between 1991 and 1997, Andersen billed Waste Management about \$7.5 million in audit fees and \$11.8 million in other fees, (iii) Andersen Consulting billed Waste Management \$6 million in additional nonaudit fees, and (iv) “[i]n setting Allgyer’s compensation, Andersen took into account, among other things, [Andersen’s] billing to [Waste Management] for audit and nonaudit services.” Seidler Stmt. to Senate Comm., *supra* note 57, at 732–33.

the largest and most profitable side of firm business? Why wouldn't all of this be particularly acceptable if the bargaining that suffered was only over where—within a permissible range—an audit client's number ended up?

Aside from the conflict created when accounting firm partners sought at one time to conduct a skeptical audit and at the same time to cross-sell consulting, another structural bias infected audit/management negotiations. Often, including in cases where audit clients published materially false financial numbers, the accounting and finance staff at the audit client included former partners or employees at the auditing firm.⁶¹ This raised the possibility that an accounting firm partner with a possible future at a client might dial down skepticism on the audit in order to further his or her prospects for a later job at the company. It raised, as well, the possibility that an auditor would “go easy” on the numbers put together by a former colleague now employed at the client company. Again, corruption of the audit process by such self-interest or friendship seems most likely where the auditor can compromise without technically breaking any rule, simply by giving a little (or a lot) in negotiating the final number to select from a within-rule continuum.

61. As former SEC Chairman Breeden testified, “Enron hired senior personnel from the audit team in[to] senior financial position[s]. The reward of a senior job could easily weaken audit independence.” *S. Banking Comm. SOX Hrg. I, supra* note 57, at 58, 65 (statement of Richard C. Breeden, Chairman, United States Securities and Exchange Commission, 1989 to 1993). The Enron Bankruptcy Examiner found that “[f]rom 1989 through 2000, at least eighty-six Andersen accountants left Andersen to become employed by Enron, some of whom became key executives in Enron’s accounting and treasury functions.” Final Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp. et al.*, Case No. 01-16034(AJG), at 39 (Bankr. S.D.N.Y., dated Nov. 4, 2003). When the SEC announced the settlement with Arthur Andersen in the Waste Management matter for mis-accounting during the years 1992 through 1996, the Commission pointed out that:

- Until 1997, every chief financial officer (“CFO”) and chief accounting officer (“CAO”) in Waste Management’s history as a public company had previously worked as an auditor at Andersen.
- During the 1990s, approximately 14 former Andersen employees worked for Waste Management, most often in key financial and accounting positions.

Press Release, U.S. Sec. and Exch. Comm’n., Arthur Andersen LLP Agrees to Settlement Resulting in First Antifraud Injunction in More Than 20 Years and Largest-Ever Civil Penalty (\$7 Million) in SEC Enforcement Actions Against a Big Five Accounting Firm (June 19, 2001), available at <http://www.sec.gov/news/headlines/andersenfraud.htm>.

2. Weak professional review that provided no counterweight

If other forces had restrained these somewhat subtle but clearly negative biases inherent in pre-reform audit practice, all might still have been well. And two possible restraining forces were on the scene. First, the audit profession policed itself. It did so through triennial peer reviews, each of which focused on the quality control systems at the reviewed firm, and each of which concluded with an opinion.⁶² Almost 96% of the peer reviews, however, detected no serious quality control problem at *any* reviewed firm,⁶³ and none of the large firms ever received an opinion finding such a problem.⁶⁴ Amidst testimony suggesting that the reviews therefore amounted to little more than backslapping by members of what amounted to an exclusive club,⁶⁵ and after Deloitte praised Arthur Andersen in a review following the collapse of Andersen's client Enron (a review which excluded the Enron audit because it was under investigation),⁶⁶ the body that oversaw the reviews voted itself out of existence.⁶⁷ The first possible check on auditor bias clearly did not work.

3. Passive audit committees that did not affect the negotiations

Audit committees at audited companies constituted a second possible check on auditor bias. Roughly speaking, an audit committee's job was to supervise the auditor, and, at least after 1999, the auditor was technically responsible to the audit committee

62. 2 LOUIS LOSS ET AL., *SECURITIES REGULATION* 396-98 (4th ed. 2007).

63. Gilles Hilary & Clive Lennox, *The Credibility of Self-Regulation: Evidence from the Accounting Profession's Peer Review Program*, 40 J. ACCT. & ECON. 211, 215, 216-18 (2005) (describing the four types of opinions with which reviews concluded, and what percentages of each type were issued).

64. *S. Banking Comm. SOX Hrg. I*, *supra* note 57, at 24 (statement of Harold M. Williams, Chairman, United States Securities and Exchange Commission, 1977 to 1981).

65. *Id.* at 246-47 (statement of Lynn E. Turner, Chief Accountant, United States Securities and Exchange Commission, 1998 to 2001).

66. Bloomberg News, *Report on Andersen*, N.Y. TIMES (Late Ed.), Jan. 3, 2002, at C3 ("Andersen said in a news release that Deloitte's review of 240 of its audits for the year ended Aug. 31 found 'reasonable assurance' that the firm's quality control standards comply with professional standards."). But the Deloitte review did not include a review of the Enron audits. *Id.*

67. *S. Banking Comm. SOX Hrg. II*, *supra* note 57, at 982, 983-84 (The Road to Reform, A White Paper from the Public Oversight Board on Legislation To Create a New Private Sector Regulatory Structure for the Accounting Profession) (2002).

at each company listed on the major exchanges or traded through NASDAQ, and the audit committee was technically charged with hiring the auditor and evaluating the auditor's performance.⁶⁸ But the audit committees were paper tigers. SEC Chairman Levitt complained of hearing about "one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to a perfunctory presentation."⁶⁹ Robert Jaedicke, the chair of the audit committee at Enron during the period in which it committed its wrongdoing, testified to his "understanding that audit committees of most corporations, like Enron, typically meet for a few hours several times a year."⁷⁰ The WorldCom Audit Committee was archetypically indolent, meeting "three to five times per year" between 1999 and 2001, with "[m]eetings last[ing] about one hour except [for] . . . the February 2002 meeting [which], likely in response to heightened awareness growing out of the Enron scandal, lasted closer to two hours."⁷¹ These examples typified the lethargic level at which most audit committees functioned at the time.⁷² The second possible check on auditor bias simply did not function much at all.

68. All three of the principal trading platforms, beginning in 1999, required that listed companies' audit committees have written charters stating that the outside auditor was ultimately accountable to the audit committee and the board of directors and that the audit committee and the board had ultimate authority to select, evaluate, and replace the auditor. Order Approving Proposed Change in NASDAQ Audit Committee Requirements, 64 Fed. Reg. 71,523, 71,524-25 (Dec. 21, 1999) [hereinafter SEC 1999 Approval of NASDAQ Audit Committee Requirements]; Order Approving Proposed Change in American Stock Exchange Audit Committee Requirements, 64 Fed. Reg. 71,518, 71,519 (Dec. 21, 1999); Order Approving Proposed Change in New York Stock Exchange Audit Committee Requirements, 64 Fed. Reg. 71,529, 71,529-30 (Dec. 21, 1999) [hereinafter SEC 1999 Approval of NYSE Audit Committee Requirements].

69. Levitt, Numbers Game, *supra* note 43.

70. *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. of Investigations of the S. Comm. on Gov't Affairs*, 107th Cong. 19, 20 (2002). The Enron Audit Committee "held regular meetings at least four or five times a year; always four, usually five." *Id.* Meetings were short. *Id.* at 458-61 (draft minutes of Enron Audit and Compliance Committee meeting on Feb. 7, 2000, convened at 3:40 PM and adjourned at 4:50 PM); *id.* at 500-05 (draft minutes of meeting on Feb. 12, 2001, convened at 1:40 PM, recessed at 3:15 PM, then reconvened for ten minutes on Feb. 13 at 7:50 AM and adjourned at 8:00 AM); *id.* at 517-19 (draft minutes of meeting on Nov. 2, 2001, convened at 9:00 PM and adjourned at 9:40 PM).

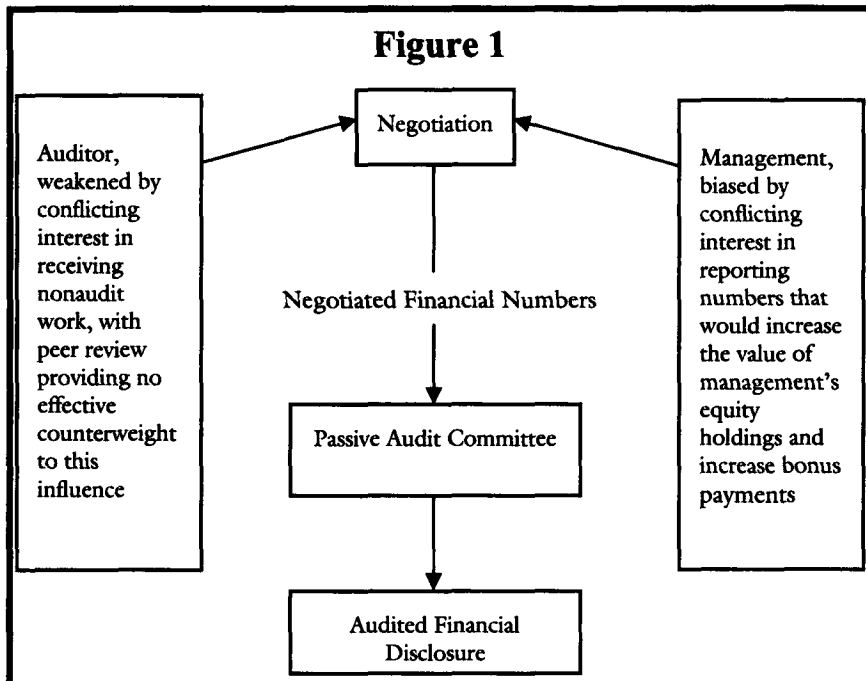
71. Special Investigative Comm. of the Bd. of Dir. of WorldCom, Inc., Report of Investigation 274 (Mar. 31, 2003) (on file with author).

72. See *infra* note 104 and accompanying text for additional statistics.

4. *How the pre-reform milieu advantaged management in audit negotiations*

In sum, the pre-reform negotiation between the company and the auditor over a particular number to select from a continuum of numbers displayed these characteristics: Management—with its special interest in reporting numbers in the audited financials that would boost or maintain executive wealth—controlled the nonaudit work that an auditor could win. An audit firm's dependence on management for consulting work that was even more valuable than the audit work weakened the audit firm's appetite for resisting management during the negotiations. The lead audit partner's financial stake in "cross-selling" the lucrative nonaudit services weakened that partner's resolve to bargain against management's preferred number. The audit profession's self-regulation, through peer review, provided no effective counterweight to these economic incentives. The audit committee devoted little time to its work, constituted no significant factor in the back-and-forth between management and the auditor and, accordingly, did not support the auditor in the negotiations.

Figure 1 portrays this world.



C. Bargaining After the Reforms: Auditors Cleansed and Strengthened

The reformers attacked the audit process. The changes they wrought transformed the negotiating paradigm just described. The underdog auditors gained power.

1. Removal of auditor bias

The reforms prohibit auditors from offering a long list of nonaudit services to their audit clients.⁷³ The ban includes some of the most lucrative pre-reform consulting services that accounting firms provided—such as designing and implementing an audit client's financial information system.⁷⁴ While the new rules still permit the accounting firms to offer limited nonaudit services to audit clients—including some tax services⁷⁵—the client must publicly report the amounts of these other services, as well as the amount paid for the audit, so that shareholders may consider whether total fees paid to the auditor, as well as the composition of those fees, compromise the outside accounting firm's independence.⁷⁶ When a

73. In late 2000, the SEC adopted revisions to its auditor independence regulation that, with some exceptions, prohibited auditors from offering specified nonaudit services to their audit clients. *Revision of the Commission's Auditor Independence Requirements*, 65 Fed. Reg. 76,008, 76,084–85 (Dec. 5, 2000) [hereinafter 2000 Auditor Independence Release]. In 2002, Sarbanes-Oxley wrote that list into law, slightly rephrasing it, eliminating many of the exceptions that the 2000 regulation included, and making it “unlawful” for an auditor to supply these services to an audit client. SOX § 201(a), 15 U.S.C. § 78(g). In 2003, the SEC then adopted a revised independence regulation setting out the prohibited work. *Strengthening the Commission's Requirements Regarding Auditor Independence*, 68 Fed. Reg. 6006, 6045–46 (Feb. 5, 2003) (adding what is now 17 C.F.R. § 210.2-01(c)(4) (2010)) [hereinafter 2003 Auditor Independence Adopting Release].

74. 17 C.F.R. § 210.2-01(c)(4)(ii)(B).

75. 2003 Auditor Independence Adopting Release, *supra* note 73, at 6017.

76. When the SEC put the 2000 independence regulations in place, it required each reporting company to disclose in its proxy statement fees paid to the auditor during the most recent fiscal year for (i) the audit, (ii) financial information system design, and (iii) all other services. 2000 Auditor Independence Release, *supra* note 73, at 76,084, 76,087–88.

When the SEC adopted the revised independence rules in 2003, it changed the disclosure scheme so that, now, a public company must disclose, separately for each of the last two years, (i) under the caption “Audit Fees,” the total billed for professional services rendered for the audit; (ii) under the caption “Audit-Related Fees,” the total amount billed by the auditor for services such as employee benefit plan audits and consultation concerning financial accounting and reporting standards; (iii) under the caption “Tax Fees,” the total amount billed by the auditor for “tax compliance, tax advice, and tax planning”; and (iv) under the caption “All Other Fees,” the total amount paid to the auditor for all other services. 2003 Auditor Independence Adopting Release, *supra* note 73, at 6,048 Sch. 14A (Item 9(c)).

new threat to auditor independence appeared in 2003—auditors “cross-selling” tax shelters to audit clients and their executives—that cross-selling, too, was rule-constrained.⁷⁷

As laws and rules have separated auditors from conflicts of interest generated by nonaudit work, the industry itself has changed. Most of the large accounting firms divested their consulting practices,⁷⁸ and two of them later restructured, curtailed, or otherwise limited their tax shelter practice.⁷⁹ As a result of all of these developments—laws, regulatory rules, and industry self-transformation—the amounts that companies pay to auditors for nonaudit services, and the percentage of total fees that companies pay to auditors for nonaudit services, have dramatically declined.⁸⁰

Attacking incentives at a more personal level, the SEC adopted a regulation that effectively prohibits an auditing firm from compensating an audit partner for selling nonaudit work to audit

77. News articles in 2003 reported that audit firms were providing tax avoidance advice to high executives at audit clients. See Jonathan D. Glater & Stephen Labaton, *Auditor Role in Working for Executives Is Questioned*, N.Y. TIMES (Nat. Ed.), Feb. 8, 2003, at C1. Government investigations showed that auditors provided tax shelters to both their audit clients and executives at those clients. S. Rep. No. 109-54, at 70 (2005) [hereinafter Senate Report on Role of Professional Firms in Tax Shelters]. In response, the Public Company Accounting Oversight Board adopted rules that effectively prohibit auditors from seeking or performing such work. Public Company Accounting Oversight Board Release No. 2005-014, Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, at A-6 to -7 (July 26, 2005) (adopting, among others, PCAOB Rules 3522, 3523, and 3524).

78. In 1998, there were five large accounting firms in the United States. U.S. GENERAL ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 11 (2003). Arthur Andersen went out of business as a result of its indictment for obstruction of justice in the Enron investigation. *Id.* at 12. By 2003, the remaining “Big 4” audited “over 97 percent of all public companies with sales over \$250 million.” *Id.* at 16. Three of the Big 4 sold or divested large portions of their consulting services, *id.* at 9, so that the three selling firms in 2002 received no revenue from management consulting, *id.* at 17.

79. The Senate report stated that KPMG had committed to “dismantl[e] its tax shelter development, marketing and sale resources” and that Ernst & Young had committed to “eliminat[e] the tax practice group that produced its tax shelter sales.” Senate Report on Role of Professional Firms in Tax Shelters, *supra* note 77, at 6.

80. One study examining fee information for companies filing with the SEC during the period 2000 through 2005 found that, for companies using large auditors, “average *Audit fees* increased from \$596,081 [in] the pre-SOX period to \$1,478,905 [in] the post-SOX period, an increase of 148%,” while “*Nonaudit fees* decreased from \$1,438,447 to \$851,189, a decline of 41%.” Alok Ghosh & Robert Pawlewicz, *The Impact of Regulation on Auditor Fees: Evidence from the Sarbanes-Oxley Act*, 28 AUDITING: A J. OF PRACTICE AND THEORY 171, 181, 185 & tbl.2 (2009).

clients.⁸¹ To inhibit the migration of auditors to financial reporting positions within clients, the law and regulations prohibit an accounting firm from auditing a public company if the CEO, CFO, controller, chief accounting officer, or other executive with a financial reporting oversight role was a member of the audit engagement team, unless a year has passed after the now-executive participated in the audit.⁸² To forestall too-close relationships forged by auditors who deal with the same management year-in and year-out, the reforms effectively require that the lead audit partner and the concurring partner rotate off the audit after five years and remain off the audit thereafter for five years, and that all other partners who provide more than ten hours of service rotate off the audit after seven years and remain off thereafter for two years.⁸³

2. A new system of auditor review

To replace the feeble peer reviews of yesteryear, Congress created an entirely new auditor regulator, the Public Company Accounting Oversight Board (the “Board” or “PCAOB”). The Board—appointed by the SEC—not only has the power to create auditing standards, but inspects and disciplines auditors as well. This new body is a vast operation, with a home office in Washington, D.C. and twelve offices in seven regions spread across the country.⁸⁴ The Board inspects the large auditing firms every year⁸⁵ and, in the

81. 2003 Auditor Independence Adopting Release, *supra* note 73, at 6047 (adding 17 C.F.R. § 210.2-01(c)(8) (2010) (providing, with an exception for small audit firms, that an accounting firm is “not independent . . . if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with [the] audit client to provide any products or services other than audit, review or attest services”). As set out in note 27, *supra*, an accounting firm must be “independent” in order to provide an audit opinion for a public company. Therefore, adding a criterion to the definition of “independent” is the equivalent to adding a requirement for public company auditors.

82. SOX § 206, 15 U.S.C. § 78j-1(l); 17 C.F.R. § 210.2-01(c)(2)(iii) (2010). For certain exceptions—e.g., for persons who devoted less than ten hours to the audit—and related definitions, see 17 C.F.R. § 210.2-01(f)(3)(ii).

83. SOX § 203, 15 U.S.C. § 76j-1(j); 17 C.F.R. § 210.2-01(c)(6)(A)&(B) (2010). For related definitions, see 17 C.F.R. § 210.2-01(f)(7). Again, the regulation imposes the requirements by providing that an auditor violating the rotation rules is not “independent.”

84. See About the PCAOB, <http://pcaobus.org/About/Pages/default.aspx> (last visited Jan. 2, 2011).

85. SOX § 104(b)(1)(A), 15 U.S.C. § 7214(b)(1)(A) (requiring the PCAOB to inspect every year each firm that “regularly provides audit reports for more than 100 issuers”).

process, looks at their work on hundreds of audits.⁸⁶ In 2008, the PCAOB “performed field work” at the national office of each of the big four accounting firms and at more than one hundred practice offices as well.⁸⁷

Each inspection yields a report. The statute creating the Board includes an incentive to encourage audit firms to correct problems that PCAOB inspections find: the portion of a report identifying defects in an accounting firm’s audit quality control systems is never publicized, provided that the firm takes remedial action, satisfactory to the Board, within a year of the report’s completion.⁸⁸ That incentive works, with most firms resolving quality control issues to the PCAOB’s satisfaction in order to keep those problems confidential.⁸⁹

The Board does, however, publish the other portions of the reports. Those published portions include specific criticisms of particular audits, with the names of the clients omitted. Significantly for this Article, such criticisms include *errors in auditing the kinds of numbers over which auditors and management negotiate, such as allowances for loan losses, reserves for impaired loans, and the valuation of illiquid securities.*⁹⁰ Moreover, the SEC and the Board—now both

86. See PCAOB, 2006 ANNUAL REPORT 9 (“In 2006, PCAOB inspectors reviewed portions of more than 360 audits performed by the largest nine firms and 720 audits performed by 163 smaller firms.”).

87. PCAOB, REPORT ON 2008 INSPECTION OF DELOITTE & TOUCHE LLP 2 (Apr. 16, 2009) [hereinafter 2008 D&T REPORT] (inspecting twenty-four practice offices); PCAOB, REPORT ON 2008 INSPECTION OF ERNST & YOUNG LLP 2 (May 19, 2009) [hereinafter 2008 E&Y REPORT] (inspecting twenty-two offices); PCAOB, REPORT ON 2008 INSPECTION OF KPMG LLP 2 (June 16, 2009) [hereinafter 2008 KPMG REPORT] (inspecting twenty-nine offices); PCAOB, REPORT ON 2008 INSPECTION OF PRICEWATERHOUSECOOPERS LLP 2 (Mar. 25, 2009) [hereinafter 2008 PWC REPORT] (inspecting thirty offices).

88. SOX § 104(g)(2), 15 U.S.C. § 7214(g)(2); PCAOB, Rule 4009.

89. In mid September 2010, the PCAOB website listed 1156 inspection reports dated more than one year before that date. <http://pcaobus.org/Inspections/Reports/Pages/default.aspx>. Of those, the PCAOB identified only 79 (a bit under 7%) as containing quality control criticisms that the Board had identified through inspection and that had not been addressed to the Board’s satisfaction. No report in any year for any of the big four firms reflected unremediated quality control issues.

90. See 2008 D&T REPORT, *supra* note 87, at 4–6 (citing failures to test one audit client’s assumptions for calculation of allowance for doubtful accounts, to sufficiently test another client’s allowance for loan losses in light of declining collateral values, and to evaluate the reasonableness of a third client’s assumptions relating to the value of illiquid investment securities it held); 2008 E&Y REPORT, *supra* note 87, at 6–7 (citing failures to sufficiently assess the valuation of certain securities held by one client, to assess the valuation of certain loans that the same client had made, and to evaluate (except by questioning management) the

responsible for discipline of the audit profession⁹¹—have meted out in recent years some very harsh punishments to major accounting firms and their partners,⁹² including punishments for violations of auditor independence rules.⁹³ The point is that the new regulatory

methods and reasonableness of another client's reserve analysis for impaired loans); 2008 KPMG REPORT, *supra* note 87, at 4–8 (citing failures at multiple clients to sufficiently understand or test management valuations of assets in pension plans; failure to test assumptions behind one client's allowance for loan losses and inappropriate reliance on that client's internal controls relating to that allowance; acceptance at another client of percentages used to calculate the noncurrent component of the allowance for loan losses without determining whether the percentages were supportable); 2008 PWC REPORT, *supra* note 87, at 5–6 (citing failure to address inconsistencies in client's differing valuations of an acquisition for goodwill impairment; failure in another audit to understand the methodologies and evaluate the assumptions used to estimate fair value of illiquid investment securities).

91. Congress empowered the Board not only to inspect audit firms but also to conduct investigations and institute disciplinary proceedings against them. SOX § 105, 15 U.S.C. § 7215. The Board may investigate and impose sanctions for violations by a registered auditing firm of any provision in SOX, any provision of the securities laws concerning audit reports, any related SEC rules, or any related professional standards. SOX § 105(b)(1), (c)(4), 15 U.S.C. § 7215(b)(1), (c)(4); PCAOB, RULE 5100(a), 5101(a)(1), 5300(a). The Board's disciplinary actions complement those of the SEC, which retains its own right to sanction auditors for securities law violations (e.g., through injunctions under 15 U.S.C. § 78u(d)(1) and suspension of a firm's ability to practice before the Commission under 17 C.F.R. § 201.102(e) (2010)).

92. *See, e.g.*, Order Making Findings and Imposing Sanctions, In the Matter of Thomas J. Linden, CPA, PCAOB Release No. 105-2009-004 (Aug. 11, 2009) (barring Deloitte & Touche partner from association with any accounting firm registered with the Board, with permission to petition for reinstatement after two years and imposing \$75,000 civil penalty); Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions, In the Matter of Christopher E. Anderson, CPA, PCAOB Release No. 105-2008-003 (Oct. 31, 2008) (barring Deloitte & Touche partner from association with any registered firm for one year, restricting his participation in audits for an additional year, and imposing \$25,000 civil money penalty); Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions, In the Matter of Deloitte & Touche LLP, PCAOB Release No. 105-2007-005 (Dec. 10, 2007) (censuring the firm and imposing a \$1,000,000 civil money penalty); Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions, In the Matter of Deloitte & Touche LLP, SEC Admin. Proceeding File No. 3-11910 (Apr. 26, 2005) (settling with firm that agreed to pay \$25 million, and to take remedial measures to be evaluated in eighteen months by an independent consultant).

93. *See* Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Ernst & Young LLP, et al., SEC Admin. Proceeding No. 3-13114 (Aug. 5, 2008) (E & Y agreeing to pay more than \$2.9 million to settle charges that the firm violated independence standards, one individual partner agreeing to a cease-and-desist order, and a second partner agreeing to be barred from SEC practice, with permission to apply for reinstatement after one year); Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities and Exchange Act of 1934 and

structure both enforces auditor independence and inspects for audit errors involving exactly the “soft” numbers that result from auditor/management negotiation.

3. *A more active audit committee*

Sarbanes-Oxley requires auditors to “timely report” to audit committees “all critical accounting policies and practices”⁹⁴—policies that can affect the soft numbers over which management and the auditor argue. The statute also requires auditors to report to audit committees “all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management . . . , ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the [auditor].”⁹⁵ So, for example, if different treatments would produce different numbers and if management and the auditor have discussed those different treatments and resulting numbers, both the treatments and the different numbers must be provided to the audit committee. Moreover, Sarbanes-Oxley demands that auditors provide to the audit committees all “material written communications between the [auditor] and . . . management . . . , such as any . . . schedule of unadjusted differences.”⁹⁶ Thus, if the auditor and management disagree in a material way on a reserve figure, or other soft number and, after discussion, the disagreement remains, the auditor will document that difference on a schedule that the audit committee receives.

Rule 102(c) of the Commission’s Rules of Practice, Making Findings, and Imposing Remedial Sanctions, In the Matter of Ernst & Young LLP, SEC Admin. Proceeding File No. 3-12600 (Mar. 26, 2007) (E & Y agreeing to pay more than \$1.5 million to settle alleged auditor independence violations); Order Granting Motion for Expedited Entry of Final Order and Notice that Initial Decision has Become Final, In the Matter of Ernst & Young, SEC Admin. Proceeding File No. 3-10933 (Apr. 26, 2004) (ordering E & Y to pay more than \$2.1 million, to retain independent consultant, and to refrain from accepting audit engagements for new public company clients for a period of six months, after initial ALJ decision on Apr. 16, 2004, finding that E & Y violated auditor independence standards).

94. SOX § 204, 15 U.S.C. § 78j-1(k)(1); 17 C.F.R. § 210.2-07(a)(1) (2010) (imposing the same requirement). These are policies that directly affect the kinds of negotiation with which this Article is concerned. *See supra* notes 19–23 and accompanying text.

95. SOX § 204, 15 U.S.C. § 78j-1(k)(2); 17 C.F.R. § 210.2-07(a)(2) (imposing the same requirement).

96. SOX § 204, 15 U.S.C. § 78j-1(k)(3); 17 C.F.R. § 210.2-07(a)(3) (imposing the same requirement).

Sarbanes-Oxley then proceeds to mandate that audit committees resolve any matters on which auditors and management disagree⁹⁷ and mandate that financial statements filed with the Commission “reflect all material correcting adjustments that have been identified by [the auditor] in accordance with generally accepted accounting principles and the rules and regulations of the Commission.”⁹⁸ This means that, if the management and the auditor cannot agree, then the audit committee must decide and, effectively, means that the audit committee must decide in the auditor’s favor if push really comes to shove on a material matter and the auditor pounds the table.

Even before Sarbanes-Oxley, listing standards required that boards of directors control auditor hiring,⁹⁹ but Sarbanes-Oxley makes this requirement part of the federal securities law, explicitly placing the responsibility and power over auditors with listed company audit committees.¹⁰⁰ And the new law requires that audit committees pre-approve not only all audit work but also, with a de minimis exception, all nonaudit work that the auditor performs for the company.¹⁰¹ The reforms also tighten the independence requirements for audit committee members, to further remove them from management influence.¹⁰² The auditor therefore now has a real client other than management—the audit committee.

97. SOX § 301 commanded the SEC to issue regulations requiring the exchanges and NASDAQ to prohibit the listing of any company unless its audit committee is “directly responsible for the appointment, compensation, and oversight of the work of [the auditor] . . . (including resolution of disagreements between management and the auditor regarding financial reporting)” and unless the auditor reports “directly to the audit committee.” SOX § 301, 15 U.S.C. §§ 78j-1(m)(1)(A), (2) (emphasis added). The Commission issued such a regulation. 17 C.F.R. §§ 240.10A-3(a)(1), (b)(2). Listing standards now demand that audit committees comply with that rule. See NYSE, Inc., Listed Company Manual § 303A.06 [hereinafter NYSE Listed Company Manual]; NASDAQ, Inc., Stock Market Rule 5605(c)(3).

98. SOX § 401, 15 U.S.C. § 78m(i).

99. See *supra* note 68.

100. See *supra* note 97 citing the statute, regulation, and listing standards.

101. SOX § 202, 15 U.S.C. § 78j-1(i); see also the related SEC rule at 17 C.F.R. § 210.2-01(c)(7)(i) (2010) (providing that an auditor is not “independent” of a client company unless the client’s audit committee pre-approves audit and nonaudit work that the auditor performs for the company).

102. See the changes in listing standards at Order Approving Proposed Rule Changes Relating to Corporate Governance at NYSE and NASDAQ Listed Companies, 68 Fed. Reg. 64,154, 64,157–58, 64,161–64 (Nov. 12, 2003). For the current listing standards, see NYSE Listed Company Manual, *supra* note 97, § 303A.02(b) (containing specific independence tests), *id.* § 303A.07(b) (mandating that all members of audit committees satisfy the independence tests of section 303A.02), and similar provisions at NASDAQ, Inc., Stock

As a result of these and other reforms,¹⁰³ audit committees today display far more industry than in the past. The average number of audit committee meetings per year at a random sample of thirty small companies (market value of less than \$75 million) rose from 1.7 in 1998 to 5.1 in 2004. At thirty medium-sized companies (market value from \$75 million to \$700 million) the number rose from 2.3 to 6.2, and at thirty large companies (market value over \$700 million) from 3.2 to 8.2.¹⁰⁴ Another study of 164 companies found that “[f]rom 2002 to 2006, the average annual number of audit committee meetings doubled from about five to ten meetings” with 60% holding nine or more meetings in 2006, compared to 7% in 2002.¹⁰⁵

The impact of Sarbanes-Oxley and other similar reforms on the participation of audit committees in discussions between management and auditors is obvious when one compares the findings of two surveys, one published prior to Sarbanes-Oxley, and the other after. A pre-SOX survey found that (i) auditors met regularly with the committees about two to three times a year, (ii) auditors believed the “members of audit committees often lack[ed] the expertise to perform their job effectively,” and (iii) the meetings with the committees were generally passive ones in which the auditors reported and the directors on the committees listened but did not actively discuss matters.¹⁰⁶ Some audit firm partners “indicated that, in general, audit committees [were] ineffective and [were] not powerful enough to resolve contentious matters with management.”¹⁰⁷

Market Rule 5605(a)(2), (c)(2)(A). SOX included its own independence requirement, which listing standards had to incorporate, and which among other things prohibited audit committee members from receiving any consulting fees from the company. SOX § 301, 15 U.S.C. § 78j-1(m)(3)(B)(i); 17 C.F.R. § 240.10A-3(b)(1)(ii)(A) (containing the related SEC regulation).

103. See, e.g., NYSE Listed Company Manual, *supra* note 97, § 303A.07(b)(iii) (listing eight tasks that audit committees must now perform).

104. James S. Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors*, 22 REV. FIN. STUD. 3287, 3296, 3307 tbl.5 (2009).

105. HURON CONSULTING GROUP, 2007 AUDIT COMMITTEE RESEARCH REPORT unnumbered second and fourth pages (counting cover) (2007).

106. Jeffrey Cohen et al., *Corporate Governance and the Audit Process*, 19 CONTEMP. ACCT. RES. 573, 586 (2002).

107. *Id.*

A similar survey conducted in 2006 found auditors reporting that, on average, they met with audit committees 6.4 times a year.¹⁰⁸ This time “93 percent of the auditors reported that the audit committee had sufficient expertise and 96 percent note[d] that audit committee members [had] sufficient power to confront management with respect to the financial reporting process.”¹⁰⁹ A little over half the auditors said that discussions with the audit committee affected resolution of contentious issues,¹¹⁰ and a number of specific comments suggested that management was now disinclined to have a disagreement with auditors over issues that went to the audit committee.¹¹¹

Even more pertinent to this Article, audit committee members are now more likely to support auditors in their negotiations with management. DeZoort and others presented a hypothetical to 131 audit committee members before the passage of the Sarbanes-Oxley Act and to 241 audit committee members after that legislation became law.¹¹² In the hypothetical, management had written down a

108. Jeffrey Cohen et al., *Corporate Governance in the Post Sarbanes-Oxley Era: Auditors' Experiences*, 27 CONTEMP. ACCT. RES. 751, 754–55, 760 tbl.3 (2010).

109. *Id.* at 768.

110. *Id.* at 760 tbl.3. Some auditors, however, commented that committees wanted management and auditors to work out disputes among themselves rather than referee contentious issues. *Id.* at 767.

111. One partner reported:

In the course of the discussions with the audit committee we were reporting on adjustments not recorded and the audit committee chairman said, I don't think so, I think we should record known errors [and] departures from GAAP. So we want you to go back and record that adjustment

Id. at 766 (alteration in original). Another partner commented:

Audit committees challenge management . . . they ask questions of management[,] whereas in the old days it was much more focused on the auditors. So it is very even. Audit committees are much more serious today than they used to be. . . . It's a completely different view than it was Pre-Sarbanes.

Id. at 768 (first and third alterations in original).

A further comment by an audit partner reflects the shift in power between auditors and management, a shift due to the increased power of the audit committee: “[CFOs] don't want to have unrecorded adjustments on their score sheet as it were, on the summary of adjustments[,] because they know they are going to get picked at from the audit committee.” *Id.* at 772.

112. F. Todd DeZoort et al., *Audit Committee Member Support for Proposed Audit Adjustments: Pre-SOX Versus Post-SOX Judgments*, 27 AUDITING: J. PRAC. & THEORY, at 85, 87 (May 2008) [hereinafter DeZoort 2008]. This piece includes the results of the post-SOX experiment and contrasts them with the pre-SOX results reported in F. Todd DeZoort et al., *Audit Committee Member Support for Proposed Audit Adjustments: A Source Credibility Perspective*, 22 AUDITING: J. PRAC. & THEORY, at 189 (Sept. 2003).

portion of inventory and the auditor recommended an additional write-down “equal to three percent of pre-tax income, making the materiality of the adjustment unclear.”¹¹³ Since this additional write-down was discretionary, it was a soft number—either management’s write-down number, or the auditors’ number, would likely be acceptable under GAAP. The researchers measured the “audit committee member[’s] judgment about the auditor’s proposed adjustment . . . on a continuous scale from 0 = definitely do not adjust to 100 = definitely adjust.”¹¹⁴ DeZoort and his colleagues found that, without controlling for other variables, the mean post-SOX support score (65.85) was 11.6% higher than the mean pre-SOX score (58.99) and that this difference was statistically significant.¹¹⁵ Even after controlling for other variables, such as whether the additional adjustment would cause the earnings per share to fall below analyst forecasts and whether the adjustment was proposed for a quarterly report or an annual report, DeZoort and his fellows still found that “*audit committee members are significantly more supportive of the auditor-proposed adjustment post-SOX than pre-SOX.*”¹¹⁶

4. How the reforms advantage the auditor in negotiations

To summarize: without the legal and organizational ability to offer consulting services to clients, an auditing firm no longer has the same economic incentive to yield to management when negotiating over the soft numbers that can, by accounting rules, fall within a range. As payment to an audit partner for successfully soliciting nonaudit work is now forbidden, an individual auditor no longer faces pressure or temptation to “cross-sell” nonaudit services in order to protect or enhance compensation, and cross-selling efforts consequently no longer bias that partner to set low goals in negotiations with management or to accept numbers that are technically permissible but that the partner does not believe best reflect the company’s economic performance. Moreover, because an individual auditor can no longer move straight from his or her accounting firm to a job at an audit client, the auditor has less

113. DeZoort 2008, *supra* note 112, at 87, 89–90.

114. *Id.* at 93 tbl.2.

115. *Id.* at 92, 93 tbl.2.

116. *Id.* at 93–94 & tbl.3.

incentive to advance a career move by going soft in negotiations. And, since the top partner on the audit must rotate every five years, he or she should not become so cozy with management that personal relationships will compromise bargaining. The principal factors that arguably weakened the auditor's resolve are gone.

Management likely will still seek to report numbers that will protect or increase stock prices and thereby protect or increase officers' wealth derived from large equity stakes that executives still hold in their companies.¹¹⁷ But management no longer controls the hiring of auditors; the audit committee does. And management no longer is able to unilaterally bestow permissible nonaudit work on auditors. The audit committee must pre-approve even those jobs.

Moreover, the audit committee is now a genuine participant in any negotiations. No longer can management lean on auditors in disputes over a number to select from a range of figures that are all acceptable, then present the resulting number to the audit committee as a *fait accompli*. Now the auditors *must* provide audit committees with the fundamental information about the very matters over which management and the auditor are negotiating: the critical accounting policies that inform the choice of a particular number from a discretionary range, the alternative accounting treatments discussed with management for selecting the number, the different numbers that different treatments would produce, and the alternative that the auditor prefers. And simply by putting an interchange with management in writing and deeming it material, auditors can ensure that that communication comes before the audit committee. Further, the committee—not management—is charged with resolving the financial reporting disagreements that auditor/management negotiations raise, in a legal context requiring that the final product include all of the material adjustments that the auditors identify.

In discharging this more active role, the audit committee's incentives are likely to be the same as the auditor's. The audit committee typically enjoys modest upside from misstated financials (and, in most cases, far less than management)¹¹⁸ but does face

117. See *supra* note 44, the 2008 numbers.

118. Audit committee members typically hold less equity than top executives. As of December 31, 2009, the General Electric ("GE") CEO held stock or other equity interests in the company equivalent to almost 6 million shares, while all six of the audit committee members, taken together, held such interests in less than 625,000, with five out of the six

downside risks, such as investigation and possible enforcement action by the SEC as well as possible civil suits and potential personal liability in such litigation.¹¹⁹ Moreover, the change in objectively

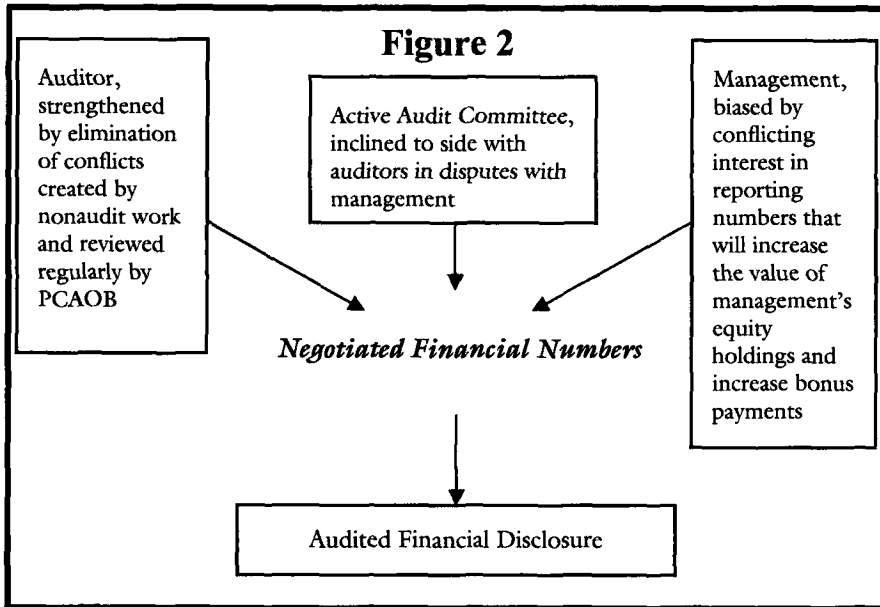
members owning less than 150,000 each. GE, Notice of 2010 Annual Meeting and Proxy Statement, at 9, 15, 41 (filed with Sched. 14A on Mar. 5, 2010). As of February 22, 2010, the Intel CEO held interests in almost 8.8 million shares (owned outright or underlying options that were or would be exercisable within sixty days or in restricted stock that would vest within sixty days), while the five members of the audit committee held, together, similar interests in less than 430,000 shares, with four members each holding interests in less than 48,000. Intel Notice of 2010 Annual Stockholders' Meeting and Proxy Statement, at 7, 10, 20 (filed with Sched. 14A on Apr. 2, 2010). As of March 12, 2010, the new Chevron CEO held interests in over 576,000 shares (owned outright, or underlying options that were or would be exercisable within sixty days or in the form of stock units constituting the economic equivalent of shares), compared with interests in less than 103,000 shares held by all four audit committee members combined. Chevron Notice of 2009 Annual Meeting and 2010 Proxy Statement, at 18, 21, 65 (filed with Sched. 14A on Apr. 15, 2010).

Since audit committee members must be independent directors, they cannot by definition be current executives and therefore cannot receive the cash incentive payments made to executives for achieving financial metric or stock price goals. See NYSE Listed Company Manual, *supra* note 97, § 303A.02(b)(i) (stating that a director cannot be independent if he or she "is, or has been within the last three years, an employee of the listed company"); *id.* § 303A.07(b) (mandating all members of audit committee to satisfy independence tests of section 303A.02); NASDAQ, Inc., Stock Market Rule 5605(a)(2)(A), (c)(2)(A) (containing similar provisions).

119. Very few outside directors, whether sitting on audit committees or not, ever pay out of their own pockets for company securities fraud. See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006). But some committee members have been sued, and practitioners continue to caution that "the SEC and increasingly the Courts have focused on the fact of audit committee membership in alleging and/or assessing liability for breach of fiduciary duties under the federal securities laws." Laurie B. Smilan, *A Wake-up Call for Audit Committees: Courts, Increasingly Critical of Uncritical Boards, Stop Short of Imposing Liability—For Now?*, in PLI COURSEBOOK/AUDIT COMMITTEE WORKSHOP 2007: WHAT AUDIT COMMITTEE MEMBERS & LAWYERS WHO ADVISE THEM NEED TO KNOW NOW 349, 356 (2007); see also Jonathan C. Dickey & Daniel P. Muino, *Audit Committee Liability: Recent Actions Against Audit Committee Members*, in PLI COURSEBOOK/AUDIT COMMITTEE WORKSHOP 2006: WHAT AUDIT COMMITTEE MEMBERS & LAWYERS WHO ADVISE THEM NEED TO KNOW NOW 493, 499 (2006) ("Two recent [SEC] actions . . . specifically targeted audit committee members for failure to fulfill their audit committee duties."); *id.* at 502 ("From 2001 to 2005, at least 12 significant class or derivative suits were filed specifically targeting directors in their capacity as audit committee members (as compared to 8 such actions from 1996 to 2000)."); *id.* at 497 (advising that "audit committee members should proceed with caution" even though "the overall risk of personal liability continues to be low"); Jonathan C. Dickey et al., *Recent Civil and Regulatory Proceedings Against Audit Committee Members*, in PLI COURSEBOOK/AUDIT COMMITTEE WORKSHOP 2008: WHAT AUDIT COMMITTEE MEMBERS AND THOSE WHO ADVISE THEM NEED TO KNOW NOW 335, 343 (2008) ("[W]e cannot conclude that the risk of personal liability to audit committee members has generally increased since 2006, [but] . . . the frequency of litigation against audit committee members picked up considerably in the period from mid-2006 to the end of 2007 . . .").

measured audit committee performance suggests that, beyond the threat of liability, the norms of audit committees have changed—with greater value placed on engagement, gatekeeping, and decisive intervention in management/auditor disputes.¹²⁰

Here is the new, and better, world.



Importantly, results show more than an improvement in the process by which public companies produce their audited financial statements. Statistics show a decline in earnings management itself.¹²¹ They show, as well, a decline in the manipulation of just the sort of

120. See Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1643 (2001) (arguing that norms create "articulated standards of conduct" more demanding than "actual liability standards").

121. Studies report a decline in the percentage of companies reporting earnings that exactly meet or just exceed the earnings that analysts project. Koh, *Meeting or Beating Analyst Expectations*, *supra* note 46, at 1071, 1073, 1078-79 & fig.2 (showing the percentage of companies meeting or just beating the last analyst estimate at over 20% during the period from the third quarter of 2001 to the fourth quarter of 2002, declining thereafter to about 15% by the second quarter of 2006, and finding a statistically significant decline even after adjusting for changes in the gross domestic product to account for changing macroeconomic conditions); see also Eli Bartov & Daniel A. Cohen, *The "Numbers Game" in the Pre- and Post-Sarbanes Oxley Eras*, 24 J. ACCT. AUDITING & FIN. 505, 507, 517-18 & Fig.2 (2009) [hereinafter Bartov, *The Numbers Game*].

numbers over which auditors and managements negotiate.¹²²

This does not mean that negotiations are at an end. They still occur.¹²³ But auditors now play with a full hand of face cards. We can remove the derisive quotation marks. It is now *hard* bargaining indeed.¹²⁴

122. One study examined earnings management during two time periods: 1987 through 2001, which the authors called the “pre-SOX period;” and 2002 through 2005, which the authors called the “post-SOX period.” Daniel A. Cohen et al., *Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes-Oxley Periods*, 83 ACCT. REV. 757, 758 (2008). The researchers defined accruals as the difference between (i) earnings before extraordinary items and discontinued operations and (ii) operating cash flow, *id.* at 763, and discretionary accruals for a particular company as the difference between (i) predicted accruals (computed by applying to company metrics the coefficients derived from a regression analysis of accruals in the company’s industry) and (ii) actual accruals, *id.* at 763–64. The investigators found that earnings management by discretionary accruals peaked in 2000, then declined thereafter, with a fairly sharp decline from 2004 to 2005. *Id.* at 772 fig.2. While the study measured discretionary accruals in absolute terms, “most of the decline in accrual-based earnings management seems to have been due to a reduction in positive discretionary accruals”—e.g., the ones that would increase reported earnings. *Id.* at 772; *see also id.* at 773 fig.3 (showing a precipitous decline in positive discretionary accruals between 2004 and 2005). After controlling for different compensation variables (such as bonus as a percentage of total compensation and vested but unexercised options scaled by total outstanding shares), the researchers still found that “the level of accrual-based earnings management declined” after SOX passed. *Id.* at 783. The authors of the study, however, were reluctant to conclude that SOX caused the decline, *id.* at 785, and also found that real earnings management (by such means as decreasing advertising and research and development expenses in a particular accounting period) had increased after SOX, *id.* at 764–65, 771–72. But real earnings management, defined in note 50, *supra*, as “real activities manipulation,” is not a matter for which accounting corrects. *See also* Bartov, *The Numbers Game*, *supra* note 121, at 526 & tbl.6 (finding a decline after SOX in the proportion of companies using accruals manipulation to manage earnings), and at 533 (concluding that the decline in accruals management contributed to the decrease in the number of issuers meeting or just beating analyst estimates).

123. *See* Brown, *Negotiation Research*, *supra* note 42, at 91.

124. Of course, SOX reforms encompassed more than those discussed in the text. For example, SOX and related regulations require that the CEO and CFO of public companies sign certifications of the companies’ quarterly and annual financial statements. SOX §§ 302, 906; 15 U.S.C. § 7241 (2006); 18 U.S.C. § 1350 (2006); 17 C.F.R. § 229.601(b)(31)(i) (2010) (setting out the exact words for the 302 certifications, with the certifications required by 17 C.F.R. §§ 240.13a-14(a), 240.15d-14(a)). As another example, regulations now require that public companies maintain internal control over financial reporting (“ICFR”). The management of each such company must evaluate that control at the end of each year and state whether management concludes that it is effective. And the auditors must audit internal controls and provide an opinion on their effectiveness. 17 C.F.R. §§ 240.13a-15(f) (2010), 240.15d-15(f) (defining ICFR); 17 C.F.R. §§ 240.13a-15(a), 240.15d-15(a) (requiring ICFR); 17 C.F.R. §§ 240.13a-15(c), 240.15d-15(c) (mandating annual evaluation of ICFR in which principal executive and financial officers participate); 17 C.F.R. § 229.308(a) (requiring annual management report on effectiveness of ICFR); Public Company Accounting Oversight Board, Auditing Standard No. 5 (2007).

V. ADDING ATTORNEYS TO AUDITOR/MANAGEMENT NEGOTIATIONS—A BAD IDEA

Today, after the reforms, a number that can fall anywhere within an acceptable range is still soft. Management still has the economic incentive, through equity holdings and bonuses tied to financial performance, to select a number within that range that will contribute to the overall financial results that will boost the value of executive stock and stock derivative holdings and trigger bonuses. The auditors, now freed of the complicating incentives derived from cross-selling consulting services and the prospect (for individual auditors) of moving swiftly from the accounting firm to an in-house position, should be motivated primarily by the reputational incentive to select the number that provides the most transparent financial disclosure. After management and an auditor stake out their initial positions, they retain their incentives through the ensuing negotiations, with the auditors now enjoying the support of the audit committee, a newly active and powerful ally.

So, can this improved bargaining be improved still more by adding attorneys, as suggested by the calls for greater participation by counsel in the preparation of financial statements?¹²⁵ The answer is “no.” It is “no” in part because attorneys suffer from the same structural bias that plagued accounting firms before the reforms.¹²⁶ The answer is “no,” again, because professional ethics and ethos may aggravate rather than control that bias and because the combined effect of these tendencies to favor management in the negotiations will not be counterbalanced by any systematic oversight of attorney participation in accounting discussions. The answer is “no,” once more, because attorneys do not now have and, with some exceptions, are unlikely in the future to have the accounting

It is quite possible that these and other reforms contribute to the reduction in accrual-based earnings management. But the changes set out in the text arguably have the greatest effect on the within-GAAP management/auditor bargaining which, to the extent the auditors “win” that bargaining, reduces *management* efforts to affect reported earnings results through judgments on numbers that can legally take any of a number of values.

125. See *supra* Part II.

126. The text focuses on lawyers in outside firms. Inside counsel should hesitate to participate in the management/auditor negotiations for many of the same reasons. But an inside counsel’s potentially compromising financial incentive results not from the cross-selling pressures, discussed in notes 127–132 and accompanying text, *infra*, but from the equity stake that an inside counsel, particularly at the highest level, often has in the company. See *infra* note 134.

knowledge needed to support useful participation in such negotiations.

A. Attorney Structural Bias

The first and most striking argument against adding attorneys to management/auditor negotiations is that the attorneys who intercede in conversations between auditors and the attorneys' corporate clients suffer from exactly the structural bias that plagued the auditors before the reforms. To perform radical surgery on the auditing profession to remove a conflict of interest only to then add another profession with the same conflict of interest makes no sense. Such a move promises to reverse, instead of advance, efforts to produce transparent financial statements.

Like the pre-reform auditors, lawyers sell a spectrum of services to corporate clients. Today's major law firms are "full service" or at least multiservice providers, each one populated by hundreds of lawyers.¹²⁷ Law firms fully appreciate that maintaining and expanding

127. The lawyers working at the top 100 U.S. law firms, ranked by revenue, tripled from 1986 to 2005, rising from 25,994 to 70,161. Bruce E. Aronson, *Elite Law Firm Mergers and Reputational Competition: Is Bigger Really Better? An International Comparison*, 40 VAND. J. TRANSNAT'L L. 763, 771 n.12 (2007). By 2009, 80,772 lawyers worked at those firms. Aric Press & Greg Mulligan, *Lessons of the Am Law 100*, AM. LAW., May 2010, at 93. Am Law 200 firms have seen similar increases. William D. Henderson, *An Empirical Analysis of Lateral Lawyer Trends from 2000 to 2007: The Emerging Equilibrium for Corporate Law Firms*, 22 GEO. J. LEGAL ETHICS 1395, 1402 (2009).

Increase in firm size reflects the economic advantage of offering a variety of services to clients. See MARC GALANTER & THOMAS PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* 50 (1991) ("Corporate counsel remain drawn to large firms because . . . 'one-stop shopping' benefits the corporate buyer by reducing not only the search costs but the transaction costs of additional quality checks, dealing with different systems of billing, and so forth."). Whether by offering a full array of legal advice or several high-profit services, the modern law firm model is multiservice, a model often developed by hiring lateral partners, who bring new expertise that a firm can market to existing clients. See Gina Passarella, *Diverse Practice, Low Debt Help K&L Gates Prosper*, THE LEGAL INTELLIGENCER 1 (Feb. 5, 2010) (describing Kirkpatrick & Lockhart's model as including "a diversity of practices" and "a strong emphasis on cross-selling," and explaining that the firm has grown by merger and lateral hiring); David Bario, *Midnight Train From Georgia*, AM. LAW., Sept. 2008, at 88 (describing King & Spalding's strategy "to invest in a few high-value practices where it was already strong Much of the boost [in revenue] has come from lateral hiring. . . . The[] new partners brought with them new clients, but . . . the strategy should . . . allow the firm to broaden ties with existing clients as well."); Daphne Eviatar, *Morgan Lewis's Midnight Oil*, AM. LAW., May 2007, at 133 ("While some firms have boosted their numbers by concentrating on a few high-value practice areas, like private equity, complex litigation, or M&A, Morgan, Lewis's strategy has been to remain a full-service firm. . . . [Thomas] Sharbaugh[, the firm's managing partner] . . . emphasizes the success of the firm's

business with *current* clients—and keeping the business from those clients that the law firms presently have—are the keys to revenue preservation and growth.¹²⁸ In recognition of this economic reality, law partners today, like the pre-reform audit partners, are urged to “cross-sell” services outside their specialties to the clients that the partners serve.¹²⁹ Compensation systems at large law firms reward cross-selling.¹³⁰ The call to cross-sell rings out today—and has for

West Coast expansion: Morgan, Lewis added nearly 60 California-based partners from Brobeck, Phleger & Harrison when that firm folded in 2003. ‘This past year we really saw the benefit of our East-West cross-selling,’ says Sharbaugh.”).

128. One commercially available analysis draws from more than 600 interviews—conducted over a period of four years (with the most recent in 2007)—of Chief Marketing Officers, Marketing Directors, and Directors of Business Development at 55% of the Am Law 100 firms and 52.5% of the Am Law 200 firms. THE BTI CONSULTING GROUP, BTI’S BENCHMARKING LAW FIRM MARKETING AND BUSINESS DEVELOPMENT STRATEGIES 5 (2008) (on file with author). It states that “[e]xpanding existing client relationships is twice as important as any other [business development] strategy” and that 92.2% of interviewed marketing officials rated that strategy a “5” on a scale of 1 to 5 (5 being most important), when assessing this strategy’s importance to developing business. *Id.* at 10. Reflecting the use of multi-service firms by large companies, a study based on survey responses from 139 S&P 500 companies and interviews with forty-three chief legal officers at such companies found that most companies sent more than eighty percent of their outside legal work to a small number of firms—average 15 (median 10)—in the period 2003 through 2006. Michele DeStefano Beardslee et al., *Hiring Teams from Rivals: Theory and Evidence on the Evolving Relationships in the Corporate Legal Market* 16, 23 (Feb. 21, 2010), available at <http://ssrn.com/abstract=1442066> [hereinafter Beardslee, *Hiring Rivals*].

129. See, e.g., John S. Smock et al., *The Current Economic Environment: What Law Firm Leaders Are Saying*, OF COUNS., June 2009, at 8 (reporting “close to unanimous agreement” on “opportunities” including “creative approaches to cross-selling . . . , along with sanctions against those partners who will not cross-sell”); Eric Seeger, *The Habits of Highly Effective Law Firm Partners*, THE LEGAL INTELLIGENCER, Mar. 23, 2009, at 5 (listing cross-selling as one of “seven behaviors that firms need their equity partners to . . . demonstrate each year”); IOMA, News Briefs, 05-7 L. OFF. MGMT. & ADMIN. REP., July 2008, at 9 (“Cross-selling is still key to growing new business, so press the issue now”; observing that “your firm’s partners may know that most new business comes from existing clients”); Alan R. Olson, *Marketing, Origination and Formulaic Law Firm Compensation Systems*, 30 REP. TO LEGAL MGMT. 1, 3 (Mar. 2003) (“To perform optimally, lawyers in a firm must cross-sell other lawyers and practice groups to prospects and clients.”).

130. Altman Weil periodically surveys law firms to obtain information on their compensation practices. Questionnaires distributed in fall 2005 yielded responses from forty-one large firms with 100 or more lawyers. ALTMAN WEIL PUBLICATIONS, INC., SURVEY OF COMPENSATION SYSTEMS IN PRIVATE LAW FIRMS 5, 13 (2006). When asked to indicate the importance of specifically identified factors in partner compensation—with a factor considered “very important” given a “1,” a factor considered “somewhat important” given a “2,” a factor of “little importance” given a “3,” and a factor of “no importance” given a “4”—the mean large-firm response for both “business origination in terms of developing new business from existing clients” and “business origination in terms of significantly growing the volume of business from existing clients” was 1.3. *Id.* at 26. That score tied with “individual work done,

years—in the halls of law firms at least as loud as it ever did in the corridors of auditors.

As a result, the securities law partner entering a negotiation between a client and an auditor could have an economic incentive to side with the company so as to smooth the path for the partner to cross-sell other services to the client and boost or protect the partner's take-home pay when next before his or her law firm's compensation committee.¹³¹ Such a partner might be similarly disinclined to anger a client—and thereby possibly lose the securities business, or, in the worst case, even other current business as well—by siding with the auditor.¹³²

And siding with the client company, in this case, means siding with management. Typically the general counsel or chief legal officer—not the audit committee or board of directors as a whole—hires outside counsel, with the occasional intervention of the CEO in hiring for particularly important engagements.¹³³ The general

measured by personal fees collected,” was only bettered by “business origination in terms of bringing new clients to the firm,” which garnered a mean score of 1.1, and exceeded the score for “case responsibility” (1.8), hours recorded (1.8), legal expertise (1.8), and client service (1.7). *Id.*

131. The NYC Task Force observed that “[a] law firm partner’s compensation . . . may depend on the business referred by the CEO of a major client.” NYC BAR REP. ON THE LAWYER’S ROLE, *supra* note 8, at 57.

Professor Coffee disagrees, arguing that as “the law firm partner has increasingly become a specialist . . . [he or she] can best serve as a gatekeeper, because the professional remains more independent of the client and suffers less from a single client’s dismissal.” Coffee, *Attorney as Gatekeeper*, *supra* note 9, at 1305–06. The evidence that cross-selling the services of other partners affects a partner’s compensation, however, suggests that a securities specialist who is dismissed by a client risks compensation committee ire not only for losing the business that he or she performs for that client but also for losing the opportunity to cross-sell to that client the skills of the specialist’s partners.

132. “Many firms . . . have adjusted their compensation systems away from ‘lock-step’ seniority models to performance-based models that reward business generation and client retention.” NYC BAR REP. ON THE LAWYER’S ROLE, *supra* note 8, at 58. The resulting competition for clients “creates pressure on outside counsel to avoid confronting clients about questionable transactions or accounting treatments in order to maintain the client relationship.” *Id.* at 113–14.

A company that is dissatisfied with service from one law firm may put that firm in the “penalty box,” reducing not only the work given to the lawyer who provided the unsatisfactory service but also the work given to that lawyer’s firm. Beardslee, *Hiring Rivals*, *supra* note 128, at 32–33.

133. LEXIS-NEXIS, HOW CORPORATIONS IDENTIFY, EVALUATE AND SELECT OUTSIDE COUNSEL 1 (2005) (yielding responses from 461 U.S. companies and 174 foreign companies); *id.* at 3 (“The chief legal officer (CLO) or general counsel takes the lead in allocating work in both high stakes and low stakes matters. While the CLO or general counsel most often makes

counsel¹³⁴ and CEO¹³⁵ have equity stakes in the company—stakes that provide them with a financial incentive to keep the company's stock price high. An attorney asked to participate in negotiations with an auditor therefore has an incentive to favor management's position in that negotiation in order to win the favor of the officers who can award work to the attorney's firm.

Moreover, individual attorneys, like the individual auditors before the reforms, may move from an outside firm to in-house positions.¹³⁶ For that reason, too, they may be inclined to support, in any negotiations with auditors, the management that might hire them at a later date into in-house counsel spots.

B. Lawyer Ethos and Ethics That May Aggravate the Bias

One answer to the argument just made—that economic incentives will bias attorneys toward a management's position in negotiations with an auditor—might be that professional norms will defeat such bias. Any confidence that professional ethics rules will prevent attorneys from siding with management against the auditors, however, loses force when we examine the specifics of those rules. Model Rule of Professional Conduct 1.2(d) forbids an attorney from counseling a client to engage in, or assisting a client in, "conduct

the final decision for allocating work to outside counsel for high and low stakes matters, the CEO may be involved in the final decision for high stakes matters.").

Of course, the manner in which a particular company hires outside counsel affects the general counsel's influence. Managers other than the general counsel may influence or control the selection of outside counsel for particular matters. Beardslee, *Hiring Rivals*, *supra* note 128, at 13.

134. In 2009, the 100 highest paid general counsels in an annual survey received average (median) stock awards valued at \$1,073,074 (\$735,031), and stock options valued at \$453,316 (\$271,043). Alan Cohen, *The Great Hangover*, CORP. COUNS. 60, 67–71 (Aug. 2010) (containing table from which calculations were made). This equity compensation bulked large in comparison to average (median) total cash compensation in 2009, which was \$1,557,316 (\$1,285,394). *Id.* Although stock prices are down today, as recently as 2002 and 2003, the "exercisable stock option values ranged from \$2,328,924 to \$13,884,923 for the top one hundred general counsels." Z. Jill Barclift, *Corporate Responsibility: Ensuring Independent Judgment of the General Counsel—A Look at Stock Options*, 81 N.D. L. REV. 1, 9 (2005).

135. See *supra* note 44.

136. See Keith R. Fisher, *The Higher Calling: Regulation of Lawyers Post-Enron*, 37 U. MICH. J.L. REFORM 1017, 1096 (2004) (finding it "[n]oteworthy . . . that Enron's General Counsel was a former V&E partner, who continued the company's tradition of sending the firm a steady stream of business" and noting that "Enron's legal department also hired approximately twenty V&E lawyers during the late 1990's").

that the lawyer knows is criminal or fraudulent.”¹³⁷ But neither this rule (aimed at preventing attorneys from actively instigating or participating in illegality) nor the recent SEC attorney rules (aimed at instances in which the attorney sees evidence of a material violation of law) would stop a lawyer from favoring management in a dispute with an auditor over choosing a reportable figure from a range, within which all numbers satisfy GAAP and legal requirements.¹³⁸ The lawyer’s principal restraint—to stop, or at least not help, a client who proposes to violate a law—provides no guidance when the client proposes to make a poor, but within-rule, accounting choice.

Indeed, outside the context in which a client proposes a crime or fraud, Rule 1.2 commands a lawyer to “abide by a client’s decisions concerning the objectives of the representation and . . . consult with the client as to the means by which they are to be pursued.”¹³⁹ This normative instruction would apply to a lawyer’s participation in management/auditor conversations where the lawyer joined the conversation in the course, for example, of legal work on a securities filing. In such a case, the lawyer’s participation is law work, and

137. MODEL RULES OF PROF’L CONDUCT R. 1.2(d) (2010) [hereinafter ABA MODEL RULES].

138. Attorney obligations under the SEC rules are limited to reporting credible evidence of material violations of federal and state law, and fiduciary violations, to officers of the issuer/client, then reporting that evidence to the board of directors if the officers fail to provide an appropriate response. 17 C.F.R. § 205.3(b) (2010); *id.* §§ 205.2(b), (c), (i) (containing key definitions). Those obligations, however, only arise when a lawyer “becomes aware of evidence of a material violation.” *Id.* § 205.3(b)(1). Absent seeing credible evidence of such a violation, an attorney subject to the SEC rules has no duty to participate in their clients’ accounting. The hypothetical in Rosich-Schwartz, *Accounting Expertise*, *supra* note 12, does not appear to present the attorney with credible evidence of a material violation but simply assumes such evidence from the circumstance that a hypothetical accounting change is material, *id.* at 559–60. As written, the SEC rules do not compel the lawyer in that hypothetical to make his or her own calculation of bad-debt reserves.

It is possible that a reported financial number materially misleads, and creates a securities law violation, even if that number accords with accounting rules. See *United States v. Rigas*, 490 F.3d 208, 220–21 (2d Cir. 2007), *cert. denied* 128 S. Ct. 1471 (2008). Accordingly, if an auditor/company negotiation produces a financial report that the lawyer understands to be materially wrong, the SEC rules require the lawyer to report that evidence to the officers of the company and, if they provide no timely and appropriate response, to the board of directors. But, except in that extreme case, the SEC rules provide no restraint under the circumstances addressed in this Article—where the auditor and management negotiate over the number to report for an accounting item and neither side advocates a number that lies outside the continuum of figures that accounting rules permit.

139. ABA MODEL RULES, *supra* note 137, R. 1.2(a).

therefore covered by Rule 1.2 directly, or “law-related” work, and thereby covered indirectly by the injunction that all the professional rules apply to “law-related” work.¹⁴⁰ And, as a practical matter, management is likely to define the “objectives of the representation” to which Rule 1.2 refers.¹⁴¹ Even if a lawyer—correctly—concluded that Rule 1.2 did not *require* him or her to argue with the auditor on behalf of management’s preferred number in a negotiation, the ethical rule could provide a moral rationalization for doing so.

The ethos of legal practice, too, may incline an attorney to side with management if the lawyer is added to the negotiation with the auditor. As has often been observed, an attorney inhabits a culture that serves the client, very different from the auditor’s culture, which serves the investing public.¹⁴² This devotion to the client and the accompanying fiduciary duties that the attorney owes a client—so

140. *Id.* R. 5.7(a)(1), (b) (defining “law-related” services as “services that might reasonably be performed in conjunction with and in substance are related to the provision of legal services” and providing that “[a] lawyer shall be subject to the Rules of Professional Conduct with respect to the provision of law-related services . . . if the law-related services are provided . . . by the lawyer in circumstances that are not distinct from the lawyer’s provision of legal services to clients”).

141. Christopher J. Whelan, *Some Realism About Professionalism: Core Values, Legality, and Corporate Law Practice*, 54 *BUFF. L. REV.* 1067, 1120–21 (2007) (footnote omitted) (“Typically, with corporate clients, it is corporate management who ‘defines the objectives of the representation, identifies the responsibilities for which the lawyer has been retained and determines whether the lawyer’s performance has been acceptable.’ Add to this a compensation culture which rewards officers if the company’s financial matrices look good, and client’s officers may put pressure on outsiders, including professional advisers.”).

142. Chief Justice Burger famously contrasted the attorney, who is “the client’s confidential advisor and advocate, a loyal representative whose duty it is to present the client’s case in the most favorable possible light,” with the auditor, who “assumes a *public* responsibility transcending any employment relationship with the client” and “owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public.” *United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984).

To be sure, some in the securities bar, led by SEC alumni, have argued that private counsel advising on disclosure issues owe a duty to investors. Professor Coffee quotes A. A. Sommer, “a long-time leader of the securities bar and at the time an SEC Commissioner” as opining that a lawyer counseling on disclosure should “exercise a measure of independence” from management and be “acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence.” Coffee, *Attorney as Gatekeeper*, *supra* note 9, at 1299.

But Professor Coffee acknowledges that “other securities attorneys might well disagree with Commissioner Sommer.” *Id.* at 1299. The ABA position is that “corporate lawyers are first and foremost counselors to their clients” rather than “enforcer[s] of law.” ABA REP. ON CORPORATE RESPONSIBILITY, *supra* note 8, at 156. The New York City Bar echoes that refrain, concluding that a lawyer’s “[d]uties are owed solely to the client.” NYC BAR REP. ON THE LAWYER’S ROLE, *supra* note 8, at 51.

admirable in many respects and so helpful in performing many of the lawyer's tasks—can combine with psychological effects of the lawyer/client relationship to create a bond¹⁴³ that disinclines an attorney to argue against a client's position in discussions with the auditor, particularly when the client's position is both legal and permissible under the accounting rules.¹⁴⁴ After all, attorneys are advocates. By training and practice, they argue for their clients' positions.

The quick rejoinder is that, in the corporate setting, it is the company that is the lawyer's client, not management—a position unequivocally supported by the text of Model Rule of Professional Conduct 1.13.¹⁴⁵ It is therefore, as a formal matter, inappropriate for an attorney to so “bond” with executives that the attorney supports management in any matter—including a negotiation with an auditor—in which management is furthering its own interests in a way that might harm the company. Yet, the corporation speaks to the attorney through management, and the attorney is more likely to form psychological ties with the individual managers providing that human contact than with the company as an institution.¹⁴⁶

143. Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 119, 122–23 (2006) [hereinafter Laby, *Gatekeepers*], characterizes attorneys as “dependent” gatekeepers, *id.* at 128, because they “provide advice and recommendations to assist a client in meeting its goals [,] . . . owing both a duty of loyalty and a duty of care to the client[, and, a]s a fiduciary, . . . act[ing] for the client's benefit, furthering its ends,” *id.* at 127. Drawing on psychology, he argues that attorneys experience commitment bias—focusing on information that supports the lawyer's commitment to a client's goals and downplaying the importance of information that cuts against pursuing those goals. *Id.* at 144–45. Again referring to psychology, Laby's analysis suggests that—when facing a problem that stretches along a continuum—attorneys will “anchor” their position at the client's location on the spectrum and adjust insufficiently from there, instead of independently selecting a starting point. *Id.* at 146–47.

144. *Id.* at 151–52. Laby contends that the psychological biases inclining attorneys to the views of their clients display most prominently when the “answer” to the presented question is indeterminate, as is true when the management and an auditor negotiate over the particular number—along a continuum of acceptable numbers—that a public company will report. See also Schwarcz, *Financial Information Failure*, *supra* note 14, at 1110 (“Lawyers are . . . much more likely than accountants to be ‘captured’ by their clients.”).

145. ABA MODEL RULES, *supra* note 137, R. 1.13(a); see also 17 C.F.R. § 205.3(a) (2010).

146. NYC BAR REP. ON LAWYER'S ROLE, *supra* note 8, at 56 (commenting that the “ethical orientation” of Rule 1.13 “is in tension with the practical reality that a lawyer's contact will be with management”); see also Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1195 (2003) (“The problem, of course, is that while the lawyer is conscious of his role as representing the corporation's

Moreover, since management controls lawyer hiring and firing, economic ties reinforce the lawyer's psychological tendency towards loyalty to the managers with whom the lawyer works.¹⁴⁷

C. Attorney Accounting Ignorance

One more factor further reduces the probability that attorney participation in auditor/management negotiations will improve financial reporting: the attorney often will not know much about the particular accounting problem that the negotiation involves. Generally accepted accounting principles in the United States are voluminous.¹⁴⁸ They are complex considered as a body.¹⁴⁹ They can be complex down to the level of a single rule.¹⁵⁰ There is no formal requirement that a lawyer know anything about accounting. Inserting a lawyer into the discussions between an auditor and

interest, it is also the case (as any practicing lawyer knows) that it becomes easy to identify with an individual or individuals representing that client.”).

147. Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J.L. BUS. & FIN. 9, 26 (2002) (“Increased competition from within and outside the bar has led to increased pressure on firms to favor responsiveness to client demands over broader societal concerns. Allegiance to management’s short-term financial interests may compromise obligations to the broader public, as well as to the entity itself, which is, at least in theory, the lawyer’s client.”).

148. U.S. GAAP historically consisted of a sprawling variety of uncodified literature. FINAL REPORT OF THE ADVISORY COMMITTEE ON IMPROVEMENTS TO FINANCIAL REPORTING, TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 19 (Aug. 1, 2008) [hereinafter ACIFR REP.] (“The vast number of formal and informal accounting standards, regulations, and interpretations, including redundant requirements, make finding and evaluating the appropriate standards and interpretations challenging for particular fact patterns.”). The Financial Accounting Standards Board (“FASB”) recently prepared a codification. See Press Release, Financial Accounting Standards Board, FASB Accounting Standards Codification™ Launches Today (July 1, 2009), available at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/NewsPage&cid=1176156318458. While the recent GAAP codification and related FASB Statement No. 168 flatten the older, complicated hierarchy of accounting rules, they “do[] not change GAAP,” but simply “reorganize[] the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics,” while also “includ[ing] relevant [SEC] guidance.” *Id.*

149. GAAP’s substantive complexity is the product, among other things, of industry-specific guidance (including exceptions to general accounting practices for certain industries) and alternative accounting policies, which provide options to reporting companies on certain accounting matters. ACIFR REP., *supra* note 148, at 26.

150. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, *supra* note 14, at 1105 (noting that Financial Accounting Standard No. 140 “alone is 156 single-spaced printed pages, not including multiple separate updates and numerous cross-references to other accounting literature”).

management on some subject such as the number at which to set a warranty or product returns reserve will very likely inject an ignorant party into the discussion. And ignorance may ease an attorney's conscience in siding with management. If the lawyer does not know the right answer, and unwittingly supports the wrong one, he or she may still sleep well.

While the initially appealing response is that lawyers can close this knowledge gap through education, two truths suggest that lawyer education is not a fix. First, while the accounting question facing a practicing lawyer will be specific, there is little certainty that whatever general accounting course the attorney took in law school, or as an undergraduate, years ago—or the accounting matters that a lawyer has happened to encounter in practice—will have addressed that question, even assuming that the accounting rules have remained the same in the interim. Second, even if a law school course—or a prior practice experience—serendipitously did cover a subject that the attorney later faced in practice, the relevant accounting rules might have changed. Indeed, public company accounting in the United States is currently migrating from U.S. GAAP to the International Financial Reporting Standards (“International Standards” or “IFRS”), the SEC having published a “roadmap” that could end soon with a requirement that even domestic companies employ International Standards when preparing their financial statements.¹⁵¹

While efforts to reconcile the two sets of standards have gone on for years,¹⁵² U.S. GAAP and the International Standards still differ in

151. Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers, 73 Fed. Reg. 70,816, 70,823 (Nov. 21, 2008) [hereinafter Roadmap to IFRS in U.S.] (U.S. companies might have to report under IFRS by 2014). More recently, the SEC identified factors that the Commission will study in order to make that decision and stated that “the first time U.S. issuers would report under such a system would be approximately 2015 or 2016.” Commission Statement in Support of Convergence and Global Accounting Standards, 75 Fed. Reg. 9494, 9497 (Mar. 2, 2010).

152. The Financial Accounting Standards Board, which controls U.S. GAAP, and the International Accounting Standards Board, which controls the International Standards, documented their commitment to “convergence” in an October 2002 Memorandum of Understanding known as the Norwalk Agreement. Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance with International Financial Reporting Standards, 72 Fed. Reg. 45,600, 45,601 & n.6 (Aug. 14, 2007) [hereinafter Concept Release on U.S. Issuer Use of IFRS]. The two standard-setters reaffirmed that commitment, with some specifics, in February 2006 through A Roadmap for Convergence between IFRS and US GAAP—2006–2008 Memorandum of Understanding between the FASB and the IASB. *Id.* at

important respects.¹⁵³ Obviously, if U.S. companies shift to the International Standards, those attorneys whose accounting knowledge derives from U.S. GAAP will have to learn the new system if they are to participate intelligently in accounting discussions with their clients' auditors. Again, the solution might be to educate attorneys. But the educational effort to acquaint *accountants* with International Standards will be comprehensive.¹⁵⁴ There is little reason to believe that anything less would be necessary to bring lawyers up to speed.

Perhaps more important, with or without a changeover to the International Standards, the assumption that lawyers can somehow simultaneously stay abreast of developments in two complicated professions is impractical. While we think of the law as ever-changing, accounting is dynamic too. Attorneys in California must complete twenty-five hours of continuing professional education every three years.¹⁵⁵ Attorneys in New York must complete twenty-four hours every two years.¹⁵⁶ But certified public accountants in each of these states must devote *more than double* that time to continuing education.¹⁵⁷ In a crude way, this comparison suggests

45,603-04 & n.30. In 2008 and 2009, they provided progress reports identifying areas in which they had reached agreement and a number of topics on which they hoped to agree by 2011. COMPLETING THE FEBRUARY 2006 MEMORANDUM OF UNDERSTANDING: A PROGRESS REPORT AND TIMETABLE FOR COMPLETION (Sept. 2008), *available at* http://www.iasb.org/NR/rdonlyres/C1DD5259-4011-4715-A807-1FD71858D37C/0/Memorandum_of_Understanding_progress_report_and_timetable.pdf; Press Release, FASB and IASB Reaffirm Commitment to Memorandum of Understanding (Nov. 5, 2009), *available at* http://www.iasb.org/NR/rdonlyres/0AE63429-BCF3-461A-8B5D-3948732CDDC2/0/Joint_Communique_October2009FINAL4.pdf.

153. *See, e.g.*, PRICEWATERHOUSECOOPERS, IFRS AND US GAAP SIMILARITIES AND DIFFERENCES (Sept. 2010), *available at* <http://www.pwc.com/us/en/issues/ifrsreporting/publications/ifrs-and-us-gaap-similarities-and-differences-september-2009.jhtml>.

154. One of the acknowledged difficulties in switching to International Standards is that "the education of most accountants in the United States—be it collegiate or continuing education—includes a comprehensive curriculum around U.S. GAAP but does not include a similar curriculum around IFRS." Concept Release on U.S. Issuer Use of IFRS, *supra* note 152, at 45,607. A massive educational campaign will be necessary to educate U.S. accountants in International Standards. Roadmap to IFRS in U.S., *supra* note 151 at 70,822.

155. RULES OF THE STATE BAR OF CALIFORNIA R. 2.72(A).

156. N.Y. COMP. CODES R. & REG. tit. 22, § 1500.22(a) (2010).

157. CAL. CODE REG. tit.16, § 87(a) (2010) (requiring eighty hours every two years); N.Y. EDUC. LAW, § 7409(2) (2009) (requiring for each year either forty hours "of acceptable formal continuing education in recognized areas of study" or twenty-four hours "of acceptable formal continuing education concentrated in [certain identified] recognized areas of study").

that attorneys who seek to keep up with accounting changes—even putting aside the tidal shift from U.S. GAAP to International Standards—will need to spend as much time, or more, on that endeavor as on staying current in the law. Even if such a conclusion is too much to draw from a single statistical comparison, quick confidence that attorneys can keep up with accounting as well as law may reflect arrogance more than reason.

That attorneys will likely know little about the accounting disputes in which management and auditors are involved has two important implications. First, even if an individual attorney could overcome the structural bias to side with management and even if the attorney could overcome the inclination to do so that the lawyer culture imbues, the attorney might not be able to determine which number—within the spectrum of permissible numbers—will provide the best information to the investing public. The pure of heart will not know for what to fight. Second, accounting ignorance makes siding with management more probable. Without the intellectual restraint supplied by the knowledge that the auditor's number is better than management's, the lawyer might take the easy road, saying to himself or herself, "Any of these numbers is fine. I will therefore fight for the number that my client believes is best. And, if I win further favor with my client by doing so, I still do no harm, for there is no right answer here."

D. No Systematic Review of Lawyer Participation in Accounting

As we have seen, the accountants who audit public companies are subject to inspection by the PCAOB, as well as disciplinary and enforcement proceedings by both the PCAOB and the SEC.¹⁵⁸ The inspections, among other things, check audit decisions on precisely the kinds of soft numbers over which auditors and managements bargain,¹⁵⁹ and the enforcement proceedings, among other things, punish for independence violations.¹⁶⁰ There are no similar checks on lawyers injected into negotiations between auditors and management. Their "contributions"—likely to support management in soft number negotiations for all the reasons set out above—will be unexamined and undisciplined. This is particularly so since even ill-

158. See *supra* Part IV.C.2.

159. See *supra* note 90.

160. See *supra* note 93.

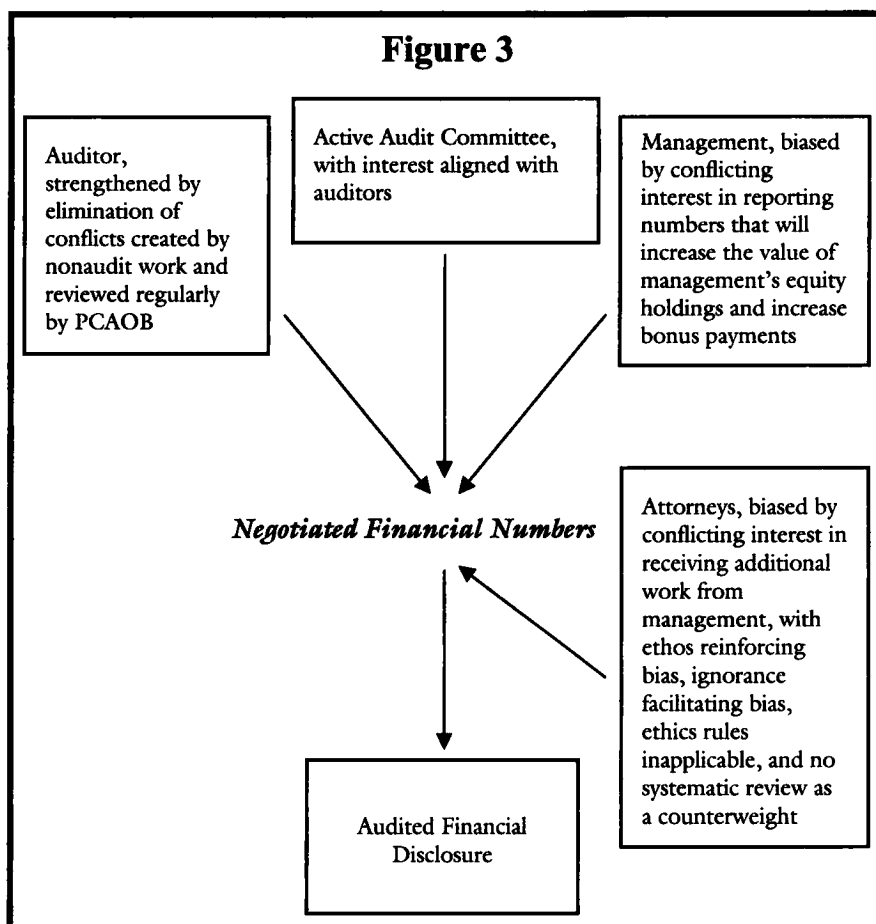
motivated and successful advocacy by a lawyer in the setting on which we focus here would likely produce, at worst, a rule-compliant accounting number—miles away from the rule-violating numbers that have led in the past to sanctions against attorneys who participate in accounting devilry.¹⁶¹

*E. Adding Lawyers Could Advantage Management in Negotiations,
Undoing Benefits of the Reforms*

In sum, if lawyers participate in negotiations to select accounting numbers from permissible ranges, attorneys' structural bias, their client-service ethos, and their accounting ignorance may contribute to the opacity of client financial statements—with the lawyers suffering neither shame nor sanction for the damage they do. Adding the lawyers thus changes the dynamics to those diagrammed in Figure 3, actually setting public company accounting back by introducing the same sorts of bias and unaccountability that triggered the Sarbanes-Oxley reforms.

161. The SEC has pursued lawyers in some instances for wrongdoing that creates false financial reporting. For example, the Commission has sued general counsel for their involvement in option backdating that caused their companies to understate expenses and overstate income. *See, e.g.*, Complaint, SEC v. HCC Ins. Holdings et al., No. 4:08-cv-02270 (S.D. Tex. July 21, 2008). As another example, the Commission sued an Enron attorney for alleged wrongdoing designed to permit the company to recognize, immediately and in deliberate violation of accounting rules, a gain on the sale of a turbine. Complaint, SEC v. David T. Leboe, et al., No. HO-06-1020 (S.D. Tex. Mar. 27, 2006).

But this Article addresses negotiations over numbers all of which are "legal" so that no enforcement action would result from the selection of the particular number from the spectrum considered, except where the financial statements are so misleading as to work a fraud. *See supra* note 138.



To be sure, adding attorneys to auditor negotiations will not, in every case, take us back to the pre-reform world. Whether that unhappy result occurs will depend on facts particular to each case, and specific conditions could reduce or eliminate the danger that this Article highlights. The less the lawyer's firm rewards cross-selling in its compensation system, the less pressure the lawyer will feel to side with management if the lawyer participates in company/auditor negotiations. The greater the value the attorney has to his or her firm as a result of business from other clients, the less pressure the lawyer will feel to side with management at a particular client negotiating with its auditor. The less influence the top management at a client has over other business that the company directs to the attorney's firm (e.g., because the client employs bureaucratic

routines to award law business), the less pressure the lawyer will feel to side with management. And the more financial independence the lawyer has from his or her firm, the less susceptible the lawyer will be to whatever pressure the firm exerts in order to encourage him or her to side with management.

The point is not that adding a lawyer to a company/auditor negotiation will always harm the auditor's efforts to ensure that the particular number selected from a GAAP-compliant spectrum will be a number that provides financial transparency to investors rather than one that does not enhance disclosure but adds to management wealth. The point, instead, is that adding attorneys is likely in many cases to hurt and unlikely in most cases to help. Adding attorneys will more probably take us backward, not forward.

VI. CONCLUSION: THE LARGER QUESTIONS

The targeted argument this Article makes—that attorneys should not join negotiations between management and auditors that select a figure from a permissible range—is part of a larger discussion. That larger discussion asks the question: When should attorneys enter the process that produces audited financial statements, other than in instances in which the relevant accounting rule requires a legal judgment?

Whenever that question arises, scholars, professional organizations, firms, and individual practitioners should candidly ask whether lawyer participation will add value to financial statements, will change nothing (except to add attorney fees), or will actually degrade disclosure to investors. The frank evaluation of those alternative results should recognize the limitations under which most attorneys labor when they enter accounting discussions, including their limited accounting knowledge and the sometimes insidious commercial forces that may consciously or subconsciously bias the lawyer in favor of the position that a company's management takes.

We law faculty should tread carefully too. We must fight the temptation to reflexively teach students to aggressively enter the accounting process at their future clients. We should ask ourselves if, in giving such advice, we are motivated less by dispassionately weighing pros and cons and more by a desire to feel important, and appear relevant, concerned, and committed to changing the world for the better. We should display judgment, and counsel students to do so as well. We should warn students that there may be instances

in which their participation in the creation of audited financial statements is a bad, rather than a good, idea.

Taking an even broader perspective, the examination of attorney participation in auditor/public company discussions suggests significant skepticism that attorney participation in other client matters beyond the law will always prove productive. When we consider each such intervention, we should look closely for conflicts of interest that lawyers may have. We should evaluate the ability of lawyers to contribute in light of the complexity that the out-of-law matter presents and the limits of lawyer knowledge and training. We should consider, too, whether attorneys providing gratuitous and bad advice will suffer sanction or endure no penalty whatsoever for any harm they cause. Caution rather than enthusiasm should inform our judgment.