MYTH OF AUDITOR INDEPENDENCE

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In response to the surge of financial accounting scandals in the late 1990s and early 2000s, Congress passed the Sarbanes-Oxley Act. The implementation of this Act caused several changes in the financial audit industry in an effort to prevent further financial fraud. This Note begins by explaining the process of creating company financial statements and highlights the incentives auditors have to falsify these statements. Financial statements are vital to a capital market because they provide information to investors about the prospective return and risk involved when deciding to invest in a company. Given the importance of financial statements and the risk that they will be falsified, Congress enacted the Sarbanes-Oxley Act in part to place a check on the accuracy of financial statements by requiring auditor independence.

After reviewing the Act's provisions regarding auditor independence, the author argues that these provisions are not sufficient. He identifies three elements of the free-market audit industry that place substantial limits on auditor independence. First, audit firms are compensated by the companies they are auditing, which makes the auditors dependent on the company's management. This problem is compounded by the fact that although the independent audits are required, they are only nominally beneficial to a company and one audit firm's product cannot be differentiated from another firm's product. Second, the relationship between a company and an audit firm is at will and can be terminated without much, if any, detriment to a company. The instability of this relationship allows companies to exercise substantial control over audit firms who have to compete for the business. Finally, a problem that coincides with the previous two issues is the high level of competition between audit firms. The author argues that the belief that free-market competition produces the best product at the lowest price does not apply to audit firms because they cannot effectively differentiate their products. Therefore, audit firms rely on the amount of their fees and their personal relationships with management to capture business. The author concludes that auditor independence cannot be achieved in a free-market audit system.

In response to the conclusion that auditor independence cannot be accomplished under the current free-market scheme, the author recommends that the government transfer responsibility for financial audits to a governmental agency. Under this proposal, all public

companies would contribute to a fund used to compensate the government auditor. A company's contribution to the fund would be determined by the expected complexity of the company's audit. The government agency would be responsible for auditing only publicly traded companies, preventing a mandatory tax on all businesses. The author concludes that creating a government audit agency would remove the shortfalls of the free-market audit scheme by reducing auditor dependence on the client company.

I. INTRODUCTION

The United States experienced a surge in financial accounting scandals during the late 1990s and early 2000s.[1] The volume and size of these scandals appalled the entire world.[2] Enron was the largest bankruptcy reorganization in American history when it filed for Chapter 11 bankruptcy on December 2, 2001.[3] Only seven months later, WorldCom replaced Enron as the largest U.S. bankruptcy reorganization when it filed for Chapter 11 protection on July 19, 2002.[4] Combined, all financial statement restatements[5] from 1997 to 2002 erased approximately $100 billion of shareholder value.[6]

People blamed financial auditors, amongst others, for these disasters.[7] It was clear that the auditors failed to fulfill their function as a public "watchdog."[8] Auditors did not catch financial improprieties of the companies they were auditing.[9] In 2002, Congress responded to the financial accounting failures with the Sarbanes-Oxley Act (SOX, or the

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1. "From January 1997 through June 2002, about 10 percent of all [public] companies announced at least one restatement." U.S. GEN. ACCOUNTING OFFICE, GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 4 (Oct. 4, 2002), http://www.gao.gov/new.items/d03138.pdf [hereinafter GAO REPORT].

2. *See supra* note 1 and accompanying text; *infra* notes 3–6 and accompanying text.

3. Wendy Zellner et al., *The Fall of Enron*, BUS. WK., Dec. 17, 2001, at 30, 33.

4. Merav Biton, *Lies, Filthy Lies and* Archer v. Warner*: Should We Allow Fraudulent Debtors to Side-Step Section 523(a)(2)(A)?*, 11 AM. BANKR. INST. L. REV. 267, 282 & n.149 (2003).

5. A financial statement restatement occurs when a company is forced to correct some information that it has previously reported on its financial statements. DONALD E. KIESO ET AL., INTERMEDIATE ACCOUNTING 1266–68 (10th ed. 2001). Each restatement recognizes that information previously reported was wrong. *Id.*

6. GAO REPORT, *supra* note 1, at 5 ("[F]rom the trading day before through the trading day after an initial restatement announcement, stock prices of the restating companies that [the Government Accounting Office] analyzed fell almost 10 percent on average (market adjusted). [The Government Accounting Office] estimate[s] that the restating companies lost about $100 billion in market capitalization . . . .").

7. *See, e.g.*, *Wrong Numbers: The Accounting Problems at WorldCom: Hearing Before the H. Comm. on Financial Services*, 107th Cong. 50–80 (2002) [hereinafter *Wrong Numbers*] (testimony of Jack Grubman, Telecommunications Analyst, Salomon Smith Barney); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 304 (2004).

8. Richard L. Kaplan, *The Mother of All Conflicts: Auditors and Their Clients*, 29 J. CORP. L. 363, 365 (2004).

9. Coffee, *supra* note 7, at 305.

Act).[10] SOX attempted to revive the financial audit practice by making the audit process more effective in preventing future financial fraud.[11] The Act introduced several changes to the financial audit industry.[12] One of the more crucial changes was increasing auditor independence.[13] The legislature believed that auditors had lost some of their independence from the management of the companies they were auditing.[14] Restoring auditor independence was one of SOX's goals.[15]

This Note reviews the state of the modern financial audit industry and concludes that the nature of a free-market audit industry is incompatible with the goal of auditor independence. Thus, neither SOX nor any other legislative attempt—short of a complete overhaul of the financial audit industry—will remove the obstacles to auditor independence. Part II reviews the Act's approach to auditor independence.[16] Next, Part III examines the nature of the financial audit industry as it stands today. Open competition between audit firms to obtain clients defines the modern audit industry. Although many other industries prosper under the scheme of open market competition, such competition is fatal to a properly functioning audit industry. Auditor independence is crucial to the reliability of auditors' reports, but free-market competition does not leave any room for such independence. The homogeneous nature of audit services forces auditors to compete for clients' business through means other than the quality of their work. Thus, auditors look for other ways to attract a prospective client's attention, which places the auditors in a position of dependence on client management. Lastly, Part IV recommends a complete overhaul of the financial audit industry. The overhaul would concentrate on removing obstacles to auditor independence created by free-market competition between audit firms. This Note recommends replacement of private audit firms with a single government audit entity. This entity would be in charge of financial audits of all public companies.

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10. *Id.*

11. *See* Kaplan, *supra* note 8, at 366 (stating that SOX was a response to the problem that "[a]udits have failed to uncover colossal frauds and major financial misstatements").

12. Coffee, *supra* note 7, at 305. The Act "shift[ed] control of the accounting profession from the profession to a new body, the Public Company Accounting Oversight Board ('PCAOB')"; the Act further "bar[red] auditors from providing a number of categories of professional services." *Id.* at 336.

13. *Id.* at 305.

14. Kaplan, *supra* note 8, at 369–70; *see also infra* note 15 and accompanying text.

15. *Wrong Numbers*, *supra* note 7, at 4 (statement of John LaFalce, Member, H. Comm. on Financial Services) ("To provide the reform we need, legislation must, at a minimum . . . restore the independence of auditors.").

16. According to the American Century Dictionary, independence is "freedom from the control, influence, support, aid, or the like, of others." THE AMERICAN CENTURY DICTIONARY 287 (2d ed. 1997). Therefore, an independent audit is an audit free from the influence or control of the client.

II. BACKGROUND

In order to understand the importance of an independent financial audit, it is first useful to understand the basics that define the modern capital market. In its simplest form, the capital market is an interaction between companies seeking investment funds at the lowest cost and investors looking to earn the highest return on their investment with the lowest risk.[17] Financial statements operate as a bridge between investors and companies seeking investment funds.[18] Financial statements provide investors with a cheap way to access the information they need to assess the investment quality of a company.[19] This information is only valuable, however, if it is accurate.[20] Even if the information itself is accurate but investors perceive it as flawed, the usefulness of the information is significantly impaired.[21] Indeed, investors recognize that the process of financial statement preparation exposes financial information to the risk of manipulation.[22]

Companies rely on their managers to prepare financial statements,[23] and these managers have incentives and opportunities to manipulate financial results.[24] A company's financial success often plays a significant role in evaluating a manager's performance.[25] In turn, the investment community determines a company's success based on its financial performance, which is reflected in the company's financial statements.[26] Thus, a company's management has strong incentives to improve company financial statements.[27] Furthermore, because management prepares

17. *See* Ovidiu Stoica, *The Role of a Capital Market in the Economic Development* 3 (2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951278 (last visited May 31, 2009) (explaining how capital markets provide companies with funds at low cost and allow investors to allocate funds according to return and risk).

18. *See* Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 407–08, 415 (2001) (discussing financial statements' role in solving information asymmetry between investors and companies).

19. *See id.* The term investment quality as used in this Note refers to the risk/return ratio of a company. Although each investor will desire a different risk/return ratio, it is safe to assume that all investors will nonetheless be concerned with the ratio.

20. "Investors' confidence in their ability to accurately value their equity holdings relies upon the accuracy of the information available. If the information provided is not accurate, the reported income stream generated from holding company shares becomes more uncertain and the stock market investment riskier." GAO REPORT, *supra* note 1, at 40.

21. *See id.* at 33–36 (discussing the impact accounting accuracy concerns have on investor confidence).

22. *See id.* at 6; JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 547 (5th ed. 2006) ("[T]here is an ever-present concern that the firm's financial statements may reflect the influence of the firm's managers over the content of the financial statements.").

23. GAO REPORT, *supra* note 1, at 10.

24. Kaplan, *supra* note 8, at 367 ("By its very nature, corporate management has strong tendencies to manipulate financial statements. Managers want to show the positive contribution that they have made to the corporate enterprise's operations. In more recent times, corporate management has had very substantial *personal* financial reasons to do so as well.").

25. *Id.*

26. *Id.*

27. *Id.*

the financial statements, managers have the opportunity to manipulate them.[28] The investment community recognizes this unfortunate collision of management's opportunity to manipulate and the incentive to distort financial information.[29] To minimize the risk of manipulation, the investment community requires an independent audit of company financial statements.[30] Auditors act as a check on management and assure the investors that management accurately prepared financial statements.[31] For this assurance to have substantial meaning, the auditors must remain independent of company management.[32] Even an appearance of lack of auditor independence may significantly compromise investor confidence in financial statements,[33] which would severely impair the flow of funds from investors to companies.[34]

The financial disasters of the late 1990s and early 2000s exposed some of the problems in the financial audit industry.[35] Auditors were failing to identify management fraud,[36] and it was evident that a part of the problem was the auditors' failure to properly question management practices.[37] Auditors yielded too easily to management's demands.[38] The legislature and academics blamed the loss of auditor independence for these failures.[39] Congress attempted to deal with the auditor independence problem with SOX.[40] The Act tried to revamp auditor independence through two provisions: overall independence of an audit firm and independence of the individual audit team members.[41]

The remainder of Part II proceeds as follows. Section A reviews the nature of the capital market structure. The capital market is essential to the growth of a capitalist-style economy.[42] At the same time, an efficient capital market relies heavily on company-produced financial statements to evaluate a company's investment quality.[43] Section B reviews the

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28. *Cf. id.*
29. *See id.*
30. *Id.*
31. *Id.* at 366.
32. Coffee, *supra* note 7, at 335.
33. *Cf.* Kaplan, *supra* note 8, at 373 (describing how the provision of consulting services by accounting firms may undermine appearance of auditor independence and lead to association of accounting firm with management).
34. *Id.* at 379 ("In response to their lack of confidence in the 'accuracy of the information available,' investors withdrew funds from the market." (quoting GAO REPORT, *supra* note 1, at 40)).
35. *Id.* ("[T]he certified audit failed to prevent serious financial misstatements before they became public.").
36. *See id.* at 372.
37. *Id.* at 367–68.
38. *Id.*
39. *Id.* at 367–70; *see also supra* note 15 and accompanying text.
40. Kaplan, *supra* note 8, at 378 ("If there is one factor that best explains why the Sarbanes-Oxley Act was enacted, it is the failure of certified audits to detect rampant and massive accounting frauds prior to a corporation's imploding.").
41. *See id.* at 367–77.
42. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 6–10 (8th ed. 2006).
43. *See* discussion *infra* Part II.A.

process of financial statement preparations. Due to the inherent pressure on management to manipulate the financial statements, the financial industry cannot simply rely on the company-produced financial information.[44] Instead, as discussed in Section C, the financial industry relies on independent auditors to review and certify the accuracy of financial statements.[45] For auditor certification to have significant meaning, the auditors must be independent.[46] Finally, Section D discusses SOX provisions that address auditor independence issues.

A. Capital Market Structure

In its basic form, the capital market performs the function of a farmer's market: it brings together sellers and buyers of a commodity. In the case of capital markets, the commodity is money or capital.[47] Capital markets place companies seeking investment funds in contact with investors willing to lend these funds.[48] Furthermore, the capital market provides investors with a tool to assess the quality of the product they are buying.[49] This tool is company-generated financial statements.[50]

Companies' need for money fuels the operation of capital markets.[51] Companies need money in their day-to-day operations as well as in their long-term expansion projects.[52] Day-to-day operations include such expenses as employee salaries, maintenance, and cost of goods.[53] Expansion activities include more massive projects, such as acquisition of other companies or building new operational facilities.[54] In both cases, companies require money to carry out such activities.[55] While some companies generate enough cash from their ongoing activities to support their daily operations and expansions, most companies reach a point where the amount of funds they need simply exceeds the capital they are able to

44. For a discussion of risks of management manipulation of company financial statements, see generally Jean C. Bedard & Karla M. Johnstone, *Earnings Manipulation Risk, Corporate Governance Risk, and Auditors' Planning and Pricing Decisions*, 79 ACCT. REV. 277 (2004).

45. Kaplan, *supra* note 8, at 372.

46. *Id.* at 366 ("[A]uditor 'independence' is the only reason to require that public corporations be audited by outsiders.").

47. *See* Healy & Palepu, *supra* note 18, at 407.

48. *Id.*

49. *Id.*

50. *Id.* at 406–07.

51. BREALEY & MYERS, *supra* note 42, at 7 ("The flow starts when the firm sells securities to raise cash . . . .").

52. *See id.* at 7 & n.6 (identifying capital markets as the "source of long-term financing" and the money market as the source of short-term financing).

53. *See* KIESO ET AL., *supra* note 5, at 207–08.

54. *Id.*

55. BREALEY & MYERS, *supra* note 42, at 6.

generate independently.[56] Unable to generate the needed funds internally, these companies turn to outside investors.[57]

Investors may be defined as individuals with unused savings.[58] Rational individuals prefer to invest their capital into companies that have an expectation of a profit.[59] The investment may take the form of either an equity or a debt investment.[60] In an equity investment, the investor becomes a partial owner of the company with rights to company earnings and its assets upon dissolution.[61] The biggest appeal of an equity investment is the potential growth of the market value of the investment.[62] With a debt investment, the investor extends a loan to a company and the company promises to pay back the loan with interest.[63] It is reasonable to assume that in most cases, rational investors prefer to receive the highest return possible on their investments.

At the same time, each investment places investors' funds at risk.[64] If something happens to the company, investors may lose a substantial portion of their investment.[65] Naturally, investors prefer investing in companies with the lowest level of risk.[66] Thus, for an investor, the attractiveness of a particular investment depends on the ratio of risk to return of that investment.[67] Although different investors may have different expectations of an acceptable risk to return ratio, it is safe to assume that the ratio is considered by most investors.[68]

The issue then becomes how to calculate the ratio for a given company. Investors assess the potential return on an investment based on the company's operational success.[69] In particular, investors look at the company's past profits and estimate whether this performance will continue in the future.[70] Estimation of future profits involves evaluation of past success factors, such as operational efficiency, control of the market,

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56. COX ET AL., *supra* note 22, at 1.

57. Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 721–22 (2005).

58. *See id.* at 712.

59. Stoica, *supra* note 17, at 2–4.

60. COX ET AL., *supra* note 22, at 19–20 (discussing various securities available to investors); *see also* EARL A. SALIERS, FINANCIAL STATEMENTS MADE PLAIN 9 (1917); Healy & Palepu, *supra* note 18, at 407–10 (discussing investors' interests).

61. *See, e.g.*, InvestorWords.com, Common Stock, http://www.investorwords.com/986/common_stock.html (last visited May 31, 2009).

62. *See* D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 237 (2d ed. 2008).

63. *Id.* at 238.

64. *See* BREALEY & MYERS, *supra* note 42, at 145.

65. *Id.* (describing the ninety percent decrease in price of Amazon.com stock after the stock peaked in December 1999).

66. *Id.*

67. *Id.* (explaining that investors require higher expected return from risky investments).

68. ROBERT C. HIGGINS, ANALYSIS FOR FINANCIAL MANAGEMENT 283 (8th ed. 2007) (describing investors' requirement that anticipated return increases as risk increases).

69. *See* COX ET AL., *supra* note 22, at 546.

70. *Id.*

and so on.[71] Furthermore, investors assess a company's level of risk based on almost the same considerations: the likelihood of a downturn in company operations.[72] Thus, in order to determine the investment quality of a company, investors need to review company operations.

There are thousands of public companies, however, and investors simply cannot review operations of every existing public company. Furthermore, review of operations of even a single company is tremendously expensive and requires a substantial amount of time.[73] For most investors, the transaction costs of such review greatly outweigh the expected return.[74] The capital markets address this issue with financial statements.[75] Financial statements essentially are company-prepared evaluations of the company's operations for a period of time.[76] It is substantially cheaper for companies to prepare this self-assessment report than for an individual investor to evaluate each company individually[77]—companies already have access to all information necessary to prepare the assessment, and company management has substantial knowledge of the business.[78]

B. Financial Statements

Financial statements provide an unlimited number of investors with an easy and cheap way to review the operations of a company.[79] Company management, however, has strong incentives to manipulate the financial statements.[80] Managers' compensation is often tied, either directly or indirectly, to the company's financial performance.[81] Furthermore, managers, like most people, enjoy a sense of accomplishment if their efforts lead to the company's improved performance. Additionally, because managers prepare financial statements, they have an excellent opportuni-

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71. TIM KOLLER ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 234–36 (4th ed. 2005).

72. *See id.* at 297–300 (discussing cost of capital and investment risk).

73. The median cost of a financial audit in 2007 was $6.9 million. *Big-Company Audit Fees Ease Up*, SMARTPROS, July 31, 2008, http://accounting.smartpros.com/x62706.xml.

74. In order to make individualized reviews profitable, an individual investor's median return on investment would have to exceed $6.9 million per year. *Id.* It is safe to assume that most investors make less that $6.9 million per year on their investment portfolios, if we consider individual investors.

75. *See e.g.*, COX ET AL., *supra* note 22, at 546 (noting that investors use financial information to decide "whether to purchase or sell a company's securities and whether to reward or terminate managers").

76. *Id.* at 547 ("The company's financial statements report on the firm's financial position and its recent performance.").

77. *Id.* ("[T]he officers of the firm in the first instance have operational control of the company's books and records.").

78. *Id.*

79. JERRY J. WEYGANDT ET AL., ACCOUNTING PRINCIPLES 2–5 (5th ed. 1999).

80. Kaplan, *supra* note 8, at 367.

81. *Id.* ("The proliferation of managers' compensation formulae that are tied to corporate financial performance measures, exacerbated in many cases with munificent grants of options on the corporation's stock, make managers keenly interested in their corporation's financial statements.").

ty to manipulate them.[82] The risk of financial statement manipulation by management significantly reduces the value of the financial statements to investors.[83]

Companies use a standardized set of financial statements to summarize their operations for a given period of time.[84] In essence, a company translates its operations into a financial statement's language. Presumably, everyone who knows this language can read a company's financial statements and understand the operations of that company. Thus, financial statements allow an unlimited number of investors to review the operations of a company at virtually no cost. Investors may use this information to estimate the risks and returns of a particular investment.[85] Despite all the benefits, however, financial statements have one crucial problem—preparers of the financial statements are the managers of the very companies the financial statements evaluate.[86] Inherently, corporate management has strong monetary and nonmonetary incentives to manipulate financial data.[87]

Monetary incentives present themselves in the form of management compensation. These incentives may take one of two forms: compensation directly tied to the company's financial statements[88] or compensation tied to the company's stock price.[89] Compensation tied directly to financial results clearly presents an incentive to improve the financial statements' data.[90] Compensation tied to a company's stock performance creates an large incentive to improve financial data as well because a company's financial results have a significant impact on the company's

82. Bedard & Johnstone, *supra* note 44, at 284–85.

83. *See* George J. Benston, *The Quality of Corporate Financial Statements and Their Auditors Before and After Enron*, POL'Y ANALYSIS NO. 497, Nov. 6, 2003, at 24–25, http://www.cato.org/pubs/pas/pa497.pdf.

84. Most financial statements released by U.S. companies comply with the requirements of U.S. Generally Accepted Accounting Principles (GAAP). *See* COX ET AL., *supra* note 22, at 546. SEC regulations force publicly traded companies to comply with GAAP. *Id.* at 554. Nonpublicly traded companies usually comply with GAAP at the request of a third party (either the company's creditors or its owners). *See generally* ENHANCING THE FINANCIAL ACCOUNTING AND REPORTING STANDARD-SETTING PROCESS FOR PRIVATE COMPANIES, FIN. ACCT. SERIES NO. 1310-100, June 8, 2006, http://www.scribd.com/doc/6789149/ITC-Private-Company-Financial-Reporting.

85. KOLLER ET AL., *supra* note 71, at 234–36, 297–300.

86. Kaplan, *supra* note 8, at 367.

87. *Id.*

88. An example of such compensation would be executive bonuses based on total company earnings or revenue. For a discussion of corporate bonuses tied to achievement of corporate performance objectives, see Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87, 105–06 (2007).

89. Examples of stock-based compensation are stock warrants and bonuses tied to the stock price. *See, e.g.*, David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 567 (2007) ("Stock options accounted for over two-thirds of the total compensation granted to the CEOs of two hundred large U.S. public companies surveyed in 2001, and over half of total compensation in 2002 . . . .").

90. Compensation tied directly to the company financial statements includes such compensation methods as profit sharing. *See* Revich, *supra* note 88, at 105. Under the profit sharing scheme, managers' compensation is calculated based on a financial statement's target. *See id.* For example, the compensation may provide a manager with an annual bonus calculated as a percentage of the company's annual net income.

stock price.[91] Moreover, the investment community expects a company's financial indicators to improve over time, and a slower rate of improvement may have a negative impact on the company's stock price.[92] Therefore, the relationship between management's compensation and the performance of a company's stock provides an incentive for management to improve financial results from one year to the next, especially given that financial results may yield low management compensation if the results fail to satisfy the investment community's demand for growth.[93] Thus, executive compensation packages tied either directly to the company's financial statements or to the performance of the company's stock make financial statement data the centerpiece of a modern manager's compensation package.[94]

Furthermore, a company's positive performance satisfies its managers' egos and makes them look good in the public eye.[95] Because financial performance and company stock price are often considered good measurements of a company's success,[96] it is an additional incentive for managers to consistently improve financial information.

It is easy to assume that management will show self-restraint and will not manipulate financial statements when company operations actually result in the desired financial growth. The situation, however, changes drastically once a company's operations no longer result in that growth. Management then faces a dilemma: accept lower financial results and thus lower compensation, or make the financial statements look better than they really are and receive higher compensation. Thus, there is an inherent risk that managers may manipulate financial data to make their company look better.[97] Additionally, even if managers restrain themselves and do not alter financial statements, the investment community cannot fully rely on those statements because of the managers' conflicts of interest.[98]

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91. FinancialWeb, Why do Stock Prices Move?, http://www.finweb.com/investing/why-do-stock-prices-move.html (last visited May 31, 2009).

92. For example, the market may look unfavorably at an earnings growth rate of eight percent if in the past company earnings were growing at a rate of ten percent. *Id.*

93. *Id.*

94. *See* Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 17 J. APPLIED CORP. FIN. 21, 23–29 (2003) (noting the temptation of managers to "artificially boost the stock price" and subsequently "cash out their equity holdings").

95. Kaplan, *supra* note 8, at 367.

96. *But see* Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law*, 3 BERKELEY BUS. L.J. 43, 46 (2005) (describing the prevalence of using stock price to measure corporate success and pointing out the flaws in this method).

97. As the financial scandals of the late 1990s and early 2000s demonstrated, the risk of management manipulation of financial statements is quite real. Furthermore, "[i]nstead of standing passively by, modern managers act affirmatively to 'manage' the results shown on their corporation's financial statements. Indeed, the very phrase, 'to manage earnings,' suggests that management is actively engaged in determining what goes into a corporation's financial reports." Kaplan, *supra* note 8, at 367.

98. Inability of the investment community to rely on the financial statements erases many benefits that may be associated with the financial statements. *See supra* Part II.B for a discussion of those

Furthermore, management's position provides it with an opportunity to manipulate financial data. Managers have virtually unlimited access and control over the process of financial statement preparation.[99] Managers oversee day-to-day operations of a company and, thus, are inherently the most qualified individuals to translate company operations into financial data. The process of financial statement preparation, however, provides management with an opportunity for manipulation.[100]

C. Gatekeepers

The investment community has long recognized this unfortunate collision of management incentives and the opportunity to commit financial fraud.[101] In response, the investment community imposed many restrictions on the financial reporting process through various regulatory agencies.[102] One such restriction is the Securities and Exchange Commission's (SEC) requirement that a public accounting firm certification accompany all financial statements issued by publicly traded companies.[103] An auditor certification states that based on reasonable audit procedures performed by the auditor, the financial statements are materially accurate,[104] thus giving the investment community reasonable assurance that management did not manipulate financial data.

For auditor assurance to have significant meaning, the auditor must be independent.[105] A manager's ability to control or influence the auditor defeats the entire purpose of an audit check.[106] Thus, financial auditor independence is essential to the accurate reporting of financial statements. Furthermore, the investment community needs auditor

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benefits; *see also* GAO REPORT, *supra* note 1, at 40 (concluding that doubts about the accuracy of financial statements substantially impair investors' ability to rely on the financial statements and make stock market investments riskier). Investors respond to the increased risk by pulling their funds out of the capital markets. *Id.* Mutual funds experienced the largest net outflow of capital (sales exceeding purchases) on record at the time of the financial scandals of the late 1990s and early 2000s. *Id.*

99. *See* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AUDIT ISSUES IN REVENUE RECOGNITION 3–6 (1999), http://ftp.aicpa.org/public/download/members/div/auditstd/revrec2.pdf (discussing management's responsibilities in preparing financial statements and implementing internal controls).

100. Kaplan, *supra* note 8, at 367 ("By its very nature, corporate management has strong tendencies to manipulate financial statements."); *see also supra* note 22 and accompanying text.

101. *See supra* note 100 and accompanying text.

102. *See, e.g.*, Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78 et seq. (2006).

103. *Id.* § 78j-1(a). Note that financial statements of many nonpublicly traded companies are also audited. Healy & Palepu, *supra* note 18, at 415 ("Research shows that capital providers require firms to hire an independent auditor as a condition of financing, even when it is not required by regulation.").

104. For an example of an audit opinion letter, see Dana S. Beane & Company, P.C., Certified Public Accountants, Sample Audit Opinion for Business Entity, http://www.dsbcpas.com/services/accounting/audit/opinionaudit.html (last visited May 31, 2009).

105. Auditors assume a "'public watchdog' function" that "demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984).

106. Bedard & Johnstone, *supra* note 44, at 284–85.

certification to rely on financial data without second-guessing every amount on companies' financial statements.[107]

D. Sarbanes-Oxley Act of 2002

The surge of financial audit scandals in the late 1990s and early 2000s[108] indicated that the financial audit profession was not working as intended—auditors were failing to identify financial frauds.[109] Many commentators blamed auditor failures on the loss of independence from client management.[110] One of the goals of SOX was to increase financial auditor independence from their clients.[111] The Act distinguished between independence of an audit firm overall and independence of individual auditors working for the firm.[112]

The SOX provisions dealing with the overall independence of audit firms focus on the conflicts of interest between an audit firm and a client.[113] Prior to the passage of the Act, it was common for audit firms to perform a variety of consulting services for their audit clients.[114] Indeed, consulting revenues often exceeded audit fees.[115] Such a setup inevitably led to conflicts of interest; it was very lucrative for audit firms to cut corners during the audit process to win a large consulting contract.[116] The Act dealt with this conflict-of-interest issue through two provisions: prohibiting certain nonaudit services[117] and requiring audit committee approval for other nonaudit services.[118]

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107. *Id.*

108. *See generally* GAO REPORT, *supra* note 1 (discussing a surge in financial accounting scandals between 1997 and 2002).

109. Kaplan, *supra* note 8, at 378.

110. *See, e.g.*, *id.* at 365.

111. *Id.* at 366; *see also supra* note 15 and accompanying text.

112. *See* Kaplan, *supra* note 8, at 366.

113. *Id.* at 373–78.

114. *Id.* at 373 ("The range of nonaudit services being offered by accounting firms [was] huge and ever-expanding.").

115. "In 2000, Andersen earned $52 million in fees from Enron. Less than half of that amount, $25 million, was for audit work; $27 million related to consulting services. . . . [I]t is difficult to comprehend how such large consulting fees could not have created a serious conflict of interest for Andersen." STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., REPORT ON FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 28 (2002).

116. Kaplan, *supra* note 8, at 373–75.

117. With a few exceptions not relevant here, the Act prohibited a company's auditor from performing the following services:

> (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible.

Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78j-l(g) (2006).

118. The Act permits audit firms to perform any service that is not listed in § 78j-1(g) "only if the activity is approved in advance by the audit committee of the issuer." *Id.* § 78j-1(h).

The second part of the SOX independence provisions deals with the independence of individual auditors that service a particular client.[119] Auditors work closely with client management during the course of an audit, and thus they often develop close, personal relationships.[120] Furthermore, audit firms often use the same auditors to serve a given client year-after-year.[121] In this way, auditors gain familiarity with the client's business, making the audit process more efficient.[122] Audit firms even encourage their employees to have positive relationships with client management.[123] Such relationships help audit firms preserve client business and obtain new service contracts.[124] Another factor contributing to a close relationship between the auditor and the client is the fact that auditors often obtain future employment with their clients.[125] When a corporation needs to fill a financial position, the company often views its auditors as the best choice because the auditors are familiar with the client's business and the industry's accounting practices.[126]

A close relationship, however, between the auditor and client management inevitably leads to problems. The auditor who has been reviewing client financial records for several years is more likely to let down his guard. In particular, the auditor may not question an accounting practice that the client has followed in the past. Indeed, the auditor would effectively have to question the conclusion that he reached in the previous year. Moreover, using the same individual auditors prevents audit firms from gaining the advantage of having a second opinion on the client's financial statements.[127] Additionally, once an auditor develops a personal relationship with the client's management, the auditor is less likely to question management's judgment and may even yield to managers' demands. Psychologically, it is difficult to question someone with whom one has a friendly relationship.

To summarize, if the same individual auditor reviews client financial information year-after-year, the auditor loses his impartiality. The auditor becomes overly familiar with the client's business and develops a desire to maintain a good relationship with the client's management. SOX

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119. *See* Kaplan, *supra* note 8, at 369–71. "The response of the Sarbanes-Oxley Act to the dilemma of auditor coziness focuses on accounting firm partner rotation and corporate hiring restrictions." *Id.* at 369.

120. *Id.* at 367–69.

121. *Id.*

122. *Id.*

123. *Id.* at 363–70.

124. *Id.*

125. *Id.* at 371.

126. *Id.* ("After all, [auditors] are already familiar with the corporation's financial activities and have accumulated a certain amount of industry experience and expertise that would have real value to that client.").

127. *See id.*

responded to this issue by requiring lead client service partner rotation[128] and by restricting clients' ability to hire their former auditors into management positions.[129]

III. ANALYSIS

The auditor independence provisions of SOX are steps in the right direction. These steps, however, are not enough. SOX fails to address three elements that are central to a free-market audit industry and inevitably lead to substantial limits on auditor independence: (1) the method of audit firm compensation, (2) the ability of a client to discharge an audit firm, and (3) the competition between audit firms. When all three factors are viewed together, it is clear that true auditor independence is impossible under the current audit scheme and that a substantial revision of the audit process is required to revive auditors' position as a public "watchdog."

A. Method of Auditor Compensation

The first flaw of the free-market audit scheme lies in the method of auditor compensation. Currently, audit firms are compensated by the very companies they are auditing.[130] Furthermore, because management runs public companies,[131] it is the management who hires the auditors and pays their fees.[132] This scheme gives company managers significant leverage over the auditors. Inevitably, auditors' fees are in the hands of their client's managers. Auditors have to please client management during the contract negotiation process, and even after the negotiation, auditors are constantly reminded of management's superior power by management's signature on the auditor's paycheck.

First, it is important to bear in mind that managers manage public companies.[133] These managers oversee many company business activities, including fee negotiation with the company's auditors.[134] Moreover, upper management often delegates the responsibility of auditor negotia-

128. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78j-1(j) (2006) ("It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead . . . audit partner . . . has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.").

129. *Id.* § 78j-1(*l*) ("It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this chapter, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.").

130. Kaplan, *supra* note 8, at 368.

131. *See* Healy & Palepu, *supra* note 18, at 409 (discussing agency problem associated with business investments). *See generally* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

132. *See* Kaplan, *supra* note 8, at 366 ("[I]t is corporate leadership, the executives who determine which accounting firm to hire.").

133. *See supra* note 131 and accompanying text.

134. *See* Kaplan, *supra* note 8, at 366.

tions to the company's chief financial officer or the chief accounting officer.[135] From upper management's point of view, these executives are best qualified to deal with the auditors due to their accounting and finance backgrounds.[136]

An average audit contract lasts one year, making the audit contract negotiation meeting an annual event.[137] The negotiation process is influenced by three factors: absence of government regulation, homogeneous nature of the audit product, and little value of the audit product to the management.[138] Combined, these factors put auditors in a position of dependence upon company management during the negotiation process.

All public companies have to comply with the SEC requirement of audited financial statements.[139] Yet, the SEC is silent on the proper amount of auditor compensation.[140] Instead, auditors negotiate their fees with the client's management as would any other two parties dealing with each other at arms-length.[141] Although arms-length negotiations work well in other areas of commerce, they are deficient in the arena of auditor compensation. The fatal problem of these negotiations is the manager's disinterest in the auditor's product. From management's point of view, auditors add very little value to the company. Although auditors may occasionally uncover an impropriety by some low-level employee, audit fees greatly outweigh any benefits from such discoveries.[142] Furthermore, most public companies have an internal audit department, which acts as management's watchdog over company employees.[143] Thus, in management's view, outside auditors contribute only one thing to the company—they catch improprieties of the managers themselves. Naturally, very few managers would think of the services of an outside auditor as beneficial. Therefore, although government regulation forces management to retain auditor services, management does not perceive these services as beneficial to the company.

Furthermore, the end product of different audit firms are indistinguishable.[144] The end result of an audit is the auditors' opinion,[145] which simply states that the company's financial statements are not materially

135. *See* Michael Gibbins et al., *Negotiations over Accounting Issues: The Congruency of Audit Partner and Chief Financial Officer Recalls*, 24 AUDITING: J. PRAC. & THEORY 171, 173 (2005).

136. *Id.* at 173.

137. James Tackett, *Sarbanes-Oxley and Audit Failure: A Critical Examination*, 19 MANAGERIAL AUDITING J. 340, 348 (2004) (recommending a mandatory four-year audit contract "rather than the traditional one year").

138. *See infra* notes 139–51 and accompanying text.

139. COX ET AL., *supra* note 22, at 547.

140. *See* Mukesh Bajaj et al., *Auditor Compensation and Audit Failure: An Empirical Analysis* 3–4 (EFA 2003 Annual Conference Paper No. 681, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387902.

141. Gibbins et al., *supra* note 135, at 175–80.

142. Bedard & Johnstone, *supra* note 44, at 277–85.

143. *Id.* at 281–82.

144. Kaplan, *supra* note 8, at 365–74.

145. *See* Bedard & Johnstone, *supra* note 44, at 277–78.

misstated.[146] Audit opinions of all major audit firms are worded in a very similar manner and any differences that do exist are trivial.[147] The auditor opinion essentially acts as a check mark on the management-prepared financial statements. Managers could care less what color ink is used to draw the check mark, so long as it is there.

The absurd nature of the management-auditor negotiation scheme is better understood through an analogy. Imagine that the government passes a new law requiring all publicly traded companies to purchase X number of widgets each year. Only a handful of companies manufacture these widgets. The government regulation does not specify the price for the widgets, nor does it require public companies to purchase widgets from the same manufacturer every year. Furthermore, imagine that the publicly traded companies have no use for the widgets and will simply store them in a warehouse after acquisition. How would such a setup affect the widget production industry? If the industry is competitive (which the audit industry is), the companies producing widgets will try to attract customers through ways other than improving the quality of their product. After all, because the widgets are useless, purchasing companies will not care about the quality of the widgets, so long as the widgets comply with the government's definition of the product. Thus, we may expect widget-producing companies to try to compete through lowering prices, providing company management with other incentives to buy their product, or trying to develop personal relationships with the company management.

Similarly, audit firms—unable to differentiate their product from the competitors' and facing management indifference to the product—look for other ways to please client management. Moreover, because an executive who is familiar with the audit industry usually handles the negotiations,[148] the management is well aware of this imbalance of power and may use it to its advantage. Even if the auditor has the best intentions, subconsciously the auditor will try to please the management.[149]

146. Robert P. Magee & Mei-Chiun Tseng, *Audit Pricing and Independence*, 65 ACCT. REV. 315, 317 (1990).

147. Compare audit opinions issued by the "big four" accounting firms for four different pharmaceutical companies: Deloitte & Touche LLP, ABBOTT LABORATORIES: 2007 FINANCIAL REPORT 63 (2007), http://www.abbott.com/static/content/microsite/annual_report/2007/support_files/Abbott_AR07_financial.pdf; Ernst & Young LLP, ELI LILLY AND COMPANY: 2007 ANNUAL REPORT 58–59, http://files.shareholder.com/downloads/LLY/549902126x0x221524/5179B2F9-7EDD-4825-895C-22B793187C8D/English.PDF; KPMG LLP, PFIZER INC.: 2007 FINANCIAL REPORT 37–38, http://media.pfizer.com/files/annualreport/2007/financial/financial2007.pdf; and PricewaterhouseCoopers LLP, WYETH: FINANCIAL REPORT 2007, at 45, http://library.corporate-ir.net/library/78/781/78193/items/283760/Wyeth_FR_07_lo.pdf. *See also* Jim Peters, *Panel 1: The Collapse of the Corporate Model*, 52 AM. U. L. REV. 579, 588 (2003) (describing an audit opinion as "three standard paragraphs that are a template right out of a textbook").

148. Gibbins et al., *supra* note 135, at 173.

149. "When people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self-interest." Max H. Bazerman et al., *Opinion: The Impossibility of Auditor Independence*, 38 SLOAN MGMT. REV.

Furthermore, this type of pay structure psychologically places management in charge of the auditors.[150] Management inevitably feels they hired the auditors and therefore have the right to control the audit process.

The auditor compensation scheme is even more troublesome considering the size of audit fees. In 2000, Arthur Andersen received approximately $25 million for its audit of Enron's financial statements.[151] Can an auditor ever be truly free from the influence of a client who pays $25 million per year for the auditor's services?

Furthermore, forcing audit firms to negotiate directly with client management is more than just a byproduct of the current audit scheme. Instead, it is essential to the operation of a free-market audit system. In a free-market industry, firms must be allowed to negotiate their contracts without involvement of government. Thus, the current format of auditor compensation is essential to a privatized audit industry, but at the same time it inevitably leads to auditor dependence on client management.

B. At-Will Relationship

The second flaw of the free-market audit scheme is the client's ability to freely discharge audit firms. Under the existing framework, companies may fire auditors at any time.[152] Furthermore, the investment community does not condemn a company's dismissal of its auditors.[153] Auditor dismissal has negligible impact on the company's stock price.[154] Thus, company management enjoys a practically unchecked power to discharge audit firms at will. One cannot reconcile this power with the notion of auditor independence. Moreover, an at-will relationship is central to the free-market audit scheme. Therefore, the at-will relationship prong of the free-market system will not allow auditors to be truly independent of company management.

Currently, companies may either fire the auditor on the spot or wait until the end of the contract term and simply not renew the contract.[155] In either case, there is no requirement of for-cause termination.[156] Indeed, if a client is a private entity, the auditor may be fired at any time

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89, 93 (1997); *see also* Coffee, *supra* note 7, at 309 ("Unavoidably, the gatekeeper as a watchdog is compromised to a degree by the fact that it is typically paid by the party that it is to monitor.").

150. Bazerman et al., *supra* note 149, at 93–94.

151. STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., REPORT ON FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 28 (2002).

152. Douglas W. Hawes, *Stockholder Appointment of Independent Auditors: A Proposal*, 74 COLUM. L. REV. 1, 3 (1974) ("In most United States corporations, management has the power to fire auditors at will.").

153. Paul A. Griffin & David H. Lont, Do Investors Care About Auditor Dismissals and Resignations? Further Evidence 4 (Mar. 7, 2007) (unpublished manuscript, http://www.victoria.ac.nz/sacl/research/researchseminarseries/2007/pg_150307.pdf).

154. *Id.*

155. *See* Hawes, *supra* note 152, at 3. *See generally* Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989, 992–1001 (2003).

156. *See* Hawes, *supra* note 152, at 3.

without any legal disclosures.[157] If a client is a public entity, the client is required to file a statement with the SEC explaining the reason for changing auditors.[158] The auditor would then file a similar statement with the SEC explaining its understanding of why it was fired.[159] In theory, this double disclosure requirement provides auditors with an opportunity to expose management to the SEC.[160] In practice, however, this setup only catches the most blunt attempts to retaliate against an audit firm.[161] First, the client may try to cover up the true reason for discharging an audit firm. The client may also shift the timing of the termination to avoid suspicion. For example, if the client disagrees with the audit firm regarding treatment of a certain transaction, and the audit firm is not willing to yield, the client can simply accept the audit firm's position in that particular instance and fire the auditor at the end of the fiscal year for no articulable reason. Afterwards, the client can honestly report to the SEC that there are no outstanding disagreements between the client and the audit firm.[162] Furthermore, because the SEC expects the audit industry to operate as a free market, disagreement over audit fees is a perfectly acceptable explanation for terminating an audit contract.[163] Management may easily manufacture a fee disagreement by asking for a lower quote. No one would blame the management for trying to get a better price on an audit contract.

Additionally, although auditors do have an opportunity to reveal management's cover-up of the true reasons for the audit firm discharge through their own SEC filing, auditors rarely do so. Audit firms dislike SEC reviews of their clients.[164] Every SEC review inevitably results in an examination of the auditor's performance.[165] With the Arthur Andersen fiasco[166] still fresh in their minds, excessive attention from the SEC scares audit firms. Thus, an audit firm will only reveal improper reasons for its

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157. *See* Lynn E. Turner et al., *An Inside Look at Auditor Changes*, CPA J., Nov. 2005 (Innovations Supplement) at 12, 12, *available at* http://www.nysscpa.org/cpajournal/2005/1105/special_issue/essentials/p12.htm.

158. *Id.* at 12, 15.

159. *Id.* at 14 ("When an auditor is informed by a company that it has been terminated, or informs the company that it will no longer serve as the independent auditor, the auditor is required to send a form letter directly to the Office of the Chief Accountant of the SEC.").

160. *See id.*

161. *See id.* at 13–14.

162. For example, only 1% of companies that changed auditors in 2004 reported disagreements with their auditors on their SEC filings. *Id.* at 16.

163. *See generally id.*

164. *See* Ehsan H. Feroz et al., *The Financial and Market Effects of the SEC's Accounting and Auditing Enforcement Releases*, 29 J. ACCT. RES. 107, 110–15 (1991).

165. If the SEC finds a financial impropriety, it also investigates the auditor in attempt to identify the auditor's responsibility for missing the error. *Id.*

166. Arthur Andersen was a large audit firm that was in charge of auditing Enron financial statements. The firm was indicted for its involvement with Enron, which effectively led to a complete dismantling of the audit firm. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1341 (2002) ("The indictment and conviction of the firm as a whole, rather than only its Houston office, pushed it toward the edge of collapse as foreign affiliates and audit clients alike promptly deserted it.").

termination when it is either confident in its prior performance or management impropriety is so severe that it outweighs the risk of the SEC review.[167]

Another factor that may affect management's decision to fire an audit firm is reaction on the part of the investment community. If the investment community perceives such discharge as negative news, it may lower the company's stock price.[168] Management has strong incentives in raising the company's stock price.[169] An audit firm switch, however, has only a marginal effect on the company's stock price.[170] Indeed, stock price fluctuates more because of the reason for auditor change than the change per se.[171] Thus, if the management covers up the real reason for the auditor change, the effect on the company's stock price is likely to be insignificant.[172]

Therefore, management may fire auditors at will without substantial fear of repercussions. The power to terminate the audit relationship gives management a great deal of control over the auditors. The situation is similar to that of regular employment. Employees are agents of the corporation and thus are supposed to act in the best interest of the corporation and not in the best interest of the company managers. But it is ludicrous to say that employees are independent of their managers. Employees are always aware of their managers' superior power. This awareness places the employees in a position of dependence upon management. Management makes decisions and employees simply oblige. How different are auditors from average company employees when it comes to dependence upon company management? Managers may fire auditors almost as easily as their own companies' employees.

Company management retains further control over the auditors with these short-term audit contracts. The competitive nature of the audit industry forces audit firms to accept these short-term contracts;[173] auditors feel pressure to oblige because if they do not, another firm will. Although management may discharge an audit firm in the middle of a contracted term, it is much easier to simply not renew a contract. Short-term audit contracts provide management with an opportunity to remind auditors of who is in charge. Currently, a typical audit contract lasts only one year.[174] Therefore, at the end of each fiscal year, client management

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167. *See* Feroz, *supra* note 164, at 109–15.

168. *See* Turner et al., *supra* note 157.

169. *See supra* Part II.B.

170. Turner et al., *supra* note 157, at 20 ("The year after the auditor change, 30% of companies with revenues greater than $100 million underperformed the S&P 500, by an average of 16 percentage points the year after the change, while 70% outperformed the S&P 500, by an average of 121 percentage points the year after the change.").

171. *Id.* at 20–21.

172. *See id.*

173. It is hard to imagine why a profit-seeking audit firm would voluntarily decline a multiyear engagement. After all, long range contracts would guarantee a constant revenue stream for the firm.

174. *See supra* note 137 and accompanying text.

meets with the auditors to discuss next year's audit arrangement and the associated fees.[175] If the parties cannot reach an agreement, either side may walk away. Needless to say, the fee negotiation meeting looms in the back of the lead client service partner's[176] mind throughout the year. Even if the partner is not concerned with management firing her firm, she is always thinking about the audit fees for the next year. Therefore, an audit firm partner cannot be truly independent of client management's opinions, especially when management can fire the auditor at practically any time.

Furthermore, an at-will relationship between the auditor and the client is a necessary element of a free-market audit system.[177] The client must have the ability to fire the auditor, and the audit firm needs the option of quitting. If the legislature simply disallows clients to change auditors, it would create a government-imposed monopoly and give audit firms too much power. Then, auditors could pressure clients into paying excessive fees. After all, auditors are in the business of earning money, and their main goal is always to maximize fees.

Thus, in a pure free-market competition system, the ability of client management to discharge an audit firm gives it substantial control over the auditor. At the same time, imposing restrictions on a client's ability to discharge an audit firm would give auditors an unfair advantage.

C. Competition Between Audit Firms

The third flaw of the free-market audit scheme is the element of competition between audit firms. In most commercial settings, competition is the best method of operation.[178] Normally, competition results in the best product produced at the lowest cost.[179] Free-market competition, however, does not work in the audit industry because audit firms cannot differentiate their product from the products of other audit firms and because company management has no incentive to seek out the best product.[180] Instead, management looks for the cheapest product and a product that does not impede managers' plans. Thus, auditors have to

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175. *See generally* Hawes, *supra* note 152 (examining the process of auditor appointment and auditor-management dealings); Kaplan, *supra* note 8 (same).

176. A lead client service partner is the partner who has overall responsibility for the audit and client relationship. Kaplan, *supra* note 8, at 369.

177. *See* Scott A. Moss, *Where There's At Will, There Are Many Ways: Redressing the Increasing Incoherence of Employment At-Will*, 67 U. PITT. L REV. 295, 300 (2005) (discussing the importance of at-will employment to a free-market economy) (quoting Bammert v. Don's Super-Valu, Inc., 646 N.W.2d 365, 369–70 (Wis. 2002)).

178. Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 695 (1978) ("The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers.").

179. *See id.*

180. *See generally* Kaplan, *supra* note 8, at 363–66 (describing fundamental problems with corporate auditing).

compete amongst themselves on the basis of their fees and perhaps personal relationships with client management. Unfortunately, both elements grant company management additional leverage over the auditors. By charging lower fees, auditors place themselves in a situation of financial dependence upon a client. Furthermore, developing personal relationships with client management gives the appearance of impropriety, if not impropriety itself. Thus, as long as audit firms compete amongst themselves for client business without the option of competing based on the quality of their product, they will remain in a position of dependence on client management.

Accounting firms cannot compete based on quality because they produce a homogeneous product. At the end of each audit, the auditor issues a one-page report, which most often simply states that the financial statements are materially accurate.[181] Reports of all audit firms are practically identical.[182] Furthermore, the management of a company being audited does not care about the quality of the audit.[183] Instead, management simply wants the auditors to assure the investment world that there are no problems within the company.[184] Thus, it is difficult if not impossible for audit firms to compete amongst themselves based on product quality. Like any other competitive industry, the audit industry responds to these limitations by placing extra weight on other factors that differentiate them from their peers. In particular, audit firms compete by offering attractive fees and through their soft skills.[185] Both the lower fees and personal relationships with client management, however, seriously impair auditor independence.

Faced with the inability to differentiate themselves from their competitors, audit firms typically accept a lower fee.[186] Auditors justify the low fee on the possibility of obtaining substantial business from the client in the future and the economies of scale.[187] By charging lower audit fees, audit firms believe that they get their foot in the door and that they will benefit from the client's future, more profitable deals.[188] Such deals may include engagements in nonaudit types of services, such as tax prepara-

181. *See supra* note 147 and accompanying text.

182. *See supra* note 147 and accompanying text.

183. David B. Kahn & Gary S. Lawson, *Who's the Boss?: Controlling Auditor Incentives Through Random Selection*, 53 EMORY L.J. 391, 399–402 (discussing management's interests in an audit opinion).

184. Management is interested in having the investment community believe that there are no problems within the company, regardless of whether this belief is correct or not.

185. *See* Kaplan, *supra* note 8, at 365–70 (describing the role audit personnel play in retaining clients by keeping them "happy").

186. *Id.* at 368.

187. *Id.* ("Since the audit of a new client typically entails *additional* work of a one-time nature, the auditing firm will almost certainly lose money on this audit engagement in the first year, and perhaps in later years as well.").

188. *Id.* at 365–66; *see also* Cassell Bryan-Low, *Accounting Firms Earn More from Consulting*, WALL ST. J., Apr. 16, 2003, at C9 (discussing the ratio between audit and nonaudit service fees paid during 2001–2002 by major companies to accounting firms).

tion.[189] Although SOX substantially reduced audit firms' ability to provide clients with nonaudit types of services, there are still plenty of nonaudit services that an auditor may provide without violating SOX.[190] Furthermore, the client may engage the audit firm to assist the client with nonrecurring audit and assurance projects, such as securities issuances, mergers, acquisitions, and divestitures.[191] Audit firms may earn higher returns on these nonrecurring services than on the regular auditing services.[192]

Additionally, audit firms charge lower fees in the beginning of the audit engagements because of the economies of scale.[193] A first-year audit is associated with significant upfront expenses.[194] For example, the audit firm needs to familiarize itself with the client's business and develop a brand new audit plan, which results in a substantial time investment.[195] Thus, almost inevitably, audit firms operate at a loss during the first year of engagement.[196] As the audit team members gain experience with a particular client, costs associated with the auditing process decrease significantly.[197]

This framework, however, places auditors in a position of dependence on company management. Termination of an audit relationship could be a financial disaster for an audit firm. For an engagement to be profitable, the audit firm needs the relationship to last long enough to recover its upfront costs.[198] Even after the audit firm recovers its upfront costs, terminating the audit relationship has a substantial opportunity cost. Following a termination, on top of losing the audit contract itself,[199] audit firms have a disadvantage in competing for future client projects.

Another way that audit firms compete for client business is through personal relationships with client management.[200] Similar to most businesses, personal relationships play a significant role in obtaining new

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189. Bryan-Low, *supra* note 188.

190. *See supra* notes 116–18 and accompanying text.

191. *See* Kaplan, *supra* note 8, at 365–70 (explaining auditors' incentives to gloss over problems to gain access to other corporate services).

192. *Id.* at 365–66 ("[M]aking trouble for a client jeopardized not only the ongoing stream of audit fees, but also the potential for cross-selling tax, consulting and other services, all of which were more profitable than auditing per se.").

193. *Id.* at 368.

194. *Id.*

195. *Id.*

196. *Id.*

197. "In effect, the firm has 'invested' or sunk significant resources in the new client relationship in the form of unbilled hours, so the firm must retain this client to make this investment pay off." *Id.* at 368.

198. "Woe be the partner who jeopardizes [a] client relationship before the written-off billings have been recovered from future years' audit fees." *Id.*

199. Presumably, at this point the audit firm has reached the economies of scale and the audit contract has become profitable.

200. Kaplan, *supra* note 8, at 365.

clients or keeping existing ones.[201] Thus, auditors try to develop friendly relationships with client management.[202] Understandably, such relationships have an adverse effect on auditor independence. Even if auditors have the best intentions, they may let down their guard when dealing with someone whom they consider a friend.

Thus, competition between audit firms for client business forces auditors to try to please client management. Unable to differentiate their services, auditors turn to lower fees and development of personal relationships with client management. In both cases, competition between audit firms places them in a position of dependence on client management. Moreover, the existence of competition between audit firms is the very definition of a free-market system.[203] It is arguably the defining element of a private audit market.

In summary, one cannot reconcile the modern free-market audit scheme with the notion of auditor independence. While the SEC requires all public companies to issue audited financial statements,[204] the SEC fails to regulate the auditor-client relationship. A company's management may freely decide which audit firm it wishes to hire and how much to pay for audit services. Furthermore, audit firms provide indistinguishable service, and an audit has little benefit to company management. Even worse, managers may fire auditors for practically any reason without fear of repercussions. Thus, auditors find themselves scrambling for audit contracts, with no way to appeal to a client's management other than through audit fees and the intangible relationship between the auditors and the client's management. It is ludicrous to argue that audit firms maintain independence from their clients under this scheme. Furthermore, these conflicts of interest are inherent in the free-market system and can only be cured with a revision of the entire audit system.

IV. RESOLUTION AND RECOMMENDATION

The legislature needs to overhaul the financial audit system to return independence to the financial audit process. Moreover, the overhaul must address auditor independence risks inherent in free-market competition between private audit firms. Government interference is the most logical solution to any problem created by free-market competition. Transferring the responsibility for financial audits to a governmental agency assures independence of the auditors from client management. The Internal Revenue Service (IRS) already acts as a government agent

201. "[T]he accounting firm culture [holds] that making trouble for a client [is] the road to professional oblivion. After all, the audit personnel who [are] the subjects of praise and admiration [are] the ones who earned the highest epithet: 'He . . . knows how to keep clients happy.'" *Id.*

202. *See id.*

203. Free market is defined as a "market with unrestricted competition." THE AMERICAN CENTURY DICTIONARY 224 (2d ed. 1997).

204. Securities and Exchange Act of 1934, 15 U.S.C. § 78m(a) (2006).

in tax audits, and there is little doubt that the IRS is independent from the entities it is auditing. The IRS budget is derived from general taxation, which has a tenuous relationship to the company being audited by a particular IRS employee.

Under the proposed government audit scheme, a government agency would be responsible for financial audits of all publicly traded companies. This is similar to the current SEC requirement of audited financial statements for all publicly traded companies.[205] Thus, the only change would be the requirement of a government audit instead of an audit by a private accounting firm.

The services of the government auditor should be compensated from a central pool of funds. All public companies would be required to contribute to the pool. These contributions would be determined separately for each publicly traded company based on the anticipated complexity of the audit. This anticipated complexity would be based on the size of the company, the complexity of its financial accounting issues, and other similar factors.

The authority of the government auditor should be limited to publicly traded companies. All other companies would have the option of hiring an independent audit firm or the government auditor. This way, the government audit scheme does not result in a mandatory tax imposed on all businesses. Furthermore, private companies do not need government audits. Usually, a specific party requests private company audits.[206] The entity requesting the audit most often has substantial control over the performance of the audit, and that entity oversees the relationship between the auditor and the auditee's management.

A government audit scheme coupled with the existing SOX legislation would substantially improve auditor independence and revive public trust in the value of the auditor's report. First of all, the government auditor would change the current method of auditor compensation and remove its shortfalls. Severing the link between client management and auditor compensation would reduce auditor dependence on company management. Furthermore, because audit fees would be mandatory and pre-determined by someone other than client management, auditors would not feel as though their compensation depends on their ability to please company management. Thus, psychologically, management and auditors would be placed on equal footing. Second, the government audit scheme would completely erase the at-will relationship between auditors and clients. Instead, audits would be mandatory, and companies would have no choice in who will perform the audit or what its scope will be. Job security would provide auditors with an opportunity to do their job without fearing termination. Lastly, there would be no competition

205. *Id.*

206. For example, a bank that lends money to the business or shareholders in a family-owned business who do not participate in management. *See* WEYGANDT ET AL., *supra* note 79, at 7–10.

between audit firms. The absence of competition would remove the need for auditors to please company management. Therefore, government audits would remove obstacles to auditor independence that are inherent in the free-market audit system.

One potential argument against a government audit agency is the potential for inefficiency, a common criticism of government institutions. This argument loses its potency when one puts it in perspective. Financial statement restatements over the five-year period between 1997 and 2002 cost financial markets approximately $100 billion in market capitalization.[207] It's unlikely that even the most inefficient government agency would lose $100 billion over a five-year period.

V. CONCLUSION

The traditional free-market system places auditors in a position of dependence on client management. Although the free market results in the best product produced at the lowest price in most situations, financial audits are not one of those products. The key difference between financial audits and other free-market products is the disparity in bargaining power between public-company management and the auditors. Although public-company management must retain an auditor, it has control over selecting an audit firm, discharging an audit firm, and deciding on the proper compensation for an audit firm.

Due to the homogeneous nature of the product (the auditor's opinion), management has no particular attachment to any given audit firm. Furthermore, from management's point of view, the auditors add little, if any, value to their company. Thus, management is more interested in obtaining the cheapest audit instead of the best one. Moreover, if management is mischievous, it values auditors that do not get in its way.[208] These managers may use their power over the auditor selection process to hire auditors that will cause the least trouble for management.

Combined, these factors force auditors to pay close attention to management's needs and try to please management in every way possible. Auditors are aware of management's disinterest in the audit, and auditors know that their services are practically identical to the services offered by any other audit firm. Thus, auditors try to compete with other

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207. GAO REPORT, *supra* note 1, at 5. "Not only do restatement announcements appear to affect company stock prices, but some evidence suggests that these announcements and the questions they raise about certain corporate accounting practices may negatively impact overall investor confidence." *Id.* at 32. "Indeed, survey evidence shows that investor confidence in June 2002, one month before the Sarbanes-Oxley Act was enacted, 'was at an all-time low due to concern over corporate accounting practices (even lower than the period just after September 11, 2001).'" Kaplan, *supra* note 8, at 379 (quoting GAO REPORT, *supra* note 1, at 32).

208. Arguably, only a small percentage of managers try to manipulate company financial statements for personal benefit. It is difficult, however, to distinguish the manipulative managers from the honest ones. Therefore, the investment community should not rely on any financial statements prepared by the company management if they are not accompanied by an independent certification.

audit firms with lower fees and with close, personal ties to management. Competing in this manner, auditors are placed in a position of dependence on client management.

A government-controlled audit system is the only reasonable solution to auditor independence issues. Government-controlled audits would achieve the level of independence desired by the investment community. Government auditors would not feel the need to please the company's management. The government auditor's job security and compensation would not depend on the will of management, and thus auditors would feel truly independent from the company they are auditing. Therefore, in order to return independence to the financial audit industry and to prevent financial disaster similar to the late 1990s and early 2000s, the legislature should replace the private audit industry with a government audit agency.