

**WHO'S THE BOSS?: CONTROLLING AUDITOR INCENTIVES  
THROUGH RANDOM SELECTION**

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At the time this article was printed in the Emory Law Journal, the article "Let's Get Real-Why the Sarbanes Oxley Act Is a Sham" did not have page numbers as presented on this website. As a result, the references to "Let's Get Real" in the Law Journal did not have page cites.

**The pages of "Let's Get Real" cited in "Who's the Boss" are as follows:**

- "Who's The Boss" page 394 refers to "Let's Get Real" at page 6;
- "Who's The Boss" page 394, n. 9; refers to "Let's Get Real" at pages 7;
- "Who's The Boss" page 398, n. 23; refers to "Let's Get Real" at page 14;
- "Who's The Boss" page 415, n. 64; refers to "Let's Get Real" at page 7.

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**EMORY LAW JOURNAL**

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**Volume 53****SPRING****Number 2**

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**ARTICLES****WHO'S THE BOSS?: CONTROLLING AUDITOR INCENTIVES  
THROUGH RANDOM SELECTION***David B. Kahn\***Gary S. Lawson\*\**

It took the promise of knowledge to get Eve to yield to temptation. For people outside the Garden of Eden, money often does the job nicely. The U.S. capital markets are the locus of an enormous amount of money—and therefore of an enormous temptation for people who provide financial information to those markets to skew the reporting process to promote their own interests. The risk and potential consequences of skewed financial reporting are matters of grave concern.

The lifeblood of capital markets is information, much of which comes from audited financial statements issued by firms. The integrity and reliability of the reporting system that produces those audited statements is crucial to the country's financial future. The U.S. economy guides capital to competing enterprises primarily on the basis of investment decisions made by private

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\*\* Professor of Law, Boston University School of Law. We have benefitted from comments by Ron Cass, Tamar Frankel, Sean O'Connor, David Walker, and the participants at a workshop at Boston University School of Law. Many of the ideas in this Article, including the idea for an auditor lottery, are based on a previous paper. See David B. Kahn, *Let's Get Real—Why the Sarbanes Oxley Act Is a Sham*, at <http://www.kahnlawchicago.com/> (last visited Mar. 14, 2004).

investors, either directly or through investment intermediaries.<sup>1</sup> Those investment decisions are typically based, in some measure, on descriptions of the financial positions of competing firms provided by the firms' managements.<sup>2</sup> If some of that information paints an unduly rosy picture of the firms' financial positions, investors may be led (or misled) to direct financial and human resources to companies that do not warrant the investment—and perhaps even to failing companies that are masquerading as successful firms. This causes serious harm and dislocations to both the economy and investors.<sup>3</sup> Moreover, if there are systematic defects in the reporting and auditing system, it becomes impossible, at least within a range, for investors to distinguish *ex ante* between good and bad information. Investors accordingly must discount *all* corporate financial information, which reduces value across the board and harms the ability of deserving companies to raise capital.<sup>4</sup> The cumulative effect of problems with the reliability of financial information can be staggering. It is difficult to overstate the economic importance of sound financial reporting.

Given the stakes involved, the current system of presenting and verifying financial information is downright bizarre. Financial statements are prepared by the firms' managements, which have strong incentives to present as favorable a picture of their firms as possible. Managers can make millions if they report profits and lose their positions if they do not. The auditors who

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<sup>1</sup> See Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?*, 28 J. CORP. L. 69, 75 (2002) (“[F]inancial markets affect the cost of raising capital, which affects the profitability and level of investment, which in turn affects employment, output, and income.”).

<sup>2</sup> To be sure, there can be circumstances in which investment decisions will (and rationally should) be based entirely on future projections without any reference to past or current events; past performance, as investment companies are required to remind us, is not a guarantee of future success. More generally, the amount and character of the information that investors want depends upon, *inter alia*, the information that they already have, the cost of acquiring and processing more information, and the composition of their overall investment portfolios. But at least much of the time, investors will want to see evidence of the company's recent cash flows, current assets, and current liabilities before committing capital to the enterprise.

<sup>3</sup> Of course, the notion of harm and dislocations to the economy and investors presupposes the existence of some standard by which effects on large groups of people can be measured and evaluated. Professor Lawson is skeptical about the meaning or utility of any such standard. See Gary Lawson, *Efficiency and Individualism*, 42 DUKE L.J. 53 (1992). Every event in the world, including investment or other business decisions, benefits some people and harms others, and in the absence of a coherent metric for aggregating effects interpersonally, any statements about social or group consequences, however they are formulated, must be very carefully defined, qualified, and limited. See *id.* Mr. Kahn is dubious about the meaning or utility of Professor Lawson's skepticism.

<sup>4</sup> See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 786 (2001). All else being equal, uncertainty reduces the relative value of an investment, and doubts about the quality of financial information represent an important form of uncertainty.

verify the financial statements are hired and paid by the management and, therefore, have strong incentives to use the flexibility inherent in generally accepted accounting principles (GAAP) to accede to management's desire to present as favorable a picture of the firms as they can.<sup>5</sup> It is as though baseball pitchers called their own balls and strikes and then hired and paid umpires to verify their calls. Indeed, the major difference between the pitcher-umpire example and the operation of the financial reporting system is that the incentives to abuse the process, and the consequences of that abuse, are enormously greater in the case of financial reporting. For the accounting firms that perform audits of corporate financial statements, the audit fees and other benefits can run into tens of millions of dollars for a single audit. For the audited companies, the differences among clean, qualified, or adverse audit opinions could easily involve billions of dollars in stock value. That is a lot of temptation to place in the path of fallible people. Given the record of human history, it would be astonishing if a significant number of auditors and auditees did not attempt to use the financial reporting process for personal gain. A system that lets interested parties describe their own performances and then hire and control the people who check those descriptions is inviting disaster.<sup>6</sup>

It is therefore unsurprising that many people besides us have observed that the current auditing system is, in many respects, perverse.<sup>7</sup> We do, however, offer what we think is a novel solution. The actual assignment of umpires in baseball is random (and independent of the pitcher) precisely to avoid the kinds of problems that we have just described. Accordingly, we propose that auditors be selected at random from among a pool of willing and qualified

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<sup>5</sup> There are, of course, legal and economic forces that push auditors toward objectivity, but as we explain later in this Article, it is easy to overestimate the strength of those forces. *See infra* Part I.B.

<sup>6</sup> As one of history's wisest institutional designers once said in a slightly different context:

Ambition must be made to counteract ambition. The interest of the man must be connected with the constitutional rights of the place. It may be a reflection on human nature that such devices should be necessary to control the abuses of government. But what is government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.

THE FEDERALIST NO. 51, at 347 (James Madison) (Jacob E. Cooke ed., 1961) (citations omitted).

<sup>7</sup> *See, e.g.*, Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989 (2003); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39 (2002); Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of 'Auditor Independence' Under the Current Audit System* 50 (Mar. 1, 2002) (unpublished manuscript), at [http://papers.ssrn.com/sol3/delivery.cfm/SSRNID303181\\_code020311510.pdf?abstractid=303181](http://papers.ssrn.com/sol3/delivery.cfm/SSRNID303181_code020311510.pdf?abstractid=303181).

auditors, subject to certain guarantees against discharge by the firms. One of us (Mr. Kahn) also proposes that auditor compensation be set by a body other than the firm, which further insulates auditors from management influence. By reducing management control over the hiring, firing, and compensation of auditors, we can reduce the extent to which auditor incentives are misaligned with those of management without destroying features of the current audit system that serve positive functions.

In Part I, we describe in more detail the problems posed by the current audit system, even as “reformed” by the Sarbanes-Oxley Act of 2002<sup>8</sup> and recent Securities and Exchange Commission efforts at regulation. We explain more fully the sources and nature of the misaligned incentives between auditors and audited firms that are created by a system in which the auditors’ objects of investigation are also the clients, and we explain why the existing legal and economic incentives for auditor objectivity are inadequate. In Part II, we present our proposal for an “auditor lottery” in more detail and compare it to some other suggested solutions to the problem of misaligned auditor incentives ranging from investor-sponsored audits to government-run audits to private audit insurance.

There are myriad extremely difficult problems of implementation with which any proposal such as ours must deal. Indeed, the authors here do not agree with each other about the best way to address those problems, and we accordingly present and discuss two different forms of an auditor lottery, one of which relies on government supervision and enforcement and the other on voluntary action by exchanges. Moreover, the causes and consequences of inadequacies in the corporate auditing process are so complex that any claims concerning a single aspect of that process must be guarded. Accordingly, we do not suggest that an auditor lottery is a panacea for all of the problems of the financial reporting system. It is one piece, albeit an important one, of a very large puzzle, and we must leave the other pieces for other days.<sup>9</sup>

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<sup>8</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 29 U.S.C.).

<sup>9</sup> In particular, we do not discuss in this Article whether auditing standards should be changed to make them more transparent, more verifiable, or better barometers of corporate financial health. Cf. Ronen, *supra* note 7, at 60-67 (combining a proposal for structural reform of the audit process with suggestions for changed auditing standards). One of us has briefly addressed that issue elsewhere. See Kahn, *supra* note \*\*. There is a good argument that changes in accounting standards would likely be ineffective without prior changes in the structure of the auditing process. See William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1026, 1037 (2003).

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In the end, one must guard against the grass-is-greener, or “Nirvana,” fallacy: the real question is not whether we can put forward a perfect audit system, but whether we can suggest a specific reform of the system whose marginal benefits and costs (including the costs of transition) are more favorable than the available alternatives. We think that we can do that much. One can argue—as we do, to some extent, with each other in this Article—about the appropriate institutional mechanisms through which an auditor lottery should be implemented and whether any additional measures for changing the audit process might be worthwhile, but the stakes are high enough to make an auditor lottery in some form worthy of serious consideration.

### I. AUDITORS OR ACCOMPLICES?

The current system of financial auditing does not assure that corporate financial statements reflect the economic health of the audited company. That is not a surprising conclusion, because the system is not *structured* to produce such assurances.

#### A. *The True Character of Financial Statements*

Financial statements are claims made by the company’s management. It requires little imagination to see that management has powerful incentives to shade its claims on the rosy side. The managers’ compensation and careers quite probably depend to some substantial degree on the company’s depiction of its performance and the firm’s stock price, which in turn reflects the company’s (relative) perceived attractiveness as an investment vehicle. This becomes increasingly true as managerial compensation is tied to firm stock performance. There may be very good reasons, grounded in basic agency-cost theory, why one might want to link managerial compensation to stock prices,<sup>10</sup> but doing so increases the incentives for management to present financial information in the form most likely to maximize stock prices over the period during which those prices affect managerial compensation.<sup>11</sup> The manage-

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<sup>10</sup> The standard argument (which we neither endorse nor reject in this Article) is that managers on straight salaries are likely to be overly conservative, because they lose enormously if the company fails but do not fully share in the gains if the company is extremely successful. Thus, this argument contends, salaried managers may be less inclined to pursue high-risk/high-return projects than shareholders would prefer, especially given that shareholders are likely to have diversified portfolios while managers’ employment fortunes are tied to one company.

<sup>11</sup> For a careful discussion of the effects of providing management with equity compensation that is

ments' incentives for accurate disclosure are especially tested if the company is actually in serious danger of failing, as is inevitable for some companies in the "creative destruction"<sup>12</sup> of the capitalist process. In that circumstance, the managers' only chance of retaining their positions, or even their careers, may be to attract additional investment that will keep the sinking ship afloat in the hope that something turns around.<sup>13</sup>

These incentives can affect the objectivity of management reporting even if one does not believe that managements will often deliberately attempt to submit misleading information (though that is a nontrivial risk). In many cases, the managements that prepare financial statements may believe their unrealistically optimistic scenarios with all of their collective hearts. There are very good reasons why one might expect even the most honest management to be systematically over-optimistic about its own performance—reasons that have been elegantly collected and analyzed by Professor Donald Langevoort.<sup>14</sup> Information flows within corporate structures can be expected to emphasize good news over bad news because of the incentives facing the lower-level employees who initially possess, and must convey, information up the hierarchy to those who make decisions and prepare financial reports.<sup>15</sup> Moreover, there are pervasive cognitive biases—biases in the ways in which people view and process information—that can be expected to generate

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highly liquid in the short term, see John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. (forthcoming 2004).

<sup>12</sup> JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 84 (1942).

<sup>13</sup> For more on this crucial problem of failing companies, see *infra* pp. 400-401.

<sup>14</sup> Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

<sup>15</sup>

The employees with the most immediate access to basic information are almost always line personnel with a range of operational duties. . . . Compensation is often subjective and set by the immediate supervisor. . . . For that reason alone, the natural reporting temptation is to transmit information in a way that minimizes the potential for blaming oneself for bad news. . . .

The highly situational incentive to distort is exacerbated by the promotion and termination structures commonly found in large corporations. Especially for junior managers on the executive track, there is a rapid rotation of responsibilities. . . . To an ambitious manager facing a series of such "probationary crucibles," adverse information that would taint his or her candidacy but will not be realized more broadly within the organization until that manager has either moved up or out—at a time when any attribution of personal responsibility is either impossible or unlikely because so many possible causes intervene over time—should be concealed or distorted.

*Id.* at 121-22 (quoting ROBERT JACKALL, MORAL MAZES 40 (1988)).

systematic over-optimism within corporate organizations.<sup>16</sup> In this environment, accountants who challenge the corporation's optimistic self-assessment could quite understandably be viewed with disfavor by management.

Furthermore, even if a particular management recognized and countered all of these biases, it is not clear that management has strong incentives to act on that knowledge. If competitors are engaged in "earnings management," as manipulative financial reporting is often called, then firms that do not employ such devices may be at a disadvantage in the market because they are depicting themselves as less successful. No managers want their companies' objectively reported earnings to be compared to the inflated earnings of competitors—just as professors who personally dislike grade inflation may nonetheless be reluctant to give their students honest grades that must compete against the inflated grades given by less responsible instructors. Moreover, if markets react to reported figures, companies that fail to exaggerate to the same degree as their competitors may find it difficult to raise capital or could even fail.

Accordingly, financial figures provided by management come burdened with enough doubts to reduce the value of the information by some potentially significant degree. Outside auditing firms are accordingly brought in to certify the managers' presumptively self-serving representations about their companies.<sup>17</sup> One must, however, understand the nature and limits of that certification.

An unqualified audit opinion states, based on a sampling of the company's records, that the management's financial statements were prepared in accordance with GAAP. GAAP are guidelines that reflect "the consensus [among accountants] at a particular time" concerning the recordation and reporting of financial affairs.<sup>18</sup> These accounting principles are not hard-and-

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<sup>16</sup> See *id.* at 130-57; see also A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 4-7 (2003).

<sup>17</sup> In principle (apart from regulatory requirements), firms could rely entirely on internal auditors and ask investors to trust in the auditors' professional ethics to ensure their reliability. In practice, it is doubtful whether the promise of ethics alone will convince a reasonable investor to pony up a significant sum of money. See Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1654-55 (2000) (noting empirical and theoretical reasons to doubt the efficacy of ethical constraints on auditors).

<sup>18</sup> CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Financial Accounting—General No. 3, § 1026 (Am. Inst. of Accounting Standards ed., 1970).

fast rules. They represent “shared understandings evinced over time,”<sup>19</sup> and can include, in addition to principles established by authoritative bodies such as the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the newly-created Public Company Accounting Oversight Board, guidelines drawn from such sources as “textbooks, articles, practice, and expert opinion.”<sup>20</sup> To no small extent, GAAP are developed by people who make their livelihood working for corporate management, and it is not surprising that those principles leave much room for maneuvering.<sup>21</sup>

Given the subjective character of much financial reporting,<sup>22</sup> compliance with GAAP, while significant, is nothing close to an assurance that the company’s financial position has been represented in a manner conducive to sound investment choices.<sup>23</sup> For investors, the relevant information is not really whether the management’s financial representations comply with what

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<sup>19</sup> Reid Anthony Muoio, *An Independent Auditor’s Suit for Wrongful Discharge*, 58 ALB. L. REV. 413, 419 (1994).

<sup>20</sup> *Id.*

<sup>21</sup> As we have already noted, the problems involved in the creation, promulgation, and application of accounting standards are a topic for another paper. See McCoy, *supra* note 7, at 999, 1006-07 (offering a brief introduction).

<sup>22</sup> It is easy and common to underestimate the judgmental character of financial reporting. Financial accounting generally requires conceptual judgments about the appropriate *timing* of the recognition of income and costs. Asset values and costs, to the extent that they are based on accruals rather than on cash collections and payments, inevitably involve uncertainty and judgment.

For example, for plant and equipment, the estimated useful life and the salvage value at the end of the estimated useful life must be estimated, and the pattern of depreciation over time must be selected. For inventory, an assessment must be made of obsolescence and net realizable value. For receivables, uncollectible accounts must be estimated.

William H. Beaver, *What Have We Learned from the Recent Corporate Scandals That We Did Not Already Know?*, 8 STAN. J.L. BUS. & FIN. 155, 157 (2002). Accounting involves *making* numbers as much as it does *crunching* them.

<sup>23</sup> See Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C. J. INT’L L. & COM. REG. 725, 796-97 (2003). Formal legal doctrine may well hold that accountants’ certifications really are supposed to constitute an assurance that the “financial statements provide the necessary disclosures for a holistic understanding of the issuer’s overall financial position.” John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1417 (2002); see also Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 1005 (2003) (“If GAAP does not result in an accurate picture, then the accountant must go beyond GAAP to ensure that a fair and accurate picture was presented. From time to time the SEC has joined in this view.”). As a practical matter in the real world, the audit process and its evaluation tend to rotate entirely around compliance with GAAP, which is generally the be-all and end-all of the audit process. Specifically, this is true in litigation, where the central issue in cases involving statements in financial reports is most often, “Is the statement compliant with GAAP?” rather than, “Is the statement materially misleading?” See Kahn, *supra* note \*\*.

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the auditors have agreed is GAAP, but whether those representations, GAAP-compliant or not, present the company's financial position and prospects with as much objectivity as the reporting enterprise permits. In order to determine whether management's financial statements present the most informative picture of the company's condition possible, one would have to go well beyond compliance with GAAP to ask whether management selected the methodologies and judgments that are in the range permitted by GAAP *and* which, in the context of the particular company at issue, were best calculated to give an objective representation of the company's financial situation. An auditor engaged in this task would need to have a mindset to challenge and question management's judgments, especially its conceptual judgments about the timing of income and expenses, at every important turn to determine whether management exercised its discretion so as to present information that is conducive to sound investment decisions.

*B. The True Character of Financial Audits*

Auditors generally do not engage in this kind of inquiry because they are not paid to do so. Accountants are hired by companies with the hope that they will enhance the credibility of the companies' claims about their financial condition. The auditor's job is to certify the professional reasonableness of the methods employed by the company's management to produce financial statements. Why would the auditors adopt an adversarial stance toward their employers? And why would their employers pay them to adopt such a stance?

There are, in fact, some occasions in which companies might want adversarial accountants or in which accountants might take an adversarial stance on their own initiative. The important question is how often those occasions arise. Any answer short of "almost always" poses large problems for the financial reporting system. And given the realities of human nature, an answer of "almost always" is very difficult to defend.

Consider first the incentives of the audited firms. There are at least two apparent reasons why a firm might want an adversarial audit: to improve its internal governance and to enhance the public reliability of its information and thereby reduce its cost of capital. Both reasons, however, are more apparent than real. Given the incentives that operate within the corporate structure, only rarely would these reasons actually lead a firm's management to pursue a searching, questioning, adversarial audit.

Careful audits can indeed serve important internal management functions for companies. In order to make effective business plans and decisions, companies need to know where they have been, where they stand, and where they are going. If their self-prepared financial statements do not give informative accounts of the companies' status, the business may well suffer. Accordingly, auditors were employed long before they were necessary for compliance with the federal securities laws or for giving assurances to outside investors because companies found them a useful tool.<sup>24</sup> Auditors who bend over backwards in order to certify management's financial statements do not provide the companies with an objective assessment of their performance and thus do not fulfill their original internal governance function.

The fly in the ointment, of course, is that "the company" and "the management" are two separate entities. It may well be good for the company—i.e., the company's owners—to know if something is seriously wrong in its business, but it is not necessarily good for the company's management for anyone to know this. After all, if the owners find out about problems, it might occur to them to try to fix the problems by firing the managers. The managers, who are aware of this possibility, may prefer hiding business problems to solving them. Corporate officials, after all, have a limited time horizon.<sup>25</sup> They are unlikely to stay in a single job for their entire professional lives. Accordingly, in each job their focus will be on the period of time during which they can plausibly be blamed for bad things (and rewarded for good things) that can happen to the company that they are running. Concealing problems may well be a winning strategy; if one is lucky, the problem might just go away, and no one will ever be the wiser. Alternatively, even if everything ultimately hits the fan, perhaps someone else will be in charge to take the blame, or perhaps assignment of blame will become difficult or impossible. Of course, the choice between solving and burying problems is often a complex one. But there are likely to be many scenarios in which management will be less than enthusiastic about an audit that tries to uncover problems brewing on its watch and will accordingly favor and reward auditors who avoid confrontation.

Even in the extremely rare cases when the shareholders are in a position to know of management's misstatements, there will be times when the

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<sup>24</sup> See Ross L. Watts & Jerold L. Zimmerman, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence*, 26 J.L. & ECON. 613 (1983).

<sup>25</sup> See Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1146 (2003).

shareholders and managers *all* would have incentives to bury the truth. Companies sometimes fail. Perhaps they fail because of bad management, or perhaps they fail because of exogenous factors that no one reasonably could have avoided. But whatever the reasons for failure may be, if the company fails, the managers lose their jobs and the firms' owners lose their investments. For the same reasons that managers may sometimes want to conceal problems from shareholders, the managers and shareholders together may sometimes want to conceal problems from the rest of the world. If the outside world discovers that a company is in trouble, the business may lose the ability to acquire capital; in this fashion, the likelihood of actual termination of the business increases dramatically as the risks of potential termination become known. The failing company's shareholders, in turn, are unlikely to be able to find buyers for their stock at a favorable price if the true circumstances of their company are known. When companies face a realistic prospect of failure, it can easily be the case that everyone associated with the company has an interest in presenting the company's position in the best possible—or even the best impossible—light in order to keep capital flowing into the firm as long as possible. Thus, while it is theoretically possible that companies might sometimes want auditors to tell it like it is, regardless of the consequences, there are many circumstances in which that is precisely what firms do not want from their auditors.

Similarly, there are some theoretical circumstances under which an adversarial audit can potentially improve the value of the company by reducing its cost of raising capital. All financial information emanating from companies must be discounted by investors because of concerns about its potential accuracy. If a particular company can reduce the discount associated with its information, it can increase the value of that information, which is tantamount to a reduction in the company's cost of capital.<sup>26</sup> To the extent that corporate

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<sup>26</sup> Consider two companies making stock offerings. Suppose that, after examining the available financial information, an investor determines that Company A's stock is worth \$100.00 per share and Company B's stock is worth \$99.50 per share. If each stock is selling for \$99.00 per share, obviously the investor will prefer Company A. Suppose, however, that the information supplied by Company B is substantially more credible than the information supplied by Company A. For instance, assume that there is a 99% chance that Company B's financial information provides an accurate account of its financial situation, so that there is 99% chance that B's stock is worth \$99.50 per share and a 1% chance that it is really worth, let us say, \$80.00 per share. Company A's information, on the other hand, has only a 95% chance of accurately reflecting the company's position, so that its stock has a 95% chance of being worth \$100.00 per share and a 5% chance of being worth \$80.00 per share. On these numbers, the value of A's stock to the investor is \$99.00 while the value of B's stock to that investor is \$99.31. When one takes into account the different levels of reliability of the

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officers and managers benefit from high stock prices, they have incentives to take action that will increase those prices. Of course, management must balance the potential gains to itself from increased corporate value against the risks posed to itself by an audit that might uncover problems for which management can be blamed, but enhancement of the credibility of the firm's information disclosures is at least a vector in the rough direction of a management desire for objective audits.

A company that undergoes an adversarial audit, however, will likely have a problem communicating to the public the beneficent character of its audit. A public announcement that a company is instructing its accountants to engage in an adversarial investigation can only work if the company's announcement is itself credible. After all, every company will always declare that its accountants are performing a thorough, searching, objective audit. Management must somehow distinguish its claims from those of its competitors in a world in which there is no obvious way for investors to evaluate the character and quality of audits. And even if management can successfully communicate its plans, that communication, as with other management representations, is subject to a discount for possible inaccuracy; management would, after all, be thrilled if it could get the benefits of enhanced credibility while still retaining its ability to employ a good-news bias. Thus, the benefits to management of an adversarial audit are speculative and uncertain, while the costs to management are much more concrete. Moreover, it is easier for management to diversify the risks to itself from loss of corporate value than the risks from loss of corporate employment; broad investment portfolios are more common than broad job portfolios. This further skews the balance away from management support for strict auditor scrutiny.

Thus, a corporation's desire to hire accountants who will parrot the company line is a natural and understandable by-product of the incentives and biases that inevitably pervade corporate organizational structures. The forces that occasionally push managers toward desiring searching audits are very weak by comparison.

If one cannot realistically expect the companies to urge their accountants to take an adversarial stance, can one expect the accountants to adopt it

voluntarily? The argument for a “yes” answer would run something like this:<sup>27</sup> Companies hire accountants (apart from the need to satisfy regulatory requirements)<sup>28</sup> at least in part in order to enhance the credibility, and thus the value, of the companies’ representations to investors. The accountant’s attestation to the reasonableness of a company’s claim serves this function only if the accounting firm has a reputation for accuracy. Accordingly, the story goes, accounting firms with good reputations for objectivity are more valuable to audited companies than are firms that are perceived as lapdogs. Such accounting firms can therefore command higher fees and/or receive more engagements than firms with poorer reputations. In this fashion, the auditors’ roles as reputational intermediaries<sup>29</sup> create market incentives for auditing firms to maintain at least some measure of distance from their clients. This story has a measure of truth. The magnitude of that measure, however, is another matter altogether.

There does seem to be some modest evidence that auditor reputation affects a firm’s stock prices,<sup>30</sup> which suggests that markets do consider auditor credibility. To the extent that markets value auditor credibility, auditing firms have some incentive to maintain and enhance that reputational capital. The best situation for accounting firms, however, is to maintain their reputations without adversely affecting their relationships with firm managements—that is, without actually conducting audits that seriously challenge the managements’ representations. Can they do this? Over a certain range, the answer is surely “yes.” In order to secure a reputational benefit, auditing firms do not have to be perceived as *good*; they need only be perceived as marginally *better* than their competitors. If the overall level of complicity with management is high, small deviations from that baseline may be enough to generate (modest) reputational differences without a lot of substance behind them. This is

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<sup>27</sup> See Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOK. L. REV. 1051 (1987) (offering a succinct presentation).

<sup>28</sup> This is, of course, a nontrivial aspect of the market for accounting services: the federal securities laws require publicly traded companies to issue certified financial statements, which surely affects the demand for accountants.

<sup>29</sup> The concept of reputational intermediaries, or “gatekeepers,” was pioneered by Ron Gilson and Reinier Kraakman. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). For an illuminating discussion of the roles (and frequent failures) of various gatekeepers in the financial reporting system, see Coffee, *supra* note 11.

<sup>30</sup> See Jeffrey L. Callen & Mindy Morel, *The Enron-Andersen Debacle: Do Equity Markets React to Auditor Reputation?* (2002) (unpublished manuscript), at [http://papers.ssrn.com/sol3/delivery.cfm/SSRN\\_ID341440\\_code021029140.pdf?abstractid=341440](http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID341440_code021029140.pdf?abstractid=341440); Srinivasan Krishnamurthy et al., *Auditor Reputation, Auditor Independence and the Stock Market Reaction to Andersen’s Clients* (2002) (unpublished manuscript), at <http://bingweb.binghamton.edu/~srinik>.

consistent with the fact that auditing firms frequently seem to be largely immune to losses in reputation from bad audits. In part, this might be due to the fact that major audit firms have all had a substantial share of bad audits. It may be due in part to the tendency of cognitive dissonance to affect the way we look at audit firms and other institutions in our society; people, including investors, seem to believe many things, even when those beliefs are costly, if the alternatives to those beliefs are too unsettling.

In any event, there are many reasons to doubt the extent to which auditors will always, or even often, find it in their own best interests to challenge management. First, the financial benefits of complicity with management, in the form of audit fees, future engagements, favorable recommendations, and the like, are tangible and concrete, while the costs in terms of lost reputation are remote, speculative, and uncertain. Indeed, there will be no costs at all unless something gravely wrong is revealed. And even if the audited financial statements are eventually shown to have been seriously in error, the accountants can (and do) always argue that they were misled by management, and the claim may be very hard to disprove or evaluate.<sup>31</sup> These possibilities must be weighed against cash in hand, and perhaps a great deal of cash in hand, from audit engagements.

Second, the incentives of the individual auditors reinforce the perverse incentives faced by their audit firms as a whole.<sup>32</sup> Auditors may be even more concerned than their firms about the loss of particular clients because they may have a substantial percentage of their professional capital tied up in those clients. This appears to have been part of the problem with Arthur Andersen's audit of Enron: "Enron might have been a relatively small client for Andersen, the firm, but it was the largest client for its Houston office, and, for the Enron relationship partners, perhaps their only significant client."<sup>33</sup>

Third, auditors are subject to many of the same cognitive biases that plague all people, and many of those biases work in favor of complicity with

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<sup>31</sup> See Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 139 (2002) ("[R]estatements most often arise not because of the potential of an alternative accounting treatment but because of misrepresentation of material facts to the auditing firm.")

<sup>32</sup> See Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 500 (2001); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 184 (2000); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 13-14 (2002).

<sup>33</sup> Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1239 (2002).

management.<sup>34</sup> Those biases, of course, exist regardless of who hires and pays the auditors, but the incentive structure faced by auditors amplifies precisely those biases that reinforce the biases of management. Furthermore, as Jonathan Macey and Hillary Sale have recently argued in an important analysis, the evolution of the internal governance structure of accounting firms and of the concept of “auditor independence” have exacerbated all of these tendencies, making audit firms and individual auditors especially vulnerable to client capture.<sup>35</sup>

Fourth, and most importantly, it is hard to dispute the evidence of what actually happens. “Despite the clear logic of the gatekeeper rationale, experience over the 1990s suggests that professional gatekeepers do acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.”<sup>36</sup> Or, as King Arthur said to the Black Knight in *Monty Python and the Holy Grail* when the Black Knight refused to acknowledge that both of his arms had been cut off: “Look!”<sup>37</sup> We will not attempt an exhaustive catalogue of instances in which auditors signed onto obviously dubious management claims,<sup>38</sup> but a few examples may prove useful.

Investment bankers, analysts, auditors, and management have recently made fortunes on telecommunications companies that attracted enormous investment long after the companies were in serious financial trouble. The method of choice for creating the illusion of profitability in this industry involved the purchase and sale of line capacity. Taking a simplified example, a telecommunications company could buy line capacity rights at \$1 million per year for twenty years. This line capacity obviously generates no revenue, in the common-sense, ordinary-language understanding of “revenue,” until it is sold. Suppose, however, that line capacity of equal value is “sold” to another company. On the sale, the company would include in the current year’s income the entire present value of the \$20 million in line-capacity payments it would receive in the future. By contrast, the company would report only the

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<sup>34</sup> See Prentice, *supra* note 32, at 142-81 (offering an exhaustive catalogue of those biases).

<sup>35</sup> Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167 (2003).

<sup>36</sup> Coffee, *supra* note 23, at 1405. Indeed, the accountants may even facilitate, and not merely acquiesce in, such misrepresentations.

<sup>37</sup> MONTY PYTHON AND THE HOLY GRAIL (Columbia Tri-Star 1975).

<sup>38</sup> For a detailed account of some of the more notorious recent accounting scandals, see Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 928-36 (2003), and Markham, *supra* note 23, at 773-86.

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\$1 million it paid in the current year as a current-year expense. Accounting for these essentially offsetting transactions in this way creates the illusion of profitability on paper without an actual profit. Of course, in subsequent years the company would find itself in an increasingly deeper hole because it had already harvested the income from those years and would have to report the costs without the associated income. In order to avoid admitting that it was unprofitable, the company would have to repeat this procedure in greater amounts, thereby creating even bigger future deficits. Eventually the pyramid would collapse, unless (and this is the hope that drives the whole process) the industry becomes so fantastically successful that one could cover up the accounting gimmicks with real profits in the future.

How did accounting firms react to this obvious chicanery? As Professor Lawrence Cunningham explains:

Determining how to account for novel transactions entails a dialogue between finance managers and their outside auditors. The conversation ordinarily sees the manager asking the auditor how the relevant industry is treating a transaction. The auditor usually appeals to such practice whether so prompted or not. The danger is that if the leading industry innovator is a fiend using aggressive accounting judgments, the consequent norm is fiendish. The result is a contagion of accounting aggression.

Telecom capacity swaps are a case in point. They were an innovation of the telecom cohort and the industry began to adopt the practice widely. The accounting developed uniformly, following the industry norms . . . .<sup>39</sup>

Another example is the subprime auto loan industry. Bad-debt costs are the principal costs of such companies, and these costs are recognized through the creation of a loan loss allowance or, in common parlance, a bad-debt reserve. Before they collapsed in 1997, these companies avoided charging bad-debt costs against income by reporting small reserves based on unrealistic assumptions. As the loan charge-off rates grew higher, the auditors did not require the companies to increase their reserves as a percentage of the loan portfolio and even approved decreasing the reserves. The companies accelerated the reporting of income by funding the reserve exclusively through dealer discounts—the amount less than the face value the company pays the auto dealer for the loans that it purchases.

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<sup>39</sup> Cunningham, *supra* note 38, at 933.

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In a simplified example, a company might suffer an average of twenty percent in nonpayment on each loan portfolio it acquires. The company purchases a \$100 million face amount portfolio in its first year for \$95 million, constituting a five-percent dealer discount. Instead of carrying a twenty-percent or \$20 million bad-debt reserve to cover such losses, it would carry a five percent reserve, which it covered with the \$5 million dealer discount. Because the loans were newly issued, there was a small charge-off rate in the first year and the \$5 million reserve more than covered their first-year losses. Even though the company was paying far more for the loans than it could hope to recoup, it buys an even greater loan volume in the next year. In that year the loss rate on the first-year loans increases significantly. In the second year, however, the company would buy three times the volume of loans, or \$300 million, and book an additional \$15 million dealer discount in reserve. Because the newly acquired loans also have low first-year loss rates, the dealer discounts on the newly acquired loans exceed their initial-year losses and the company uses them to cover the charge-offs of the old loans in their second year, when their losses became much larger. By buying ever-increasing amounts of new loans and using the new loan dealer discounts to cover the old loan losses, the company could hide greater and greater losses. This process could only continue by the purchase of exponentially greater volumes of money-losing loans. When financing dried up in 1997, subprime auto loan companies were unable to continue hiding their losses through dealer discounts from exponentially larger new loan pools, and many went bankrupt.

It would have been apparent that these companies were losing money on their loan pools if they had ever tried to estimate the loss rate on each loan pool and had compared it to what the company was paying for that pool. A thorough review of the records of two such companies and of their auditing firms revealed no such computations.<sup>40</sup> That the companies were losing money on each pool seemed irrelevant to management and the auditors so long as dealer discounts on ever-larger new loan pools would cover the prior pool losses.

All of the financial statements in these examples were certified by officers and directors in both industries. No company's officers were prosecuted for securities fraud in either industry for engaging in these distortions, though there have been prosecutions in the telecommunications industry for looting or for accounting practices that had no auditor support and clearly violated

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<sup>40</sup> Mr. Kahn has litigated cases involving precisely this circumstance.

GAAP. Nor was a single auditor prosecuted for signing off on such financial statements.

Of course, it is always treacherous to base conclusions on anecdotal evidence. The dangers are especially great when the anecdotes involve notorious events. Academics, just like politicians, need to avoid the tendency to put expensive padlocks and armed guards on the barn doors after one horse has escaped, when all of the other horses are peacefully in their stalls munching on hay. In the case of the accounting scandals that have recently come to light, however, there is good reason to take the anecdotes seriously as suggestive of broader problems. When one combines the amounts of money involved in financial reporting with familiar facts about human nature, it is reasonable to conclude that we are only seeing the tip of an iceberg. In order to have a good, empirically grounded grasp of the extent of the problems with the financial reporting system in the United States, someone would systematically have to audit the auditors in a fashion that could yield statistically sound results instead of (as happens now) episodically checking audit quality whenever a company implodes and someone is sufficiently motivated to sue. That will never happen, both because it would be too costly and because the scientific tester would need access to sensitive records. Accordingly, we can only make more-or-less educated guesses about the extent to which reported examples of accounting chicanery represent a widespread problem rather than isolated incidents that ought not to be of general concern.<sup>41</sup> We believe that the problem is widespread, but we cannot ground that belief in anything more scientific than knowledge of human behavior and (at least in the case of Mr. Kahn) experience with the subject matter and extensive conversations with past and present participants in the financial reporting process. We take some solace in the fact that people in other contexts—for example, drafters of constitutions—often have little more on which to go.

Even if one is not convinced that accounting problems are in fact pervasive, one still ought to be concerned about the incentives for the production of financial information. The integrity of the capital markets is too important to ignore. We attempt to minimize the extent to which judges have financial interests in the cases that they decide because the risk of tainted decisions is too strong.<sup>42</sup> The capital markets, as with the judicial system, are extremely important institutions, and the financial reports on which those markets depend

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<sup>41</sup> See Langevoort, *supra* note 25, at 1146.

<sup>42</sup> See 28 U.S.C. § 455(b)(4) (2000); *Tumey v. Ohio*, 273 U.S. 510, 535 (1927).

similarly need to be insulated against the obvious risks of temptation. It is worth guarding important institutions against even small risks. In the case of the capital markets, risks that may seem small turn out to be very large. The amounts of money involved in the capital markets are so staggeringly huge that relatively minor effects can have very major economic consequences. Simple mathematics tells us that if the base amount is sufficiently large, tiny percentages can quickly translate into an impressive number of zeroes to the left of the decimal point. Accordingly, very small improvements in the quality of financial reporting can generate enormous cumulative benefits that would outweigh even significant costs of improvement. As we explain in Part II, we think that the potential benefits of our proposed reforms are large and the likely costs small. But even if the costs of our proposal are larger than we anticipate, our argument remains a strong one given the magnitude of the benefits.

### *C. The True Character of the Sarbanes-Oxley Act*

Revelations of accounting problems such as those described above prompted enactment of the Sarbanes-Oxley Act of 2002,<sup>43</sup> which amends the securities laws to attempt to deal with some of these problems. None of those amendments, however, will have more than a marginal effect on the audit process.

#### *1. Audit Committees*

The Sarbanes-Oxley Act puts a great deal of faith in audit committees, which are committees “established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.”<sup>44</sup> Such committees are required by exchange rules for any listed company.<sup>45</sup> The idea is to have the auditors selected and supervised by a subunit of directors who have special expertise in and responsibility for financial oversight. The Sarbanes-Oxley Act specifies that the audit committee must, subject to some minor exceptions, pre-approve all services provided to their firms by auditors<sup>46</sup>

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<sup>43</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 29 U.S.C.).

<sup>44</sup> 15 U.S.C. § 78c(a)(58)(A) (Supp. 2002).

<sup>45</sup> See Thomas Wardell, *The Current State of Play Under the Sarbanes-Oxley Act of 2002*, 28 N.C. J. INT'L L. & COM. REG. 935, 937 (2003). For background on the adoption of these rules, see Helen S. Scott, *The SEC, the Audit Committee Rules, and the Marketplaces: Corporate Governance and the Future*, 79 WASH. U. L.Q. 549, 561-66 (2001).

<sup>46</sup> 15 U.S.C. § 78j-1(i)(1)(A).

and “shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.”<sup>47</sup>

The audit committee does not come close to solving the basic incentive problems inherent in the current audit system, for several reasons. First, and most fundamentally, audit committees existed well before the Sarbanes-Oxley Act and appear to have had little effect on the fundamental problems with the audit process. Formalizing those committees' responsibilities in law does not change their basic character. When the dust settles, it remains true that the audit committee is closely tied to, and has incentives aligned with, management.<sup>48</sup> If people did not receive substantial, management-conferred benefits from serving on audit committees, why would anyone serve on them? Perhaps intracorporate biases toward good news can be mitigated to some degree by the device of the audit committee, but there is no evidence that this effect is significant.<sup>49</sup> Second, audit committees can only work with the information that is brought to their attention. If there are systematic problems with the incentives facing auditors, the establishment or empowerment of audit committees does little to address those problems; it simply focuses the problems through another set of institutions. Unsurprisingly, audit committees

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<sup>47</sup> *Id.* § 78j-1(m)(2). The Act further provides that “each such registered public accounting firm shall report directly to the audit committee.” *Id.* Those reports to the audit committee must include:

- (1) all critical accounting policies and practices to be used;
- (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
- (3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

*Id.* § 78j-1(k)(1)-(3). The Act further mandates that members of the audit committee be “independent,” *id.* § 78j-1(m)(3)(A), which means that, subject to case-by-case exemptions granted by the Commission, “a member of an audit committee . . . may not . . . (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.” *Id.* § 78j-1(m)(3)(B)(i)-(ii).

<sup>48</sup> See Darin Bartholomew, *Is Silence Golden When It Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 85-86 (2003); accord McCoy, *supra* note 7, at 1007-08.

<sup>49</sup> See Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 381-82 (2003); O'Connor, *supra* note 7, at 48.

do not have the kind of record that would commend them for a central role in accounting reforms.<sup>50</sup>

## 2. *The Provision of Nonaudit Services*

The Sarbanes-Oxley Act expends a great deal of energy regulating the extent to which auditing firms may provide nonaudit services to their clients, in response to the widespread perception that auditing firms were compromising their audits in order to attract clients to lucrative consulting opportunities. Under the Act, auditing firms are generally forbidden from providing nonaudit services to clients “contemporaneously with the audit,”<sup>51</sup> subject to some very important exceptions.<sup>52</sup> But while the provision of nonaudit services by accounting firms may have exacerbated the tensions inherent in the audit system, it did not create them; and distancing audit from nonaudit services will not make those tensions go away. Audit firms with an eye on fees and future employment<sup>53</sup> have strong incentives to please the managers of the audited firms even if audits are the only service provided. Arthur Andersen, after all, received \$25 million from Enron in audit fees in 2000 (compared to \$27 million in nonaudit fees).<sup>54</sup> And, of course, the separation of audit and nonaudit services under the Sarbanes-Oxley Act is not total: accounting firms can provide tax services contemporaneously with an audit if they have approval from the audit committee, they can provide services (such as tax planning and tax shelter advice) to the officers and managers of the firm, and they can provide nonaudit services if the services are not “contemporaneous” with the audit. The accounting firms continue to make significant amounts of money from the provision of these services.<sup>55</sup>

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<sup>50</sup> See Beecher-Monas, *supra* note 49, at 363-65.

<sup>51</sup> 15 U.S.C. § 78j-1(g).

<sup>52</sup> Certain services, such as tax services, can be provided if they are either preapproved by the audit committee, *id.* § 78j-1(h), or fall within a de minimis exception, *id.* § 78j-1(i)(B)(i)-(iii).

<sup>53</sup> The incentives concerning future employment are modestly attenuated by recent Securities and Exchange Commission (SEC) rules that essentially require a one-year “cooling off” period before members of an audit team can take employment with their client. See SEC Qualifications of Accountants, 17 C.F.R. § 210.2-01(c)(2)(iii)(B)(1) (2003).

<sup>54</sup> Christine E. Earley et al., *Some Thoughts on the Audit Failure at Enron, the Demise of Andersen, and the Ethical Climate of Public Accounting Firms*, 35 CONN. L. REV. 1013, 1021 (2003).

<sup>55</sup> A survey reported in September 2003 that income to the Big Four accounting firms from the provision of nonaudit services in the previous year was \$733.6 million. See *Technology Briefs*, SEATTLE TIMES, Sept. 8, 2003, at D3. That was a significant twenty-seven percent drop from the \$998.7 million received from nonaudit services in the year before that, but it is still a hefty chunk of change.

### 3. Auditor Rotation

The Sarbanes-Oxley Act also requires rotation of the lead auditor of any audit team every five years.<sup>56</sup> The obvious goal is to provide a fresh look at the audited company's practice. The effect may well be to mitigate some of the cognitive biases that might plague the auditor—for example, by reducing the extent to which a specific auditor acquires a psychological (or financial) interest in defending certain questionable past practices. There can be some merit in this kind of practice, and we suggest a form of it in Part II of this Article. But its efficacy is open to serious question. The new lead auditors that rotate into service will face the same incentives as did their predecessors. Furthermore, they will have to decide whether they are publicly going to challenge their own colleagues. The same is true of the rest of the audit team, to whom confrontation with the client management (or other members of their firm) may not appear to be the best route to promotion or future employment.<sup>57</sup> And if a particular audit team decides to take a stand against management, nothing prevents the management from going over its head to more senior persons within the audit firm. One can engage in opinion shopping without changing audit firms. As long as auditors have incentives to please their audit clients, financial statements will reflect undue optimism, no matter how many times a company rotates auditors.

### 4. Certifications and Penalties

The Sarbanes-Oxley Act contains other provisions dealing with corporate governance, but those provisions do not even remotely address the problem of auditor incentives, nor do they obviate the need to focus on those incentives. For example, the Act amplifies the pre-existing requirement that corporate officers certify that their companies' financial statements comply with federal law,<sup>58</sup> and it enforces that requirement with criminal penalties of increased severity.<sup>59</sup> The stock market, like the academic community, has treated

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<sup>56</sup> 15 U.S.C. § 78j-1(j) ("It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of the issuer."). However, there are exceptions for small audit firms. See 17 C.F.R. § 210.2-01(c)(6)(ii). Furthermore, the SEC has—feebly—attempted to define what qualifies as a lead or coordinating audit partner. See *id.* § 210.2-01(f)(7)(ii).

<sup>57</sup> See Macey & Sale, *supra* note 35, at 1185-86 (suggesting that the effects of auditor rotation might well be perverse).

<sup>58</sup> 15 U.S.C. § 7241(a).

<sup>59</sup> 18 U.S.C. § 1350(c).

enactment of this certification requirement as a nonevent.<sup>60</sup> This is not surprising, as management certification was required before passage of the Sarbanes-Oxley Act without notable results, and nothing in the Act makes it significantly easier to prosecute and prove alleged violations. As one commentator has argued in depth, the certification provisions “may not progress beyond the symbolic.”<sup>61</sup>

The basic problem is the incentives of accountants, not the ability of corporate officers to sign their names. Sensible reform must focus on restructuring the incentives of auditors so that they do not so readily share management’s systematic over-optimism.

## II. A RANDOM WALK THROUGH THE ACCOUNTING PROFESSION: HIRING BY LOTTERY

If a basic problem with modern financial reporting is that accountants have strong incentives to reinforce management’s over-optimism biases, then something needs to be done to alter those incentives. And if the source of those incentives is firm control over auditor hiring, firing, and compensation, then that is the pressure point at which attention should be directed.

### A. *Random Auditors*

Our suggestion is that auditors be selected at random—literally by lot—from among a group of willing candidates. Once an auditor is selected for the engagement, that auditor should be removable only for cause and the removal should require the approval of some entity other than the audited firm’s management. One could, if so inclined, add other elements to the plan, such as a rotation scheme that would require selection of a new auditing firm after a specified number of years (perhaps five years, which is the period chosen by the Sarbanes-Oxley Act for the rotation of lead auditors) and (as Mr. Kahn strongly favors) a complete prohibition on the provision of any nonaudit services to the audited firm or its management. But the essence of our proposal is to change the methods of auditor selection and retention in a way that reduces management control over the financial reporting process.

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<sup>60</sup> See Aronson, *supra* note 31, at 143.

<sup>61</sup> Lisa M. Fairfax, *Form over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 3 (2002); see also Cunningham, *supra* note 38, at 942, 955-56 (making the same point, and calling the certification requirement a “yawn”).

This suggestion immediately raises a host of practical questions: how does one determine which auditors are willing and able to perform particular engagements? How would auditor compensation be determined in the absence of one-on-one bargaining with audited firms? How could one assure that auditors have the proper incentives to perform good audits? And would such a system have to be implemented through regulation, or is it possible to imagine private mechanisms by which such a system could emerge?

The devil, as always, is in the details, and our proposal for random auditor selection is devilish enough to occupy two of Dante's circles. The authors of this Article, quite frankly, do not agree on the best method for implementing an auditor lottery, and we therefore present here two possible mechanisms for random auditor selection. Both mechanisms are intended to be suggestive rather than definitive; after all, when one is proposing to restructure a major economic institution, a modest amount of humility is appropriate.

One method for random auditor selection, favored by Mr. Kahn, would require companies to name a pool of potential auditors, from which the actual auditing firm would be selected at random—perhaps literally by drawing the name out of a hat. (In all likelihood, one would need to have accounting firms indicate to the oversight board the size, character, and location of the companies that they would be willing to audit, and firms could select a pool of potential auditors from that database.) The physical lottery would be conducted by a public oversight board, which could be a new entity, either within or independent of the Securities and Exchange Commission (SEC), or perhaps an existing body such as the Public Company Accounting Oversight Board appropriately restructured to accommodate these functions. The oversight board would determine the number of auditing firms that must be within the initial pool selected by the audited company, though ten seems like a good target. The number could vary for companies whose size and operations require only the very largest audit firms<sup>62</sup> and for small companies in small markets for which there might not be the requisite number of practical choices. Adjustments might have to be made by the oversight body if an audited firm becomes over-subscribed or otherwise declines the engagement, in which case a second choice might have to be selected.

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<sup>62</sup> It has been suggested that only the very largest accounting firms—currently numbering four—can handle the audits of large multinational companies such as those in the Fortune 500. See O'Connor, *supra* note 7, at 69. We find it difficult to understand why a mid-size accounting firm could not handle such jobs, though we are willing to defer to a contrary consensus among experts if such a consensus actually exists.

Auditor compensation would be set by the oversight board rather than by the audited firm.<sup>63</sup> Each public company would pay into a fund, which would then pay auditors the prevailing rates for accountants working in the same area and markets. Those determinations, of course, would have to be made by the oversight board, in much the same way that “prevailing rate” determinations are frequently made today in health care or labor contexts. Disputes about auditor compensation could be resolved either through administrative adjudications or arbitration.

The SEC or the oversight board should be able to seek removal of the auditor if there are grounds for such removal. If companies are dissatisfied with their auditors, they could ask the oversight board to initiate proceedings to remove and replace them (through another lottery), but any removal of an auditing firm would have to be approved by the oversight board. Auditors could be removed only for cause; thus, a workable definition of “cause” is required. Because accounting is not an exact science, and because the preparation of financial reports is, in the first instance, the responsibility of management,<sup>64</sup> a realistic understanding of “cause” for dismissal of an auditor could at least sometimes involve disputes with management over proper accounting treatments. But because any attempted dismissals must be approved by an oversight board, management attempts to manipulate the accounting process are directly constrained.

Any system that makes it harder to fire people and that distances its compensation from the market has the potential to reduce those people’s incentives to perform well. The whole purpose of the auditor lottery is to reduce the extent to which auditors need to worry about pleasing the management of the companies that they audit. Wouldn’t an auditor lottery with limitations on management control over removal and compensation therefore adversely affect the incentives for good audit performance?

For a number of reasons, we find this doubtful.<sup>65</sup> First, the auditor lottery does not eliminate the threat of sanctions for poor performance. Managers could still fire bad auditors; they would simply have to show to an oversight

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<sup>63</sup> There is precedent for this practice in nineteenth-century British corporate law. See Sean O’Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 46 B.C. L. REV. (forthcoming 2004).

<sup>64</sup> There is much to be said for having outside accountants, to the extent possible, prepare and not simply review financial statements. See Kahn, *supra* note \*\*.

<sup>65</sup> Although Professor Lawson does not favor a governmentally administered auditor lottery, see *infra* pp. 416-17, he agrees with Mr. Kahn that this particular objection has little weight.

board why the auditors were bad. Second, if the oversight board took its task seriously (which is admittedly always an important question with government agencies), it could impose sanctions on bad auditors that are likely to be more effective than discharge by an unhappy audit client. Auditors who perform their tasks badly (through incompetence, corruption, or both) could be subjected to a range of sanctions, including censure, citation, fines, forfeiture of fees, reduction of future rates, and suspension from practice by the oversight board. Furthermore, extending those sanctions to supervisory personnel within the audit firm could have a salutary effect on the audit firm's culture.<sup>66</sup> Third, and most importantly, the auditor lottery gives management incentives to oversee accountants in the right way rather than the wrong way. Presently, management wants accountants who will sign on to management's self-serving representations. A "bad" accountant, in management's eyes, is an accountant who will not do this. Of course, no management affirmatively wants accountants who make basic technical errors—for example, by failing to detect obvious embezzlement (assuming that the relevant managers are not the ones doing the embezzling). But under the existing incentive structure, managers may be willing to overlook a fair amount of bad technical auditing if the end result is a clean audit opinion. In other words, the existing system provides a perverse definition of what counts, at least from the perspectives of management and the auditors, as bad auditing. If management's ability to select and control accountants who will do its bidding is reduced, perhaps management will supervise accountants in more constructive ways, in which case more attention, rather than less, might be paid to the auditors' technical performance. Accordingly, we see little reason to think that an auditor lottery would reduce incentives for good auditor performance in any desirable sense of the word "good."

Other reforms that do not directly pertain to auditor selection could usefully be added to the lottery procedure. Auditors could be strictly banned from performing any nonaudit services for the audited companies or for any of the officers of the audited companies for some period of time after the audit engagement is complete, in order to reduce the incentive to shade audits in the hope of nonaudit business. It might also be valuable periodically to require rotation of the audit firm and not merely (as under current law) the audit

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<sup>66</sup> In particular, direct sanctions (such as suspension from practice) on supervisory personnel might counteract the reduced incentives to monitor affairs within accounting firms that have been caused by the firms' use of the limited liability partnership form to shield individual partners from liability for firm misdeeds. See Macey & Sale, *supra* note 35, at 1170-72.

partner. Given the movement of personnel among audit firms, especially among the Big Four audit firms, one should not overestimate the benefits of such a requirement, but it is worth considering.

Professor Lawson does not endorse this publicly supervised lottery mechanism because of a deeply rooted philosophical opposition to government compulsion. Accordingly, he proposes a different form of lottery. Public companies would make a public offer of their auditing contract at a specified fee, and the auditor would be selected at random from among the auditing firms that express a willingness to accept the engagement at the specified price. If the company's offering price does not attract a critical mass of willing auditors, the company would have to raise its offering price until a sufficient number of auditing firms entered the pool. What number of firms is "sufficient" to constitute a reasonable pool, of course, would have to be determined by someone other than the audited firm. If regulatory solutions to problems are off the table, the only evident candidate to make that kind of determination would be the stock exchanges.<sup>67</sup> They have an interest in accurate financial reporting; if improvements in the auditing process can reduce the broad-based discount that must presently be applied to financial information, the exchanges become more valuable along with the companies that they list. Determining the size of audit firm pools does not seem like the kind of intrusion into corporate governance that would send exchanges scurrying for cover.<sup>68</sup>

In order to avoid the spectacle of a boutique auditing firm winning the bid to audit General Motors, there would need to be criteria to determine which auditing firms are eligible to bid for particular audits. Those criteria could be established by the exchanges that administer the lottery. One might also consider giving the audited companies one or more "peremptory" challenges to various auditors, either before or after the bidding process is completed, as an additional safeguard against serious mismatching.

Once the audit firm is hired, the engagement would probably have to be subject to a "for cause" removal proviso, as in Mr. Kahn's plan, in order to be effective. In the absence of regulation, this would have to be mandated by the

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<sup>67</sup> An oversight body could consider a bidding process as a means for setting rates under Mr. Kahn's proposal as well.

<sup>68</sup> Some entity, such as the exchanges, would also have to determine how often the audit contract has to be rebid. Multiyear audit engagements offer learning-curve benefits, but also amplify the risks of undue firm influence.

exchanges as a condition of listing, and disputes about auditor removals would be subject to arbitration.

The Lawson plan is obviously less comprehensive than the Kahn plan. For instance, if audit contracts are bid at hourly rates rather than at fixed sums, firms could overtly or covertly affect auditor compensation through negotiations over billable hours. The Lawson plan is also less likely ever to see the light of day. There is little evidence that the exchanges have any interest in involving themselves in corporate affairs in the manner contemplated here—even if, as Professor Lawson contends, the exchanges would in fact benefit from such a plan because it would systematically increase the value of tradable securities. There have been times, however, when exchanges have taken an active interest in the financial quality of their listed companies, so perhaps Professor Lawson's vision is not quite as quixotic as it might seem.<sup>69</sup>

Either lottery plan would offer substantial benefits with few costs. Both plans would generate systems in which management control over auditors is reduced, which enhances the likelihood that auditors will actually provide a meaningful check on management's tendency toward over-optimism. The potential benefits of any movement in this direction are enormous. The costs of reducing management control over auditors are small to everyone except management—and perhaps to some segment of the auditing profession.<sup>70</sup> It looks like a pretty good deal.

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<sup>69</sup> See John C. Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 37 (2001) ("From well before 1900, the NYSE saw itself as the guardian of the financial quality of the issuers listed on it."); see generally *id.* at 37-39 (describing early reporting requirements imposed by the New York Stock Exchange that ran well ahead of state and federal regulation). If the exchanges do not see the light, Professor Lawson's response is, in stark libertarian principle: better no solution than a regulatory solution.

<sup>70</sup> For instance, one potential effect of a lottery may be to reduce the wealth and influence of the Big Four accounting firms if their current status is less the result of their unique ability to handle large clients than of management's desire to deal with known and familiar faces. (If the Big Four firms are indeed the only entities capable of auditing Fortune 500 companies, which we doubt, then lottery administrators must take that into account in constructing an appropriate lottery.) Mr. Kahn's proposal, which places auditor compensation in the hands of an oversight board, may also have consequences that some auditors may find objectionable—though many auditors surely will appreciate not having to compete for business. Professor Lawson attaches infinite weight to the "cost" of increased governmental involvement in decisionmaking from Mr. Kahn's plan, but most people take a different view of the subject.

*B. Why Bother?*

Our proposals give rise to an obvious and basic question: If the core problem with the current accounting system is that auditors work for the audited firms, why would we construct a system that retains, albeit nominally, the firm-auditor employment relationship? Why not look instead for an alternative employer for the auditors?

There are two reasons: there are enormous practical difficulties with finding an alternative employer, and there would be substantial costs to the auditing process if an alternative employer could ever be found. An examination of the problems posed by trying to alter the present auditing structure too radically will both explain the motivation behind our lottery suggestion and help point to the answers to some of the implementational questions that surround such a suggestion.

Consider first the costs of successfully finding a third-party employer for the auditor. In the wake of the recent corporate scandals, many of which have implicated the accounting system, it is understandable that many people would focus on the perceived role of the accountant as a public watchdog who provides information to parties outside the audited firm. Federal regulators, the state and federal courts, and the accounting profession's own governing bodies proclaim loudly and often that auditors serve a public function that transcends their contractual obligations to their paying clients.<sup>71</sup> The ethical code of the American Institute of Certified Public Accountants, for instance, celebrates "the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal, and as government increasingly relies on accounting information."<sup>72</sup> It is easy to forget through all of this that a basic function of an auditor is to provide the firm's management and owners with information about firm status and performance. Of course, such information could be provided, no doubt more cheaply, by in-house auditors,<sup>73</sup> but even apart from the reputational value of outside auditors, there is something to be said for bringing in an external perspective. If control over the audit function is moved outside the company, there is a danger that many of these internal-management benefits of audits

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<sup>71</sup> See Gary Lawson & Tamara Mattison, *A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation*, 52 OHIO ST. L.J. 1309, 1329-30, 1334-35 (1991).

<sup>72</sup> CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, *supra* note 18, at ET § 51.04.

<sup>73</sup> See Macey & Sale, *supra* note 35, at 1186.

might be lessened. Persons outside the corporation do not necessarily have the same incentives as does the audited company concerning the kind of information that auditors should produce. Audits paid for by outside parties accordingly might, over some range, address a different set of issues than do internally sponsored audits; outsiders will be loath to pay for audit work that redounds solely to the benefit of the audited company. It is well and good to focus on the desires of the outsiders, as we do in this Article, but one should not lose sight of the fact that audits serve functions other than the provision of information to parties outside the company and that those functions could be compromised by changing the form of the auditors' employment relationship.

A second, and even more powerful, reason for retaining a nominal firm-auditor relationship is the serious difficulty with locating an appropriate outsider to hire the auditor. The fact that auditors are generally hired by firms is strong evidence that firms are the most logical employers for auditors. The most pertinent evidence that outsider-sponsored audits are impractical is how few there are and how ineffectively those few that exist function. Of course, as our own proposal demonstrates, that does not rule out the possibility that some other arrangement would have advantages—we do not necessarily live in the best of all possible worlds, and sometimes the absence of particular institutions proves nothing beyond a failure of imagination. But it does suggest that a search for an alternative employer for auditors ought to be undertaken with great care, as we shall now demonstrate.

The most obvious solution to the problem of misaligned auditor incentives would seem to be to have auditors work directly for investors. If the problem under the current system is that investors have difficulty evaluating, and therefore must discount, the attestations of accountants, why can't investors simply hire their own auditors?<sup>74</sup>

In principle, they could. In practice, they might on occasion. There is nothing in the nature of things that prevents investors from demanding that corporate management give investor-hired auditors access to corporate books. There is also nothing in the nature of things, of course, that prevents management from telling investors to go put those books in a very dark place. The only remedy available to investors in that event would be to refuse to invest in companies that do not cooperate with their demands for information. For all we know—and we are not in a position to know these things—there

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<sup>74</sup> See Markham, *supra* note 23, at 810.

might be cases where companies are looking for large investments from discrete persons, who in turn demand and receive access to company records for their own inspection. Especially in merger negotiations, one might expect the parties carefully to examine the financial conditions of each other (though in practice that may not happen as often as one might expect). But to the extent that parties outside of the merger context presently inspect corporate records before investing, the investigations are generally perfunctory; they are hardly the kinds of adversarial audits that we suggest would be appropriate.<sup>75</sup> Banks, for instance, lend enormous amounts of money without seriously attempting to parallel or substitute for the current audit system. Institutional investors similarly put huge amounts on the line without generally insisting on their own detailed audits. There must be reasons.

The problems with any plan for investor-sponsored audits start to become clear when one realizes that the class of "investors" is not monolithic. Stockholders and bondholders have famously divergent interests in many circumstances (though, of course, they might well join hands and put on a brave face when their company is potentially failing and they need to present the best possible public front in order to attract additional investment). Existing shareholders do not have the same interests as potential shareholders; in many circumstances, the former may want "to drive up the price of their shares to sell at maximum value in the secondary market," while the latter may want to have "the most accurate information regarding the fiscal health of the company to determine whether to buy its shares in the secondary market."<sup>76</sup> Venture capitalists may have very different time horizons than do buy-and-hold investors; venture capitalists will often "be looking to liquidate all or most of their stock position in the company, which gives them a strong interest in taking actions to keep the stock price high at the times when, and for the period that, they . . . are able to liquidate their positions."<sup>77</sup> Accordingly, investor-hired auditors could at most represent one class of investors. The image of multiple audits sponsored by multiple classes of investors goes a long way toward explaining why auditors are instead hired by firms.

Moreover, it is very unlikely to be in the interest of a single investor or investor class, even a very large investor such as a pension fund, to conduct an

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<sup>75</sup> See, e.g., William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1287, 1339-40 (2002) (describing the failure of institutional investors to monitor Enron's financial condition).

<sup>76</sup> O'Connor, *supra* note 7, at 51. Indeed, nonshareholders who are prospective buyers want the current price to be as unreasonably low as possible.

<sup>77</sup> Scott, *supra* note 45, at 564.

audit before investing in a specific firm. Large investors have diversified portfolios, which limits the value to them of detailed information about specific firms. Moreover, because of free-rider concerns, investors who hire auditors will find it difficult to capture the full value of that audit. There are, in sum, good reasons why we do not observe widespread investor-sponsored audits.

Perhaps, however, one can find a proxy for investors with the requisite interest to hire an auditor on their behalf. One likely candidate for that role is the government. A proposal for government-sponsored audits was put forward and extensively defended by Mark Gullotta, then a law student, in 2001.<sup>78</sup> Variations on this idea were described and evaluated (though not advocated) by Professor Sean O'Connor in 2002,<sup>79</sup> and a similar proposal was put forward in that same year by a noted financial columnist.<sup>80</sup> According to Mr. Gullotta:

By disconnecting the auditors from any financial interest whatsoever, the inherent flaw in the current audit model is eliminated. The auditors could be supplied by the SEC itself or by an agency yet to be formed.

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Actual independence and apparent independence will be ensured under this model because the auditors will have no economic interest in the audited company whatsoever. No longer will the threat of being fired be used to influence auditor judgment. Except in situations of fraud or gross negligence by the government, there should be no reason to doubt the integrity and the objectivity of government auditors.<sup>81</sup>

There would be no danger in loss of expertise, Mr. Gullotta argues, because “current educational and certification processes do not need to cease once the government takes over auditing. As long as auditors are trained and certified as Certified Public Accountants, the quality of audits should not decrease.”<sup>82</sup>

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<sup>78</sup> Mark A. Gullotta, Comment, *The SEC's Auditor Independence Rule: Missing the Boat on Independence*, 42 SANTA CLARA L. REV. 221 (2001).

<sup>79</sup> O'Connor, *supra* note 7, at 71-73; *see also* Prentice, *supra* note 17, at 1666 (suggesting that the idea of government audits might have substantive merit, but dismissing it as politically infeasible).

<sup>80</sup> *See* Holman W. Jenkins, Jr., *Welfare Reform for Accountants*, WALL ST. J., Jan. 16, 2002, at A17 (“[T]he SEC should contract directly with accounting firms to audit books of companies that want to raise money in the public markets.”).

<sup>81</sup> Gullotta, *supra* note 78, at 242-43.

<sup>82</sup> *Id.* at 244.

Such a proposal has historical support in the practices of state commissioners in the era before enactment of the federal securities laws.<sup>83</sup>

The problems with having the government hire auditors are numerous. First, it would essentially mean the destruction of the modern accounting industry and its transformation into a government bureaucracy. Our proposal looks modest by comparison. The benefits of enhanced auditor independence can be achieved at a much smaller cost.

Second, allowing the government to control auditors introduces an enormous opportunity for political pressure and corruption. As examples from recent presidential administrations demonstrate, the Internal Revenue Service, which Mr. Gullotta invokes as a model,<sup>84</sup> is a powerful tool that can easily be put to political purposes, either to harass political enemies or to extort favors. An agency with the power and responsibility to conduct corporate audits would pose, and increase, those risks.<sup>85</sup> Random selection avoids this set of problems.

Third, government-sponsored audits offer enormous quality-control problems. Audit quality is not solely a function of auditor training; it is also a function of auditor incentives. Government auditors would have the same incentives as do any government employees with job protection, and that is not an encouraging observation. The present system of bank auditing, in which government bank examiners monitor compliance with reserve requirements and other banking regulations, offers a sobering example of what one might expect from a government audit bureau. Perhaps one could improve the incentive situation somewhat by keeping auditors private and having a government agency contract with them, which is not too many steps removed from Mr. Kahn's proposal. But in that case one might as well go with Mr. Kahn's lottery plan, which accomplishes the same ends while maintaining a better incentive structure throughout the auditing process.

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<sup>83</sup> See Muoio, *supra* note 19, at 436.

<sup>84</sup> See Gullotta, *supra* note 78, at 242.

<sup>85</sup> Mr. Gullotta suggests creating an independent government auditing agency on the model of the U.S. Post Office. *See id.* He does not defend this proposal on the ground that it will minimize the risk of political abuse of the agency (perhaps because he does not acknowledge the existence of such a political risk), but someone might argue that such independent status could insulate the agency from political control. There is an enormous literature on the extent to which nominally independent agencies—that is, agencies whose heads are not subject to at-will removal by the President—are genuinely independent of the President, Congress, or both, and we do not intend to engage that literature here. Suffice it to say that Presidents and legislators would be most unlikely to create such arrangements if they did not at least expect to exercise a considerable measure of political control.

Another attempt to find an alternative employer for the auditors was recently sketched by Professor Joshua Ronen in the form of financial statement insurance.<sup>86</sup> Professor Ronen shares our assessment of the fundamental problem with the current financial accounting system. According to Professor Ronen, “the critical—albeit not sole—cause of the recent [financial reporting] debacles was misaligned incentives of the auditors,”<sup>87</sup> resulting from the fact that auditors “are paid by the companies they audit,”<sup>88</sup> which effectively means that they work for the companies’ managements. The only solution is to sever the link between auditors and management and “create instead an agency relationship between the auditor and an appropriate principal.”<sup>89</sup>

For Professor Ronen, the “appropriate principal” is an insurer:

Instead of appointing and paying auditors, companies would purchase financial statement insurance that provides coverage to investors against losses suffered as [a] result of misrepresentation in financial reports. The insurance coverage that the companies are able to obtain is publicized, along with the premiums paid for the coverage. The insurance carriers then appoint—and pay—the auditors who attest to the accuracy of the financial statements of the prospective insurance clients.<sup>90</sup>

Through this mechanism, companies would have incentives to produce and to signal the production of high-quality financial statements through the relatively extensive coverage and low premiums that firms with high-quality financials could obtain.<sup>91</sup> Insurance companies, in turn, would have incentives to seek out companies with high-quality financial statements and to encourage future quality in order to minimize payouts. And, most pertinent to our story, auditors would have the right incentives because “[t]he auditor would be identifying with the person or entities that would suffer a loss in the event of a misrepresentation or omission in the financial statements.”<sup>92</sup>

Obviously, we think that Professor Ronen is on the right track by trying to restructure the auditors’ incentives away from undue deference to

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<sup>86</sup> See Ronen, *supra* note 7. The proposal is further advanced, and its anticipated benefits formalized, in a preliminary working paper. See Alex Dontoh et al., Financial Statements Insurance (June 16, 2003) (unpublished manuscript), at <http://pages.stern.nyu.edu/~jronen/articles/FSI%28Academic%29.pdf>.

<sup>87</sup> Ronen, *supra* note 7, at 41.

<sup>88</sup> *Id.* at 47.

<sup>89</sup> *Id.* at 48.

<sup>90</sup> *Id.*

<sup>91</sup> See *id.* at 48, 59-60.

<sup>92</sup> *Id.* at 56.

management. His proposal, which has been favorably noted by such scholars as Joseph Grundfest,<sup>93</sup> Patricia McCoy,<sup>94</sup> and Larry Ribstein,<sup>95</sup> finds support from a number of considerations. First, insurance for misstatements in financial reports is currently offered to corporate directors and officers through their directors and officers (D&O) insurance policies,<sup>96</sup> so Professor Ronen's idea has some real-world foundation.<sup>97</sup> Second, a study of D&O insurance premiums for Canadian companies for the years 1993 and 1994 found "a significant association between D&O premiums and variables that proxy for the quality of firms' governance structures,"<sup>98</sup> which at least hints that insurance of the kind proposed by Professor Ronen can be priced to respond to firm risks. Third, another study of D&O insurance suggests that insurers perform some degree of monitoring with respect to corporate governance issues such as acquisition policies and internal organizational structures,<sup>99</sup> which could be taken to provide (weak) support as well for the possibility of the kind of external monitoring of financial statements contemplated by Professor Ronen.<sup>100</sup>

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<sup>93</sup> Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 6-8 (2002).

<sup>94</sup> McCoy, *supra* note 7, at 1010-12.

<sup>95</sup> Ribstein, *supra* note 32, at 55.

<sup>96</sup> For a useful and readable primer on directors' and officers' insurance, see Terrence G. Stolly, *Scienter Under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D&O Insurance*, 29 CAP. U. L. REV. 545, 582-86 (2001). For a much more detailed primer, see Michael Sean Quinn & Andrea D. Levin, *Directors' and Officers' Liability Insurance: Probable Directions in Texas Law*, 20 REV. LITIG. 381, 411-80 (2001).

<sup>97</sup> To be sure, the history of D&O insurance has not always been a happy one. The D&O insurance industry went through what was widely described as a crisis in the 1980s, in which coverage was dropped or reduced and premiums skyrocketed. For the classic analysis, see Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989). Although the industry rebounded, "over the past several years, the D&O industry has [again] experience grim financial results . . . . Accordingly, D&O insurance premiums are skyrocketing and policy forms are being rewritten to limit coverage in especially risky cases." Kenneth J. Philpot & Kirsten J. Handelman, *Securities Liability Concerns of Target Defendants in a Down Economy*, in HOT SECURITIES LITIGATION ISSUES IN A DOWN ECONOMY 2002: THE IMPACT OF SUDDEN FINANCIAL LOSS 281, 281 (PLI Corp. L. & Practice Course, Handbook Series No. B0-01K7, 2002). For an intriguing study of the problems with D&O insurance, with specific attention to the savings and loan industry (which reinforces much of our argument here), see M. Mazen Anbari, Comment, *Banking on a Bailout: Directors' and Officers' Liability Insurance Policy Exclusions in the Context of the Savings and Loan Crisis*, 141 U. PA. L. REV. 547 (1992).

<sup>98</sup> John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J.L. ECON. & ORG. 449, 449 (2000).

<sup>99</sup> Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT'L REV. L. & ECON. 115, 128 (1990).

<sup>100</sup> There is, of course, a very large difference between monitoring a firm's acquisition policies and organizational structures and monitoring its financial statements; we mention this study more for the sake of

Despite all of this, however, we doubt whether the insurance mechanism would be an effective way to realign auditor incentives. Professor Ronen's suggestion that insurance companies would voluntarily serve as effective monitors of the corporate reporting process does not come to grips with the economic incentives that drive such insurance transactions. These incentives induce insurers to rely on mechanisms other than preventive monitoring to limit their liability. And if insurers were, as Professor Ronen at one point suggests,<sup>101</sup> compelled to provide such insurance, the insurers would still lack the requisite incentives to make the scheme work.

Consider the illuminating example of D&O insurance. Insurance companies currently insure corporate officers against precisely the kinds of claims that are at the heart of Professor Ronen's proposal, but they do not typically engage in detailed audits or investigations of corporate financial reports. Indeed, as Joseph Grundfest has pointed out in a comment on Professor Ronen's plan, D&O insurers have not sought to exercise any effective control over the corporate audit process.<sup>102</sup> Real-world insurers simply do not protect their exposure to damages from financial misstatements by attempting to scrutinize corporate financial reports in advance. Instead, they rely on coverage limits and exclusions—and with good economic reasons.

The goal of insurance companies is not to minimize claims against their insured clients. Their aim is to maximize the excess of premiums and resultant investment income over payouts. Reducing the incidence of claims against the insured parties could, in some circumstances, be a means to achieve that end, but it is hardly the only or even the most obvious means. The most obvious way to limit exposure is through coverage limits and exclusions, and every D&O policy has such limits and exclusions. The coverage limits can be very large, sometimes running into the tens of millions of dollars,<sup>103</sup> but they are evidently enough, in conjunction with exclusions and other elements of the policy, to eliminate the risk to the insurers of catastrophic overexposure.

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completeness than as a strong indicator of the possibility or likelihood that insurance companies would ever serve as monitors of the auditing process.

<sup>101</sup> See Ronen, *supra* note 7, at 68.

<sup>102</sup> See Grundfest, *supra* note 96, at 7-8 ("D&O insurers could today easily make the retention of insurer-approved auditors a condition of coverage. They could today also require an element of control over the audit process. Yet they don't.")

<sup>103</sup> See Quinn & Levin, *supra* note 99, at 480 n.399 ("Median limits can be quite high: \$75 million in the utility industry, \$35 million in durable goods manufacturing, \$25 million in non-durable goods manufacturing, \$10 million in health care, and \$6.5 million in the high tech sector.")

The exclusions in the policy play an even more critical role in limiting the insurer's risk. For example, exclusions for fraud (intentional or dishonest acts) are a standard part of such policies,<sup>104</sup> both to guard against familiar risks of moral hazard and adverse selection<sup>105</sup> and to comply with state insurance laws that may, on public policy grounds, forbid coverage of fraudulent acts. Such exclusions afford the insurers great opportunities to limit their exposure once claims are filed. For example, to the extent that claims alleging financial misstatements stem from § 10(b) of the Securities Exchange Act of 1934,<sup>106</sup> such claims must allege fraud or dishonesty, which insurers can and do contend place them outside the scope of coverage.<sup>107</sup> Furthermore, the insurance company obtains a great deal of leverage simply by being able to drag out proceedings in disputes about exclusions because the insurance company is holding the insured party's money. A chance that the insurance companies will lose a dispute with the insured party over the scope of an exclusion and will therefore have to fall back on the coverage limits as a last line of defense is possible, but the exclusions are generally broad enough to give the insurers a great deal of leverage across a significant range of potential claims—even when, as is often the case, the insurance policy specifically extends coverage to securities law claims.

The reason why insurers would prefer to limit their risks through coverage limits and exclusions rather than through detailed monitoring of clients is easily understood. Monitoring expenses must be incurred *before* the insurer knows whether a claim is likely to be filed. Disputes about the scope of exclusions, by contrast, take place only *after* a claim is filed, meaning that the insurer only incurs expenses when money is actually on the line. Moreover, intrusive monitoring is quite likely to irritate the insurance company's clients, which risks the loss of business and premiums. Monitoring thus would involve relatively certain up-front costs in lost premiums and monitoring expenses in pursuit of contingent and remote benefits in claim reduction. It is therefore quite sensible for insurers to prefer a possible legal expense at the back end of

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<sup>104</sup> See *id.* at 433.

<sup>105</sup> "Moral hazard" refers to the bad incentive effects against loss prevention that insurance might have on insured parties, and "adverse selection" describes the increased incentives of high-risk persons to join risk pools, which induces the low-risk members of the pools to drop out, which ultimately leads to the disintegration of the pools.

<sup>106</sup> 15 U.S.C. § 78j(b) (2000). Claims under this provision universally invoke Rule 10b-5, 17 C.F.R. § 40.10b-5 (2003).

<sup>107</sup> Cf. *Level 3 Communications, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001) (holding that damages under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k(a), can be restitutionary and therefore are not "losses" within the meaning of the relevant D&O policies).

the process to a certain monitoring expense at the front end—which is exactly what they do in fact.

If insurers were induced or compelled to institute financial statement insurance, they would have the same incentives with respect to minimizing their exposure as they do now. Accordingly, one would expect them to insist upon the same exclusions and coverage limitations that they presently offer in their D&O policies. There is no reason to think that insurance companies would not adopt precisely the same “back-end” strategy that they currently employ to minimize their exposure. If a plan such as Professor Ronen’s wanted insurance companies to engage in serious monitoring of corporate financial reporting, it would have to forbid insurance companies from relying on exclusions and policy limits as their first lines of defense. It would need to change altogether the way that insurers do business. That is far more intrusive than Professor Ronen evidently contemplates, and it would run afoul of basic features of insurance markets.

The nature of insurance markets explains why insurers who deal with financial statements rely on exclusions and coverage limitations. Insurance works through risk-pooling: certain events that are unpredictable in individual cases can be more or less accurately predicted in the aggregate, and risk-averse insured parties can therefore reduce their expected variance in payouts from those events by joining an insurance pool.<sup>108</sup> The insurance pools only hold together if the pools reflect predictable risks and if premiums can be adjusted to fit the risk levels of different pools. Most critically, insurance only works if the events to be insured are *independent* of one another. The independence of events lets the law of large numbers do its work by bringing the aggregate risk posed by the various independent risks toward a stable level. It also allows insurers to spread their payouts over time instead of getting wiped out by economy-wide crises.<sup>109</sup>

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<sup>108</sup> The operation of insurance markets is summarized in George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1539-50 (1987).

<sup>109</sup> See *id.* at 1540.

The insurer’s function is to aggregate uncorrelated (that is, independent) risks and segregate these risks into separate risk pools. The uncorrelated character of the risks distinguishes insurance from savings. Risks that are uncorrelated are risks of which the incidence of loss is spread out, either in terms of time or in terms of the individuals suffering the loss. As long as the risks of pool members are uncorrelated, that is, statistically independent, the insurer can accumulate small premiums from each insured and still have funds sufficient in any period to pay those losses that actually occur. In contrast, if risks were highly correlated, there would be no advantage to aggregating them. Thus, losses from nuclear war are uninsurable.

Financial statement insurance with minimal exclusions and high coverage levels could only work, even in principle, if the risk of loss to the insurers posed by each insured party was substantially unconnected to the risks posed by other insured parties. There is good reason to doubt whether this is true in the case of risks posed by financial statements. Litigation based on misstatements in financial reports may be only loosely tied to the actual existence of misstatements in financial reports. Lawsuits tend to get filed more often when stock prices fall than when they rise, whether or not the actual incidence of misrepresentations changes.<sup>110</sup> The phenomenon is familiar from other contexts. Employment discrimination claims increase during bad economic times.<sup>111</sup> This does not necessarily mean that discrimination actually increases during those times (though it might mean that), but simply that the incentives to sue increase. Similarly, even if the number and degree of misstatements in financial reports stay constant across time, it would not be surprising if more suits are brought in bad times than in good times. Officers and accountants can get away with a lot more when the stock price is rising than when it is falling—which is yet another reason why everyone in the current reporting system has an incentive to hide bad news, especially during downturns in the business cycle.

If the litigation risk faced by a potential financial statement insurer is, to a significant degree, a function of extraneous market conditions, then that risk is not easily insurable.<sup>112</sup> Of course, to some extent the same risks to insurers are

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The insurer's aggregation function derives from operation of the law of large numbers—the empirical phenomenon according to which the probability density function of average loss tends to become concentrated around the mean as the sample number increases. Applied to insurance, the law of large numbers means that as one increases the number of insured persons possessing independent and identically-valued risks, one increases the accuracy of prediction of expected loss for each individual. As should be obvious, increasing predictive accuracy reduces the effective risk faced by the insurer, since the level of aggregate risk is a function of the variance of expected outcomes. Described more precisely, then, the role of the insurer is to identify risks that are independent (uncorrelated) and equally valued, and to aggregate them in order to reduce the total risk of the set.

*Id.*

<sup>110</sup> See Philpot & Handelman, *supra* note 100, at 267 (“As analysts have recognized for years, when the market plummets, an onslaught of securities actions is inevitable.”).

<sup>111</sup> See John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 STAN. L. REV. 983, 990-99 (1991).

<sup>112</sup> Professor Ronen suggests that insurers could hedge their risks through novel financial instruments. See Ronen, *supra* note 7, at 54-55.

[U]nlike property and casualty insurance for example, the losses insured against—decreases in the valuation of companies resulting from omissions or misrepresentations in the financial

posed by D&O insurance, which indicates the forces pushing against financial statement insurance are not necessarily insurmountable; the risks involved are not, strictly speaking, uninsurable. But, as we have noted, D&O insurers rely heavily on coverage limits and exclusions. A fair inference is that the existing scope of D&O coverage, including the limits and exclusions, comes close to the outer boundary of the insurability of those risks. In other words, we have good empirical evidence that risks from financial statements are only insurable up to a very limited point that is quite far from the level and kind of coverage that would be required to solve the problem of auditing incentives through an extensive program of financial statement insurance.<sup>113</sup>

To be sure, an adequate assessment of the possibility of financial statement insurance turns on some empirical questions that we are unequipped to answer (and indeed are barely equipped to pose). But there do seem to be very good reasons why financial statement insurance of the kind contemplated by Professor Ronen does not now and never will exist.<sup>114</sup>

In sum, there are very good reasons why companies hire auditors while insurers and investors do not. Any reform proposal must therefore operate within the structure of the existing firm-auditor relationship.

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statements—can be hedged in the capital markets with properly constructed derivatives, the exercise of which can be made contingent on the same triggering events that cause loss to shareholders, i.e., the financial statement and audit failures that are manifested in omissions or misrepresentations. Specifically, the insurer can buy a special put option with a duration that corresponds to the period covered under the policy. The put would be exercisable upon a stock price decline of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements. Investment funds (pension funds, mutual funds, and the like) would be willing to sell these puts for less than the price of general puts (that are not conditional on misrepresentations) and would thus enable the insurer to reinsure whichever portion of the coverage he wishes not to retain at an affordable cost.

*Id.* This does not address the difficulties of pooling the risks in the first place, nor does it fully insulate the insurers from general market declines which are likely to result in the filing of claims.

<sup>113</sup> We emphasize that the problem is not the *magnitude* of the potential losses but their *dependence*. Professor Ronen argues that the magnitude of the total losses from misstatements are likely to be lowered by change to a system under which companies and auditors have greater incentives to produce high-quality financial statements. See Dantoh et al., *supra* note 89, at 34-35. That is no doubt true, but for purposes of insurance, the magnitude of the risks is not decisive. The critical question is whether those risks, whatever their magnitude, can be reduced through aggregation. If the risks are highly dependent, the answer is no and insurance will not be available, at least without significant liability caps that undercut the case for insurance-provided auditors.

<sup>114</sup> Aren't there similar reasons suggesting that Professor Lawson's exchange-driven lottery will never exist? Perhaps, though if our analysis is correct, financial statement insurance with front-end monitoring is not in the self-interest of the insurance companies, while an accountant lottery would be in the self-interest of exchanges.

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The problem with that relationship is that it gives the firm too much control over the auditor, who therefore has incentives to replicate the firm's self-serving and over-optimistic biases and to sign off on financial statements of questionable utility. In our judgment, the best way to minimize that risk while still having the firm employ the auditor is to reduce the degree to which management can select, retain, and reward auditors who behave in accordance with management's wishes. There is probably no way to eliminate the risk of management influence altogether, but random auditor selection may be a worthwhile step to rein it in.

Of course, proposing a solution and having it adopted are two separate matters. Voluntary solutions to problems only work if people choose to employ them. The most basic difficulty with Professor Lawson's proposal for an exchange-driven lottery is that the relevant principals have demonstrated no desire to implement any such plans. The same is true for Professor Ronen's suggestion for financial statement insurance. Nonetheless, the prospects for an exchange-driven auditor lottery, however slim they may be, are somewhat better than those for financial statement insurance for two reasons. First, an auditor lottery would work to the advantage of the exchanges, while financial statement insurance would not work to the advantage of the insurers. Second, there is historical precedent—albeit distant—for exchanges to be actively involved in the financial reporting process. Over time, it is conceivable that exchanges will rediscover their interest in the quality of information provided by their listed companies.

Mr. Kahn's proposal faces no such direct obstacle because it is regulatory. But regulators often respond to concerns other than the merits of proposals. Firm managements obviously value the ability to write their own report cards, and they control substantial resources with which to defend that ability. The auditing industry is also very powerful and would be likely to resist strongly anything that reduces its value to management. This is an area in which reform has been notoriously difficult to come by. But one must start somewhere. Political support for an auditor lottery could gain currency as ideas such as those presented in this Article are disseminated. After all, people can only get behind proposals of which they are aware. Enough people have been hurt in enough tangible ways from distortions in the financial reporting system that one should not discount the likelihood of building constituencies for reform. We will never know unless we try. The cost of not trying is continued distortion of the reporting process, misallocation of resources, and loss of investor savings.