

## *The Oligopolistic Gatekeeper: The US Accounting Profession*

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THE GUARDIAN OF financial disclosure is the independent accountant. Even before the Depression-era federal securities laws mandated audited financial statements, the accounting profession provided its important attest function to issuers who wished to signal their greater trustworthiness by having their financial statements certified as complying with generally-accepted accounting principles. Upon their enactment, the federal securities laws made this formerly isolated voluntary practice a requirement for public companies.<sup>1</sup> Thus, the accountants became the most pervasive of all the gatekeepers that the federal securities laws socialized into their mission of protecting investors.<sup>2</sup>

This chapter explores the extent to which the highly-concentrated structure of the accounting profession contributes to its failure to serve

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<sup>1</sup> See Securities Act of 1933, 15 U.S.C. § 77aa(25)(26); § 13(a)(2) of the Securities Exchange Act, 15 U.S.C. § 78m(a)(2).

<sup>2</sup> Gatekeeper responsibilities are imposed selectively in other provisions of the securities laws. For example, underwriters and directors are impressed into service through their obligations to undertake a reasonable investigation in connection with registered public offerings. See Securities Act § 11(a)(2)(5) & (b)(3), 15 U.S.C. § 77k(a)(2)(5) and (b)(3). Supervisors of brokers have a duty to supervise that imposes gatekeeper-like responsibilities in appropriate settings. See Securities Exchange Act § 15(b)(4)(E), 15 U.S.C. § 78o (b)(4)(E). And the control person liability provisions, § 15 of the Securities Act, 15 U.S.C. § 77o, and § 20(a) of the Exchange Act, 15 U.S.C. § 78t, can have this effect, particularly when read to require the maintenance of compliance systems. See generally Cox *et al.* (2004: 748–50) for a review of cases where the ‘good faith’ defense requirement mandates more than the absence of knowledge.

the public interest by not being a diligent and independent gatekeeper of financial reporting. In Part I, data is presented that documents that the accounting industry is dominated by a few major firms so that it is correctly viewed as an oligopoly. The potential adverse effects of an oligopoly are described in Part II where we also review the conditions that enable firms within a highly-concentrated industry to misbehave as members of a cartel. As will be seen, industry concentration alone does not inevitably lead to adverse social welfare effects. Part III reviews the rising importance of consulting revenues to the dominant accounting firms and in Part IV the transformation of accounting firms into consulting firms is linked to the accountants being members of an oligopoly. Structure, not greed alone, is identified as an important cause of the accounting industry transforming itself from a profession to a business. The point developed in this chapter is that even though accountants compete aggressively with one another for audit clients, on closer examination we unravel just how the accounting firms pursue parallel conduct to maximize their collective wealth. Specifically, we find that during the past two decades a variety of forces drove the major accounting firms to place greater emphasis on their being providers of non-audit services to their audit clients and that the cartel-like structure allows them to pursue this course collectively.

Part IV also describes the negative social welfare that can arise when non-audit services are provided by auditors to their audit clients. It is this aspect of the auditors' business plan that the Sarbanes-Oxley Act of 2002 (the Act)<sup>3</sup> directs several of its key provisions that are examined in Part V. However, in Part VI we find some disturbing evidence that with regard to auditor behaviour, little has changed since the enactment of Sarbanes-Oxley so that the harmful effects of auditors vending non-audit services to their clients continues today at levels that pose the same threat to their independence. Part VII offers reforms that are necessary to assure that the industry competes on the basis of quality and not more harmful terrain. Part VIII concludes.

### I. A FEW FISH IN A VERY LARGE POND

There can be little doubt that structurally the accounting industry is an oligopoly. Once we could aptly describe the US accounting industry by referring to the 'Big Eight.' Life, however, is never static. As a consequence of a flurry of mega-mergers between 1987–98—mergers that sometimes crossed international borders<sup>4</sup>—the Big Eight became the Big

<sup>3</sup> Sarbanes-Oxley Act of 2002, PL 107-204 (30 July 2002).

<sup>4</sup> For example, US-based Peat Marwick Mitchell, a member of the Big Eight, merged with a non-Big Eight firm, KMG Main Hurdman, an affiliate of European-based Klynveld Main Goerdeler, to form KPMG.

Five. Following the criminal conviction and consequent disappearance of Big Five member Arthur Andersen, we now can refer to the industry as the 'The Final Four.' Legitimate external forces drove the Big Eight to become participants in a wave of consolidations within their already heavily-concentrated industry. As clients became more international, their auditors needed to become more global.<sup>5</sup> With the rise of expensive data processing, there was the need for the accounting firms to achieve critical economies of scale.<sup>6</sup> Having more auditors married to an expensive infrastructure was a wise financial strategy especially if it also meant they would bring to the acquiring firm their clients as well.

By gaining auditors and clients, the surviving firm achieved important economies of scale that could support the expensive technology that became an integral part of the work of the industry. And, as audit clients became more specialized, global, and complex, there was the need on the part of the accounting firms to stay abreast with their audit clients, i.e., the auditing firm also had to acquire pockets of specialization, be global in its operations, and have an infrastructure that could address the complexities of their clients' businesses and systems. Finally, growth and consolidation were strategies to maintain market share of the surviving firms (GAO 2003a: 12–15).

In a masterpiece of understatement, a recent GAO study of the accounting industry observes (*ibid.*: 16):

[T]he large public company audit market is a tight oligopoly. ... In the large public company audit market, the Big 4 now audit over 97 percent of all public companies with sales over \$250 million, and other firms face significant barriers to entry into the market. ... When comparing the top 25 firms on the basis of total revenues, partners, and staff resources, the Big 4 do not have any smaller-firm competitors ...<sup>7</sup>

Concentration within public accounting is evident from a variety of metrics. For example, the concentration for audit services within the industry is reflected by the fact that 2002 revenues of the fourth largest firm, KPMG, were eight times greater than those of the fifth largest firm, Grant Thornton and that KPMG had five times as many staff members as Grant Thornton (*ibid.*: 17, table 1). Even more dramatic is that the total

<sup>5</sup> Thomas, Schwab and Hansen (2001) describe the growth of accounting firms as being driven by the demands of their audit clients, and not by a quest to leverage their human capital; audit firm clients' are constantly increasing in size/complexity and becoming more international.

<sup>6</sup> Yardley *et al.* (1992: 163) speculate that economies of scale may be a influence in the market for very large audit clients.

<sup>7</sup> The high concentration is not limited to the United States. 90% of the companies listed in the Netherlands, and 80% of those listed in Japan are audit clients of a Big Four firm (*ibid.*: 18).

2002 audit revenues of KPMG were 60 per cent greater than the total revenues of the next 21 largest firms (*ibid.*).<sup>8</sup>

From another perspective, consider the Hirschmann-Herfindahl Index (HHI)—a metric commonly used by the US Department of Justice to assess the potentially anti-competitive effects of concentration within an industry. In 1998, the year of the last great merger within the industry—the combination of PriceWaterhouse with Coopers Lybrand—the HHI score for the accounting industry was more than 10 per cent above the level normally associated with a score that is likely to permit industry participants to maintain prices above competitive periods for significant periods of time (*ibid.*: 19, Fig. 3). Following the demise of Arthur Andersen in 2002, the HHI increased to more than 40 per cent above this anti-competitive warning level (*ibid.*).

Although it may seem improbable, the provision of audit services is even more concentrated than described above. Within certain industries, an individual accounting firm's expertise enables it to be a virtual monopolist because it enjoys the dominant body of expertise for audits within that industry. Stated differently, public companies seeking an auditor gravitate toward the audit firm they understand possesses industry-specific expertise. As a consequence, one or two accounting firms perform a substantial amount of the audits within certain key industry sectors. For example, 76.4 per cent of total assets of the petroleum and coal products industry were audited by PricewaterhouseCoopers, and nearly 60 per cent of the assets of non-depository institutions were audited by KPMG. In 1997, before the demise of Arthur Andersen, 32.9 per cent and 31.6 per cent of total assets within the general building contractors industry were audited by Ernst & Young and Arthur Andersen, respectively; following the 2002 demise of Arthur Andersen, Ernst & Young's percentage rose to 60.7 per cent (*ibid.*: 28–9, Fig. 7).<sup>9</sup>

The cause for such industry concentration cannot all be placed solely at the door of the auditors' clients. To be sure, large multinational firms can be expected to seek auditors of comparable geographical breadth and staffing relative to their audit competitors. But this should only explain a small amount of the forces causing accounting firms to be so highly concentrated in their provision of audit services. One can question skeptically what percentage of the 17,000 public companies and nearly 7000 mutual funds that file reports with the SEC for which each registrant must have financial statements certified by a public accountant are either so global or so extensive that they require the services of a Big Four

<sup>8</sup> In 2002 KPMG had total audit revenues of \$2.016 billion and the next 21 firms combined audit revenues were \$1.231 billion (*ibid.*).

<sup>9</sup> We also note a large number of industries in which two of the Big Four dominated in 2002 with the two firms in combination having a total market share in terms of assets audited in excess of 70% (*ibid.*: App. IV, Figs. 13–14).

accounting firm. Big audit clients do not inherently call for their audits to be performed by members of an oligopoly.

## II. A THEORETICAL FRAMEWORK FOR UNDERSTANDING AND HEALING THE ACCOUNTING INDUSTRY

Concentration within any industry is rife with the possibilities of collusion since collusion is more likely to be achieved, and successfully maintained, when a few members of an industry control the bulk of the goods produced than when production is dependent upon hundreds of producer firms. When an industry's production is dominated by a few firms, it is more likely that an agreement by three or four of them regarding price or production of a product will affect the products supply and its price since collectively they represent a dominant share of the market. Their actions in turn make it more likely that other producers will understand that their profits will increase by following the pricing or supply decisions of the colluding members. In this manner, the rising tide of prices lifts all industry-members boats. On the other hand, when there are numerous producers within an industry, agreement among enough of its participants to affect the market is very difficult to achieve. And, even if an agreement were reached, individual members are likely to defect from its terms thereby robbing the agreement of its intended effects. Moreover, an agreement among numerous industry members is far more likely to be detected by antitrust enforcers. Consequently, collusion is more likely to be successful within concentrated industries than those that are competitively structured. Industry concentration, therefore, always raises concerns that there will be either overt collusion or conscious parallel behaviour that yields the same effects as an agreement.

The adverse social welfare of collusive behaviour is well understood. Firms that are permitted to coordinate on price or production will see it is in their interest to do so. This strategy enables colluding firms to increase their collective profits at the expense of consumer welfare. Simply stated, an industry does best if its members act collectively to mimic the practices that would be engaged in by a monopolist. When an industry's market structure is that of an oligopoly, the power of an individual firm to increase its profits by changing the price of its product, or even by altering the quantity and quality of the goods or services it produces, depends on the actions of its competitors. Thus, pricing strategies within an oligopoly frequently reflect a good deal of interdependence among rivals within the industry.<sup>10</sup>

Despite the potential rewards of acting in parallel with industry

<sup>10</sup> See Areeda and Hovenkamp (2003: § 1429 at 207).

members, the oligopolist faces the ongoing dilemma whether to act individually or collectively. Each firm has an incentive to obtain gains by undercutting its rivals but at the same time coordinated action by industry members holds the promise of monopoly-like rewards.<sup>11</sup> If the oligopolist decides to compete by deviating from a prevailing industry price or production level, the benefits of pursuing such an individualistic course might prove fleeting and ultimately costly. By undercutting the price of others, the oligopolist seeks to increase its market share and/or its profits. But its success in doing so depends on the reaction of its rivals. Rivals who do not match the 'cheating' firm's lower price do so at their peril of ceding market share to the cheating rival. Rivals may, however, choose to match the pricing strategy of the cheating rival. If they do, then the revenues and profits of all industry members decline, so that the deviation from the earlier collective price results in benefits to consumers, not the oligopolists. In this case, cheating hurts not just the cheater, but its co-oligopolists. On the other hand, non-cheating rivals may decide that they all suffer if each meets the lower price of the cheater. They may conclude that the cheater will gain only a small amount of market share by its conduct (e.g., the cheating firm lacks the capacity to satiate much of the market's demand) so that their profits are likely to be larger by maintaining their present prices than if the rivals lowered their price to that of the cheating firm. The market share they concede to the cheater by not matching its strategy may not be so significant as to cause the noncheating firms to reduce the price of their product with the effect of lowering its overall profits by a greater amount than if it maintained its existing pricing strategy. The risks facing a firm that adheres to the earlier collusive price is endemic to a cartel. A firm can well see that holding to the earlier collusive practices is better for everyone.

Not all oligopolies misbehave by consciously parallel pricing or output decisions. In his now classic article, Professor George Stigler explains why not all oligopolies misbehave vis-a-vis consumer welfare (1964). His article isolates conditions that are necessary for a cartel to function effectively in ways similar to that of a monopoly: firms must be able to identify the terms of their coordination, they must be able to detect deviations, and once finding a deviation they must be able to punish those that deviate from the collusive strategy supported by the others (*ibid.*: \_).<sup>12</sup> Stigler's theory provides useful mileposts by which to gauge the behaviour of the accounting industry.

<sup>11</sup> This occurs even if greater production or sales lowers the product's price the defecting firm does not absorb the full cost of this lower price. See Hovenkamp (1994: § 4.1a at 143).

<sup>12</sup> Professor Hovenkamp (*ibid.*: § 4.1 at 141) adds to this list three other conditions that appear assumed by Stigler. Hovenkamp specifies (1) that the relevant cartelized product or service market must enjoy sufficiently high barriers to entry that prevent newcomers from undermining the cartel's pricing or production decisions; (2) that collectively the

A non-critical view of the accounting industry indicates that the accounting industry has not behaved as an oligopoly by following socially harmful parallel conduct. Stated within Stigler's three factors there are reasons to conclude that none of these three conditions are present within the accounting industry. That is, the accounting firms do not misbehave as an oligopoly because they (1) lack a standardized commodity for which they can provide a coordinated price; (2) there is an inability to detect deviations from the agreed upon price; and (3) the industry lacks any means to punish cheating firms. First, historically, accounting firms have not been price gougers; indeed, their rates over the past two decades have not increased significantly. A leading study of auditor fees found that audit fees *declined* as a function of client assets (a comparison made to capture possible rising complexity and scope of the audit engagement) (Invancevich and Zardkoochi 2000).<sup>13</sup> Two, clients appear satisfied with the fees of their auditors, believing that whatever fee increases have occurred in the past decade have been the result of externalities such as increased regulation and litigation-based concerns.<sup>14</sup> Indeed, the complaint in the post-Enron era is that in the years leading up to the recent spate of accounting scandals audit clients too frequently retarded increases in audit fees sought by the auditors and which hindsight suggests would have been wise investments.<sup>15</sup> Only in post-Sarbanes-Oxley years have we seen significant increases in audit fees and much of this can be attributed to additional compliance costs imposed by the Act as well as accounting firms responding to rising liability costs.<sup>16</sup>

participating cartel members produce a sufficiently large share of the market so that non-member's production cannot undermine the decisions of the cartel (this condition can also be satisfied if something discourages the non-members from expanding their production); and (3) that they must be able to carry out their manipulation of production or price without detection by the government or other outsiders.

<sup>13</sup> Menon and Williams (2001) provide a sample of actual fees from 1989 through 1996, and show a decline of \$3.4 to \$2.8 million, adjusted for inflation.

<sup>14</sup> GAO (2003b: 10–12) states that 93% of 158 respondents reported an increase in fees, but only one-half believed consolidation within the industry was responsible.

<sup>15</sup> Estimates of the financial fraud uncovered in the peak years of 2001 and 2002 are difficult to calculate. The bubble market's collapse removed approximately \$8.5 trillion in market value for publicly-traded securities (Kelly 2002). If one believed only 1% of the market decline was attributable to financial reporting problems, this would equal \$85 Billion. This would appear quite conservative for what we witnessed in 2001–2 since the market losses during the preceding boom years—when there were fewer large financial collapses—are estimated to be about the same. McNamee *et al.* (2000) estimate losses attributable to accounting failures between 1993–2000 of at least \$88 billion. All this resonates with an observation by a former SEC chairman (Hills 2002) who has served on many audit committees that audit committees too frequently saw as their task retarding any increase in audit fees rather than authorizing appropriate sums be paid to the auditors to assure a high quality audit.

<sup>16</sup> Salomon and Bryan-Low (2004) report that audit fees are estimated to rise by as much as 30% for 2004. A study of audit fees paid by 461 of the Fortune 500 firms found an average increase of 16% from 2002 to 2003 compared with an average increase of 22% for firms outside the Fortune 500 (Glass Lewis & Co. 2004). The greater percentage increase reported in 2004 as compared with 2003 increases reflects the effects of Sarbanes-Oxley's increased reporting requirements.

A third consideration arises from the difficulty firms would face in reaching an agreement regarding the price to charge for their service or detecting a deviation from the agreed upon price. Information is a key feature of Stigler's formula for an effective cartel since this is how deviations are detected. He predicts that 'collusion will always be more effective against buyers who report correctly and fully the prices tendered to them' (1964: 48). This condition of the model has implications for the accounting industry: the auditor's clients report in their annual filings with the SEC the sums paid to their auditors.<sup>17</sup> Such reporting arguably makes detection of cheating more likely and invites responses from competitors eager to meet the deviation by the cheating firm. However, antitrust theory informs us that, if the significant buyers of the vended product change their identity or otherwise the cost of the vended product or services is masked, collusion will be more difficult and cheating more prevalent (*ibid.*). This observation has relevance for the accounting industry; even though the client base of individual auditing firms is very stable (suggesting a lack of successful competition we would expect to find associated with the cartel-like behaviour), the services accountants provide to each client are tailored to that client's business and systems. Auditors do not in fact provide a uniform service but one that varies on a firm-by-firm basis. Since what they vend is not a commodity, their industry is rife with opportunities for a good deal of deviation with respect to pricing practices and even quantity and quality of services provided.<sup>18</sup> Stated differently, audit services are not a single commodity that lends itself to discrete market responses by an auditor's rivals. By not being commoditized, audit services are not amenable to tacit agreement as to its pricing, and departures from any understood price or quality would be difficult to detect. Thus, if harmful collusion is to occur, it must occur in some other area than the price and quality of the service provided since to be so focused is to premise the cartel's wealth on nondiscernible metrics.

A final consideration is that there does not appear to be any effective means for the industry to discipline or otherwise punish a cheating

<sup>17</sup> See Item 14 of SEC Form 10-K.

<sup>18</sup> Areeda and Hovencamp (2003: § 1429c at 209) describe oligopolists as more likely to compete via sales promotions or product variations which are not easily imitated and can sometimes be difficult for competitors to respond promptly to so that the deviating member reaps a strong first mover advantage. Similarly, any differences in preferences among buyers that give rise to differences in the product or service purchased 'complicates the process of observation, coordination, or retaliation' (*ibid.*: 211). It is difficult to determine to what extent the quality of services provided by an auditor varies across its audit clients. At the same time, it is equally problematic to suggest that a particular audit firm provides a higher quality of audit services than does its rivals. Eisenberg and Macey (2004) study earnings restatements and find that when factors are controlled for such variables as client size, time, and industry, there was no evidence of more frequent earnings restatements for companies audited by Arthur Andersen than by its rivals.



member. Even though—until the passage of Sarbanes-Oxley—the industry maintained exclusive powers to discipline its members, there is no evidence that this power was ever used against a Big Eight or Big Five accounting firm. Moreover, the stability of their client base and steady growth in their revenues belies that members engaged in any meaningful sanctions of cheating rivals. After the passage of Sarbanes-Oxley, the chief role in disciplining accounting firms is lodged in the Public Company Accounting Oversight Board (PCAOB) as well as the SEC, each of which is autonomous from the industry.<sup>19</sup>

Consistent with the above is evidence that auditors have long been sensitive to price competition. After the American Institute of Certified Public Accountants removed its ban on bidding for audits in 1972, competition among major accounting firms has been ‘intense and vicious.’<sup>20</sup> Moreover, this could explain the relative stability of the auditor’s stable of clients, namely that auditors price their services to keep the client from defecting to a competitor. As we will see in Part III, there are possibly more ominous explanations for the auditors’ ability to retain their respective clients for years and even decades. Price competition may well have contributed to the woeful poor performance of accountants to detect a host of financial frauds at the close of the last decade as well as the continuing oligopolistic structure of the industry. Absent price competition, monopoly-like profits garnered by the large accounting firms may well have either attracted new entrants or caused clients to seek lower-priced smaller accounting firms. But new entrants, and even existing smaller accounting firms, would confront serious barriers to entry, such as significant capital investment and reputational requirements, that must be overcome to serve large audit clients. Particularly important is evidence that a foremost consideration of firms opting to have their audits carried out by a Big Eight-Five-Four accounting firm is the reputational benefits they receive by signaling to investors their relatively higher quality by choosing a major auditing firm. That is, firms opt for a major accounting firm not so much because of economies that are garnered with respect to their audits, but rather to

<sup>19</sup> Sarbanes-Oxley Act § 401, 15 U.S.C. §§ 7214 & 7215 requires periodic inspections of registered auditing firms by the PCAOB and authorizing the agency to discipline violations of auditing standards.

<sup>20</sup> Zeff (2003a: 202) identifies the golden era of the accounting profession as 1940–60s and the introduction of competitive pricing, pursuant to pressure from the US Department of Justice, as a force leading auditors to be seen as members of an industry and not a profession. Professor Zeff observes, ‘The heightened competitive climate in which the firms operated seemed to haunt partners’ conduct of audit engagements’ (*ibid.*: 203). For other evidence that price competition prevails within the industry and has a harmful effect on auditor independence, GAO (2003c: 41) finds that the removal of restrictions on advertising and direct solicitation of clients have had a more direct impact on auditor independence than consolidation within the industry.

signal their firm's higher quality to investors.<sup>21</sup> This too has significance for the accounting industry performing as monopolists: the relative size and reputation of auditors are intermingled so that in combination they pose significant barriers to entry.

As seen in Part I, the accounting industry's structure is unquestionably that of an oligopoly. Nevertheless, the foregoing discussion also reflects that the industry's members are intensely competitive in the pricing of audit services. Is this because, in Stigler's formulation, the industry lacks the ability to punish 'cheaters' because they lack the ability to coordinate on setting a price for their services, cannot detect deviations, or lack the ability to discipline deviating accounting firms? Insight into the failure of the major accounting firms to misbehave as oligopolists is provided by understanding the multiple roles that their provision of non-audit services to their audit clients plays in their overall business strategy as well as the strategic thinking of their audit clients. The next section examines this, and explores the charitable explanation for the rising importance of non-audit services: they are a means for accounting firms to diversify their services, leverage their client relationships, and deviate from oligopolistic pricing without being detected. That is, non-audit services can be understood as a form of non-price competition (Ginsburg 1993).

### III. THE OLIGOPOLY SCRIPT: THE PROMINENCE OF NON-AUDIT SERVICES

Because the auditor's attest function is the heart of their engagement, the auditor's role is first and foremost that of a gatekeeper.<sup>22</sup> Other gatekeepers, such as underwriters and lawyers are also socialized into a gatekeeper function, but their role in this endeavor does not involve a

<sup>21</sup> Ireland and Lennox (2002) found that higher quality clients gravitate to Big Five accounting firms but incur higher fees in doing so than lower-quality clients; Peel and Roberts (2003) study of small UK audit clients found that they pay a premium when audited by Big Six accounting firms, which is consistent with their seeking benefits of signaling their higher quality over companies not audited; Chaney, Jeter and Lakshamanan (2004) show that private firms that are not publicly-held choose auditors by fees and do not otherwise discriminate between Big Five and non-Big Five firms.

<sup>22</sup> Apropos of the significance of any intertwining of the audit function with commercial relationships that jeopardize the independence of judgment of the auditor is the observation by Chief Justice Berger that the auditor's 'public watchdog's function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.' *United States v Arthur Young*, 465 U.S. 805, 818 (1984).

Gatekeepers have been closely examined by the commentators who generally attribute a prominent role to them, particularly the outside accountant. See generally Hamdani (2003); Coffee (2002); Partnoy (2001); Choi (1998); Jackson (1993); Kraakman (1986); and Gilson and Kraakman (1984: 613–21).

formal attestation.<sup>23</sup> Hence, only indirectly do they come to their role of being gatekeepers. It is a masterpiece of understatement, but no doubt diplomatic, to observe that the accounting profession has not earned rave reviews for its performance as gatekeepers in the aftermath of the recent financial and accounting scandals in which accountants either recklessly failed to detect their clients' false reporting or were their accomplices in their clients' fraud. This section links the accountants' failings to their metamorphoses from an auditing firm into consulting firms that provide audit services. The next section considers whether their metamorphosis can be further understood as being made possible by the highly-concentrated structure of the industry so that their recent evolution can be understood as their misbehaving as a cartel.

The prime suspect for the accounting profession's recent sorrowful performance as a gatekeeper against financial frauds is the rising importance of non-audit services in overall operations of the major accounting firms.<sup>24</sup> Non-audit service revenues now dominate the income statement of the large accounting firms. A 2002 study of 1224 large public companies by the Investor Responsibility Research Center found that in 2001 non-audit revenues garnered by the accountants exceeded \$4 billion whereas their audit fees totaled \$1.58 billion.<sup>25</sup> In

<sup>23</sup> Underwriters are among the select group of persons that are liable under § 11(a)(5) of the Securities Act if the registration statement for a public offering contains a material misrepresentation. See 15 U.S.C. § 77k(a)(5). See e.g., *In re WorldCom, Inc. Securities Litigation*, 2004 US Dist. Lexis 25155 (S.D.N.Y.). Lawyers find their role as gatekeepers no set forth in the SEC's attorney responsibility rules which impose a duty to report within the client organization when the attorney has a reason to believe a violation of the securities laws or fiduciary duty has occurred. See SEC (2004).

<sup>24</sup> There has long been regulatory action focused on shielding the auditor's independence from being compromised by the rewards and attractiveness of consulting revenues. See, e.g., SEC (1979): 'the growing importance of management advisory services to revenues, profits, and competitive position of accounting firms—are a cause for legitimate concern as to the impact of these activities on auditor independence, objectivity, and professionalism.' This release was later rescinded in the deregulatory wave of the Reagan Administration, although in Accounting Series Release 296 the SEC states it had not changed its views of the problem from that expressed in SEC (1979). Even before non-audit services became a dominant component in the accounting firms' business strategy, opinion was mixed whether the provision of non-audit services to audit clients compromised the accountant's independence. Schulte (1965) reports a survey of 383 managers of financial institutions showing that 55% believed the consulting function did not impair the accountant's independence. Indeed, when accounting firms were in the early stage of growing their consulting practices, positive support for marrying the auditor to its client's consulting needs was provided by the primary professional organ tasked with assuring the independence of auditors (Public Oversight Board 1979: 1). Eight years later, an extensive survey by the AICPA's Public Oversight Board (1986) found over half the survey respondents believed certain business consulting practices, such as merger advice, valuation of assets, and providing actuarial services compromised the accountant's independence. However, a GAO study (1996: ch. 2) equivocated on whether consulting impaired the accountant's independence and instead called on the accounting profession to be attentive to the possibility that certain types of consulting could compromise the auditor's judgment. For a detailed review of studies of the impact of consulting on the accountant's independence, see Public Oversight Board (2000).

<sup>25</sup> See Morgenson (2002).

1976, audit fees constituted 70 per cent of accounting firm revenues; by 1998 audit fees had fallen to 31 per cent of the total. These changes occurred because non-audit revenues were increasing three times faster than revenues from audit services (Levitt 2000: 156; McNamee *et al.* 2000).<sup>26</sup>

As aptly put by then Big Eight member Deloitte Haskins & Sells' CEO, the

ultimate goal ... [is] to change Deloitte's self-image from that of a professional firm that happened to be in business (the traditional view among the giant CPA firms) to a business that happened to market Professional services.<sup>27</sup>

Indeed, by 1994, a blue-ribbon panel to study the accounting industry found that five of the top seven consulting firms in the United States and six of the top seven consulting firms worldwide were the then Big Six accounting firms.<sup>28</sup>

Accountants argue that the marriage of various consulting services to their audit function not only is efficient for their audit clients but also enables the accountants to discharge their audit function due to the heightened and more intense understanding of the client that comes through their consulting activities. This argument has a good deal of intuitive appeal but little empirical support. The one study of the link between the intensity of the audit (measured by the hours expended on the audit itself) and consulting found that billed audit hours increased as a function of the amount of consulting.<sup>29</sup> Thus, the provision of non-audit services does not appear to yield scale economies for the audit itself. Moreover, arguing that the provision of non-audit services enhances the audit raises a further question about the quality of audits carried out by accountants who do not enjoy a consulting relationship with their audit clients. Former SEC Chairman Arthur Levitt, in defending proposed limits on consulting by auditors before Congress, reported that

<sup>26</sup> Between 1990 and 1999, audit fees generated by the Big Five accounting firms for SEC registrants declined from 71% to 48% of total revenues while fees for tax work increased from 17% to 20% and consulting grew from 12% to 32% (Public Oversight Board 2000: 112). In absolute terms, the total 1999 revenues of the Big Five accounting firms derived from SEC registrants was \$26.5 billion; of this amount, \$9.5 billion was generated from auditing fees (*ibid.*). Public Accounting Report (2001) provides a breakdown of revenue sources for the Big Five accounting firms. One study found that non-audit revenues paid by 1224 companies to their auditors were 2.5 times higher than audit revenues. Morgenson (2002) discusses a 2001 study by Investor Responsibility Research Center that was repeated by IRRC in 2002 with similar results. The 2002 study found that 72% of total fees paid by 1245 SEC registrants were for non-audit services. Longstreth (2002) finds a 2.69:1 ratio of non-audit to audit fees.

<sup>27</sup> See Zeff (2003b).

<sup>28</sup> See Public Oversight Board (1994: 6).

<sup>29</sup> See Davis, Ricchiute and Trompeter (1993).

approximately 80 per cent of public reporting companies awarded no or very little consulting work to their auditors. He observed (2000: 6),

[w]e do not believe that anyone would argue that the audits those companies received were somehow inadequate because those companies did not receive non-audit services from their auditors’.

Of further note regarding Chairman Levitt’s observation is that the significant revenues accountants derive from consulting arises from a distinct minority of their audit clients. Thus, non-audit services may well be a dominant component of the total revenues of Big Four accounting firms, but those revenues arise from a minority of their clients.

There are multiple reasons why the accounting firms placed such an emphasis on growing their non-audit services revenues. An unwitting accomplice in this effort was the efforts of many audit committees to gauge the committee’s success by reducing the auditor’s fees rather than, for example, enhancing the quality of the audit.<sup>30</sup> The pressure on audit fees also gave rise to a need for accounting firms to distinguish themselves from their competitors by offering a wider range of services.<sup>31</sup> Much of the revenue growth for non-audit services was based solely on client demand; clients, believing that their auditors knew the client’s business better than anyone else, concluded that there would be economies by retaining the auditors for a range of consulting services rather than to select a provider that was unfamiliar with the client’s business and supporting systems.<sup>32</sup> A further concern was the intense competition among accounting firms to recruit talent to the quiet life of the auditor. There was, of course, the quest to share the good life enjoyed by the well-compensated investment bankers and others with whom the accountants frequently interacted.<sup>33</sup>

Consider that the number of accounting majors declined 25 per cent between 1995 and 2000 matching a near similar decline in the number of individuals sitting for the national CPA exam.<sup>34</sup> To attract talented auditors, the accounting firms had to offer a broader professional profile than being solely an auditor.<sup>35</sup> This strategy also complemented the

<sup>30</sup> See Hills (2002).

<sup>31</sup> See Wyatt (2002).

<sup>32</sup> See Public Oversight Board (2000: 110–11); McNamee *et al.* (2000: 156).

<sup>33</sup> See Dugan (2002).

<sup>34</sup> Balhoff (2002) stated the number of accounting majors declined from 60,000 in 1995 to 45,000 in 2000; further, that in the decade 1991–2000 the total number of those taking the CPA exam had declined 33%. There is evidence that accounting has become more popular with undergraduates. Gullapalli (2004) reports an 11% increase in the number of accounting degrees awarded in 2003 over 2002; however, the number of accounting degrees awarded in 2003 were 10,000 less than the peak level of 60,000 in 1994–95.

<sup>35</sup> See Copeland (2002): ‘The best and the brightest seek positions that will allow them to develop their expertise, to learn, to work on cutting issues...’

reality that auditing work had by the 1990s become more complex and technical so that audit teams needed to include technical non-accounting experts who would have been underemployed absent consulting opportunities.<sup>36</sup> As a consequence, auditing firms found a significant portion of their staffs being made up of individuals who came from academic programs with less emphasis on professionalism and more on technical skills than historically prevailed in professional accounting programs.<sup>37</sup> Finally, the profit margins and growth opportunities were much greater with consulting than with auditing. Simply placed, profits could better be obtained through expanding their consulting operations than to expend efforts to rest audit clients from their competitors.

Therefore, various commercial forces that guided auditors and their clients to the joint position that their auditors should carry out consulting assignments for the client. From that point it was but a short step before these same forces spun a web that obscured the auditors from their primary professional undertakings. The popular media may rightly have characterized the role of auditing services with the national accounting firm's repertoire as a 'loss leader' whereby the provision of audit services enabled the accountants to get their foot in the door so that they could thereafter provide more lucrative consulting services.<sup>38</sup>

As seen earlier, audit fees when scaled to their client's size have declined in the last decade. But as also seen, audit hours actually increase with the level of non-audit services provided.<sup>39</sup> Thus, we might speculate what subtle trading occurred between the auditors and their clients that permit higher audit fees to accompany rising non-audit service revenues. Moreover, in view of the concentrated nature of the accounting industry joined by the importance to audit clients of their auditor having the stature of being a Big Four firm, there is cause to ponder why auditing could not be more lucrative than it has been. As seen earlier, the industry has long been dominated by a few national players so that conditions are rife with the potential for anti-competitive pricing of their audit services. However, the recent GAO study reports there is 'no evidence that price competition to date has been impaired' by the high concentration within the industry (2003a: 25).

<sup>36</sup> See Public Oversight Board (2000: 112).

<sup>37</sup> See Wyatt (2002: 3).

<sup>38</sup> See Scheiber (2002). Consistent with the loss leader thesis is an Arthur Andersen internal memorandum imposing a cap on the firm's audit fees charged Waste Management Company because the client was viewed as a 'crown jewel' with respect to the level of non-audit revenues provided by Waste Management. See SEC (2001).

<sup>39</sup> See Davis, Ricciute and Trompeter (1993). For others finding no negative correlation between the level of audit fees and non-audit revenues, see Simunic (1980); Palmrose (1986). Evidence that no negative correlation exists between audit and non-audit revenues to the auditor's clients is inconsistent with the 'loss leader' thesis.

Moreover, the absence of anti-competitive pricing<sup>40</sup> for their audit services among the large public accounting firms is not driven by demand elasticity for the services they provide. There is no substitute for the service they offer; the law mandates that publicly-traded companies must be audited by an independent auditor. Hence, the 'loss leader' thesis gains some traction as their failure to act opportunistically when pricing the audit is consistent with the view they have, at least in until very recently, pursued a strategy to use the marketing power they enjoyed in one segment—the provision of audit services—to enter a more competitive and extremely lucrative consulting segment. Certainly the behaviour of the national accounting firms is consistent with the loss leader thesis. For example, Ernst & Young set targets for non-audit services that audit engagement partners were to meet with respect to each client; missing a target resulted in a 10 per cent salary reduction.<sup>41</sup> These developments had an obvious impact on the culture of the auditing firm. For example, firm leadership roles were more likely to be bestowed on those who were successful marketers rather than the most diligent and talented auditors (Wyatt 2002).<sup>42</sup> And, completing the snare into which the engagement auditor found herself, the auditors compensation was frequently linked directly to the overall revenues produced attributed to the audit client.<sup>43</sup>

Another more troubling explanation for the growth of non-audit services is that management easily saw this was a way to keep the outside auditor on a short leash. Management unhappy with the auditor's

<sup>40</sup> For a comprehensive study of the role fees played among 389 public firms that switched auditors between 1983–87, see Ettredge and Greenberg (1990: 208): average fee reduction of 23% in the first year after switching auditors with even a greater reduction (28%) when client selected auditor with perceived greater expertise within that industry as reflected by its dominant market share of audits within that industry. Of note is that when there has been greater government focus on whether auditors price their services competitively fees declined. See Maher, Tiessen, Colson and Broman (1992) for a review of audit fees during the 1977–81 period when the accounting industry was subject to Congressional, Department of Justice, and SEC scrutiny with respect to whether its was anti-competitive.

<sup>41</sup> See Dugan (2002). Brown and Dugan (2002) report that Arthur Andersen adopted a program in 1998 that called upon engagement partners to double revenues from their clients by cross selling non-audit services.

<sup>42</sup> Accordingly, technicians were eased out of management and became themselves consultants to the auditing staff who were increasingly being overseen not by the most talented auditors but those who could sell or possessed non-audit technical skills (Seidler 2002). For example, Arthur Andersen's engagement partner for Waste Management Company, a firm that would later be the focus of among the largest reporting violations to occur in the 1990s, was Robert Allgyer, a marketing director in Arthur Andersen's national office whose job it was to coordinate the firm's cross-selling efforts. See SEC (2001).

<sup>43</sup> Turner (2002) states that the magnitude of audit and consulting fees measured the profitability of the audit client and services of the engagement partner; Stewart (2002) characterizes the year evaluation of engagement partners to be focused on what 'kind of business you brought in.' There were even powerful incentives for engagement partners not to question former financial statements as the auditor's pay would be reduced when such a restatement occurred (*ibid*).

'second guessing' management's artful use of accounting principles can, of course, threaten to terminate the relationship. Under the current regulatory regime, this threat can easily be stared down by the auditor; to replace the accountant requires a prompt public disclosure on SEC Form 8-K,<sup>44</sup> raising eyebrows within the investment community, and likely inviting inquiry from the SEC. On the other hand, reducing or eliminating the amount of non-audit services provided by the auditor is not required to be disclosed on Form 8-K or anywhere else. Thus, the provision of significant levels of non-audit services by the auditors provides management with greater leverage over the auditor in the event of disagreements between management and the auditors. That is, managers who wish to conflict their auditor's judgment can more easily achieve this goal by increasing the revenues the auditor derives from the provision of non-audit services. Herein lies one of the major concerns underlying auditors providing non-audit services to their audit clients. A further bond between the auditor and their client is that audit clients hire a significant number of their auditor's partners and staff to become members of their senior management.<sup>45</sup> Thus, the auditor frequently finds herself staring across the desk into the piercing eyes of a former colleague, or even boss.

There is no solid empirical support that non-audit services in fact systematically compromise the quality of the outside accountant's audit.<sup>46</sup> One point to begin to explore whether such a connection exists is

<sup>44</sup> See Item 4 of Form 8-K. Form 8-K must be filed with the SEC within five days of a change (whether by dismissal or resignation) of auditors. The disclosures that must accompany notice of the change are extensive with respect to whether a dispute or disagreement between the issuer and its former auditor. See Item 304 or Regulation S-K, 17 C.F.R. § 229.304 (2004).

<sup>45</sup> See generally Securities Exchange Act Rel. No. 42994 (12 July 2000) (detailing these practices). Note in this regard that Sarbanes-Oxley adds § 10A(l), 15 U.S.C. § 78j-1(l) (Supp. 2003), to the Exchange Act barring auditors from certifying the financial statements of a reporting company if certain senior financial officers of the client if such officer had within one year carried out an audit of the reporting company for the auditing firm.

<sup>46</sup> It remains a matter of speculation whether the accountant's oversight of their audit clients' financial statements was diminished by the Supreme Court's holding in *Central Bank of Denver v First Interstate Bank of Denver*, 511 U.S. 164 (1994), that there was no aiding and abetting liability under the antifraud provision. Since accountants continue to be liable for misstatements and omissions in the financial statements they audit, see *Anixeter v Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996), cf. *Wright v Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), cert. denied, 525 U.S. 1104 (1999), it is difficult to conclude that *Central Bank* provides any more than perhaps a false sense of security to the auditor. Arguably, the most significant weakening of the legal environment for auditing occurred earlier when the Supreme Court held that scienter was required for there to be a violation of the antifraud provision. See *Ernst & Ernst v Hochfelder*, 425 U.S. 185 (1976). By eliminating the possibility of negligence as a basis for liability, one might conclude that *Ernst & Ernst* induces less caution on the part of the auditors. There are at least two weaknesses to this argument. First, there is no reasonable basis to conclude that negligence was ever the standard or even an acceptable standard before *Ernst & Ernst*. See Cox (1977). Secondly, scienter was and continues to be an acceptable standard of fault under the antifraud provision. See e.g., *Sanders v John Nuveen & Co.*, 554 F.2d 790, 793 (7th



with the odor emitted by the rise in earnings restatements. For the past decade, the period in which the auditors have been more than just auditors, financial markets have been treated with an ever increasing number of earnings restatements.<sup>47</sup> Even though restatements do not necessarily suggest fraud, they may nonetheless be seen as equivalent to fraudulent reporting *sans scienter*. Evidence of the link between the auditor's independence and the provision of audit services is mixed. An early study examining this connection points in the other direction. The Panel on Audit Effectiveness studied 126 audit engagements, identifying 37 (26 per cent) in which non-audit services were provided (Public Oversight Board 2000). The Panel concluded that in none of these cases did the provision of non-audit services compromise the quality of the audit; the Panel even opined that in one-fourth of the audits that were accompanied by non-audit services that the consulting work had a positive impact on the quality of the audit (*ibid.*: 113).<sup>48</sup> The Panel report, however, did not probe the more subtle question of whether non-audit fees or even more generally the total fees received from the client compromised the auditor's judgment; the Panel's focus was instead on whether the act of providing *any* level of non-audit services impeded the audit function.<sup>49</sup>

That such a connection exists between the auditor's independence and consulting has a good deal of intuitive support. A more refined inquiry is whether the relative strength of any correlation between the auditor's financial ties with the client and compromises in the auditor's professional judgment is context dependent. This could well explain two strikingly dissimilar leading studies of whether non-audit services compromise the accountants' judgments. A 2002 study found no

Cir. 1977); *Kiernan v Homeland Inc.*, 611 F.2d 785, 788 (9th Cir. 1984). Thus, the auditor who becomes aware of a possible misrepresentation committed by management, but turns a blind eye to further investigating it would appear to have acted at least recklessly.

<sup>47</sup> In 1990, there were 33 earnings restatements. In five years, the number of restatements increased by 50% to 50 restatements. In 2000, there were 157 earnings restatements, more than triple the number five years earlier and five times the number at the beginning of the decade and in 2002 this number reached a record high of 330. See Huron Consulting Group (2003); Wu (2001). See generally GAO (2002). Earnings statements are accompanied by price adjustments in the security of the restating firm. One estimate places the loss in market value due to restatements made for the period 1998–2000 at \$73 billion. See Moriarty and Livingston (2001). The GAO (2003d) estimated unadjusted market losses of \$100 billion. Earnings restatements are symptomatic of the aggressive and opportunistic use of accounting principles. Opacity and lacunae in accounting metrics were shamelessly exploited by the firm's managers. Too frequently, it appears, the public accountants accorded their audit client the benefit of any ambiguity in accounting principles.

<sup>48</sup> Antel, Gordon, Narayanamoorthy and Zhou (2002) find no higher correlation between abnormal accruals and higher audit or non-audit fees, although other studies cited in this chapter have reached a contrary result; Frankel, Johnson and Nelson (2002) find the greater the non-audit services the more likely it is that analysts' forecasts will be met or exceeded and that there will be larger discretionary accruals.

<sup>49</sup> See Seidler (2002).

statistical correlation between non-audit service fees and the auditor providing a going concern qualification to its audit opinion (DeFond, Raghunandan and Subramanyam 2002).<sup>50</sup>

In contrast, another study published in 2002 finds that non-audit fees are positively associated with various indicia of earnings management by audited firms (Frankel, Johnson and Nelson 2002).<sup>51</sup> The latter study finds that the frequency of abnormal accruals increases as more non-audit services are provided by the firm's auditors. The conflicting results of the two studies need not lead to conflicting policy implications. Auditors may more easily succumb to management's manipulation of reported earnings when the firm is not financially distressed because the auditors view their own reputation and litigation exposure as not threatened in such context. On the other hand, when their client is financially distressed, the auditor's reputation and litigation exposure is increased so that it might be much less deferential to management judgments. Indeed, we should expect—absent self-serving concerns such as fear of litigation—that the auditor will accord a good deal of deference to the judgments and choices of their audit client. Well recognized cognitive forces no doubt compromise the auditor's independence. The most dominant force at play is that of self-interest. That is, individuals, even professionals, are not very good at acting impartially when their self-interest dictates otherwise.<sup>52</sup>

The GAO's study of the accounting profession found in its survey of clients, accountants, and academics mixed reports whether the consolidation that began within the industry in the late 1980s had made auditors less independent or otherwise adversely affect the quality of audits. For example, 60 per cent of the large public companies surveyed believed their auditors were more independent post- consolidation whereas 18 per cent believed their auditor's independence had become

<sup>50</sup> The study focused on 1158 firms that, during a 4 month period in 2001, were financially distressed (defined to mean the firm either had negative earnings or operating cash-flows) and within this group assessed whether a firm was less likely to obtain a going-concern qualification if their auditors in comparison to the ratio of non-audit to audit revenues. For a study finding no correlation between earnings restatements and the level of non-audit services provided by the accountants, Raghunandan, Read and Whisenant (2003) find that non-audit fees for 100 firms making earnings restatements not statistically different than larger sample that did not engage in restatements.

<sup>51</sup> The study finding that indicia of earnings management are exceeding forecasted earnings, and the magnitude of various discretionary accruals. Another study found such a correlation, but it was only statistically significant for non-Big Five auditors (Francis and Ke 2002).

<sup>52</sup> For a discussion of the social and psychological forces that can compromise the auditor's independence, see Moore, Tetlock, Tanlu and Bazerman (2005). Audit committees also may suffer behavioral limits when confronted with a reporting crisis, see Beecher-Monas (2003): cognitive dissonance makes it difficult for a committee to revisit its prior decisions and its risk preference may be magnified due to group polarization.

worse (2003a: 41).<sup>53</sup> There are abundant anecdotal reports of professional judgments being so compromised.<sup>54</sup> This indeed is an area where it would not be foolish to trust one's intuition. Doing so, however, has significant implications for considering the social welfare implications of auditors having collateral but dependent relationships with their audit clients (Wyatt 2002):

[T]he loss of a client is a negative in one's career path. Since many decisions required of audit firm managers and partners are judgmental in nature, rather than clearly prescribed by extraneous forces, such judgments are, at the margin, sometimes influenced by perceptions of the attitudes of leaders of a given firm. If those perceptions by firm audit personnel are that the loss of a client is damaging to one's career path, the judgments made may be more in the direction of keeping the client than to achieving the fair presentation of financial statements.<sup>55</sup>

It is also possible to conclude it is myopic to focus so intently on the revenues associated with non-audit services. Audit failures predate the accounting industry's undertaking significant consulting activities (Pitt 2002). Indeed, a good deal of the auditor's independence is compromised by the sheer magnitude of the audit fees associated with a client, especially if they view these fees as a perpetuity (Breedon 2002).<sup>56</sup> With there being few instances historically of firms changing their auditors, the auditors can easily come to view the yearly audit revenues from a client as a perpetuity.<sup>57</sup> So seen, the value of a client relationship can easily be

<sup>53</sup> Of interest is the report of other possible impacts of other factors on audit quality. According to knowledgeable individuals, a variety of factors may have had a more direct impact on audit quality and auditor independence than consolidation. For example, they cited the removal of restrictions against advertising and direct solicitation of clients, the increased relative importance of management consulting services to accounting firms, legal reforms, changing auditing standards, and a lack of emphasis on the quality of the audit by clients and some capital market participants.

<sup>54</sup> For example, in the Enron/Andersen case, an Andersen e-mail reveals that members of the engagement team were concerned about Enron's financial statements, but that same e-mail also cautioned that future work for Enron 'could reach \$100 million per year.' See Mayer (2002). McRoberts and Alexander (2002: 1) quote a former Andersen client who observed, '[T]he more consulting business we did with them, the more companies they would refer to me and the easier their audit partners would be in approving the deals'.

<sup>55</sup> Kaplan (2004: 366–68) details the pressures on the auditor to retain her client.

<sup>56</sup> See also Prentice (2000: 209) review studies reflecting that auditors are more likely to accede to the client's reporting choice when the client is large.

<sup>57</sup> See e.g., GAO (2003b: 1): of 159 respondents to the GAO survey, 37 had switched accountants within 2 years due to the demise of Arthur Andersen, 3 switched accountants within 2 years for other reasons, 10 had switched within past 2–5 years and eighteen had switched within past 6–10 years. This means that the bulk of those surveyed had been with the same accounting firm for more than a decade. This changed in 2003, with slightly more than one-third of the Russell 3000 firms changing auditors (excluding changes caused by the demise of Arthur Andersen) (Krantz 2004). Michaels (2004) reports a study by Glass Lewis regarding 900 auditor changes in 2003.

determined by capitalizing the yearly audit fee at a low discount rate—low to reflect the small likelihood that the relationship will be terminated. This calculus yields a very high dollar value the engagement partner can place on preserving the relationship with the audit client.<sup>58</sup> It is that calculation that underlies the arguments advanced by those who favour the periodic rotation of auditors.

On the other hand, thoughts of strengthening the auditor's independence by mandating the periodic rotation of auditing firms must confront the realities of the marketplace, and more importantly the high concentration levels within the industry. The GAO study found that 88 per cent of those surveyed reported that if required to switch auditing firms periodically they would *not* consider a smaller (i.e., non-Big Four) firm (2003a: 26).<sup>59</sup> This survey is supported by the practices followed by those firms who had been Arthur Andersen clients before its demise in 2002; 87 per cent of the former 1,085 former Arthur Andersen public company clients migrated to a Big Four firm (*ibid.*: 107, Table 10).<sup>60</sup>

Finally, even those who support the belief there are social justifications for auditors to provide consulting services to their audit clients must address the awkward juxtaposition this poses since that the same relationship, if carried out by a director, could prevent a director from being deemed independent as defined by applicable listing and SEC requirements. That is, an ongoing consulting relationship will prevent a director from being considered independent under both the NYSE and Nasdaq listing requirements,<sup>61</sup> but no such prohibition occurs for the

<sup>58</sup> For example, the most recent audit fees Arthur Andersen received from Enron were \$25 million. If viewed as a perpetuity and capitalized at 10%, the value of the Arthur Andersen/Enron relationship to Arthur Andersen is \$250 million.

<sup>59</sup> The study suggests that in light of likely serious costs and difficult to measure benefits of mandatory audit firm rotation the recommended course is to monitor closely the effects of Sarbanes-Oxley Act to determine if enhanced independence of auditors can be achieved through its provisions; GAO (2004) sets forth the questionnaires and summary of responses that were the basis for GAO (2003a).

<sup>60</sup> The number five firm, Grant Thornton, obtained over 30% of the former Arthur Andersen clients who did not engage a Big Four firm.

<sup>61</sup> Under NYSE Rule 303A.02, no director with a 'material relationship' with a listed company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company, is deemed independent. Factors determining whether a 'material relationship' exists include consulting relationships. The board is to determine whether the relationship poses such a conflict; however, the NYSE provides that, among other factors, receipt during the prior three years of more than \$100,000 per year in direct compensation from the listed company (other than director or committee fees) or being an executive officer of a company that receives payments which in any single fiscal year exceeds the greater of \$1 million or 2% of such other company's consolidated gross income. The listing requirements for Nasdaq are slightly different as Nasdaq Rule 4200 reference point is \$60,000 in payments or being a partner, executive or controlling stockholder of an entity that received the greater of 5% of its consolidated gross revenues or \$200,000. We could well find that a audit partner who garnered more than \$100,000 (or \$60,000 for a Nasdaq listed company) as a consequence of sharing in non-audit fees from the audit client would not meet the standard of independence applied to directors. Also, since it is the opinion of the audit firm and not the

accountant unless it falls within one of the limited areas proscribed by Sarbanes-Oxley.<sup>62</sup> Both the auditor and the outside director serve crucial monitoring functions of management's stewardship. However, the auditor's task can be seen as the more demanding and important because the auditor is required to carry out a professional investigation discharged with reasonable care and to attest as to its findings. Just how can we demand of such a person a lower level of independence than we expect of the outside directors who depend on the auditor's services?

#### IV. PRACTICE MEETS THEORY

The evidence is clear that the Big Eight and later Big Five accounting firms collectively transformed themselves from audit firms to business consulting firms that also provided audit services. Their great competitive advantage over non-auditing consulting firms was that the accounting firms could bundle their audit function with their consulting services. By competing with pure consulting firms the accounting firms enjoyed operational efficiencies that flowed from their greater familiarity with their clients' problems and systems. Certainly there is every reason to believe there were operational synergies to be reaped by melding some of the staid audit functions with the early stages of a challenging consulting project. We might also speculate whether they enjoyed another advantage over the pure consulting rivals—the accountants could trade off the quality of their audits to obtain consulting revenues whereas their pure consulting rivals had nothing comparable to put on the bargaining table. As will be seen, the marriage of consulting to auditing poses distinct risks to the auditor's independence and, hence, the overall quality of the audit. To such risks we might question whether the market would not penalize firms whose auditor's independence was perceived as being seriously compromised by the provision of non-audit services. Financial theory supports the view that any such a disclosure risk (i.e.,

individual accountant, the focus arguably should be on the revenues of the audit firm and not the individual auditor. Under this approach, the audit firm's independence would be with reference to the \$100,000 (or \$60,000) figure. Former SEC Chairman Arthur Levitt (2000) also called for stricter standards for auditor independence: 'A public accountant acknowledges no master by the public. But when auditors engage in extensive services for an audit client truly unrelated to the audit, they must now also serve another master—management. In this role, the auditor who guards the integrity of the numbers, now both oversees and answers to management ... [If auditing is a loss leader for valuable consulting] it is becoming more and more difficult to ascertain where one relationship ends and another begins'.

<sup>62</sup> Somewhat related is the notion that an investment by the auditor in its audit client or a direct 'business relationship' disqualifies the auditor, but providing non-audit services does not. See Longstreth (2002: 7): '[If the definition of] "business relationship" does not include audit services' one faces the absurdity of a rule that is absolute in banning financial and business relationships that are utterly inconsequential while appearing to allow any level of non-audit fees to be paid to the audit firm.'

weakened trustworthiness of a company's financial reports) will effectively raise the firm's cost of capital due to investors discounting the traded firm's security market price. Therefore, would not this be a market-based solution to possible abuses so that audit clients would find it in their interest to moderate or eliminate such a discount? Moreover, would not such a pricing dynamic cause some accounting firms to distinguish themselves from their rivals by taking the 'high road' of refusing to certify the financial statements of firms to whom they provided audit services?

Financial theory appears not to have guided the marketing department of any accounting firm. No accounting firms made any effort to enhance its relative reputation for independence and the quality of its audits by refusing to provide consulting services to its audit clients. Instead, each of the Big Eight and later Big Five and now Final Four firms aggressively pursued consulting services with their audit clients. None sought to step aside from the pack by assuring financial statement-users that its audit enjoyed greater independence than that of rivals because the auditor did not provide consulting services to its clients. Instead, all firms pursued the same parallel behaviour of leveraging their audit relationship to expand their profits through the rapid growth of consulting. There should be little doubt that each firm's pursuit of this parallel strategy was made possible by the industry's concentration.<sup>63</sup> In their joint pursuit of consulting, the dominant accounting firms behaved as a cartel and they were assisted in so behaving by the nature of auditing and the questionable goals of their audit clients. The contributions of each of these is examined below.

Auditing is not a service that can easily be commoditized. As seen earlier, the demands each audit assignment invites discrete pricing decisions so that pre-agreed-to pricing by cartel members is not realistic and, correlatively, deviation from an agreed-upon price will be impossible to detect. But more importantly, external assessments by investors of the quality of a particular audit are equally impossible. The inability of financial statement users to determine the quality of an audit makes it highly problematic for market-based forces to either discipline or penalize firms obtaining poor audits. To be sure, the 'markets of lemons' argument is that the market will raise the cost of all firms by an

<sup>63</sup> Professors Macey and Sale (2003: 1177) provide a complementary view of the industry. Two important forces they identify as explaining why auditors in recent years have less concern for their professional reputation are the advent of the LLP form of their doing business and the SEC's commodification of 'independence.' These forces are not, however, independent of the industry's structure since a more competitive structure could be expected to introduce competition among auditors on the basis of their relative reputation and independence.

amount equal to the expected cost of weak audits averaged across all firms. Even this overstates the case for such market discounting. First, not until 2000 was there much disclosure regarding the amount any public firm paid its auditors for non-audit services. Before 2000, investors lacked information whether a specific publicly-traded company engaged its auditors as consultants. And, as will be examined below, today the disclosures that are now required are opaque. Secondly, there are other investor concerns that can be equally compelling bases for compromising the accountant's independence. An example of such a factor is the long-term relationship between auditors and their clients, and particularly the value of that relationship; as seen earlier, the Arthur Andersen/Enron relationship was not just a perpetuity, but a highly valuable perpetuity independent of the consulting fees that accompanied that relationship. Enron in this regard is no different than most public firms where changing accounting firms has long been seen as an infrequent event. Other compromising relationships appear in the degree former auditor firm staff members are now within the client's executive suite. Thirdly, the auditor assigned to the audit or the supervising attorney may wish to obtain a position with the audit client. The lure of a position with an audit client is well understood generally and has long been a potential perk of the sometimes nomadic and underpaid auditor. As a result, the audit personnel may be reluctant to raise with the audit client issues that will jeopardize her obtaining a future position with the client.

Fourthly, poor audits can arise for reasons other than a lack of independence. The quality of the auditors assigned to the engagement may be poor or their supervisors overworked or distracted. The latter is a real fear in light of the evidence, reviewed earlier, that audit fees have declined relative to the size and complexity of their audit clients. Thus, supervisors are responsible either for more audit clients or larger more involved audits than years earlier. Either event erodes the quality of the audit. Factors such as these confound the external assessment of the quality of an audit and the overall trustworthiness of a firm's financial statements so that markets are poor forces to discipline firms for retaining their auditors to provide consulting services. Thus, any market-based penalty that may be imposed because auditors perform auditing services for its client may at best be an obscured impact.

Quite independent of market-based incentives for firms to eliminate or moderate ties the auditors might have that compromise their independence is management's interest in obtaining a 'good' audit. This aspect of the professional issue poses a problem of definition. When we refer to a good audit from whose perspective is this assessment to be made? Management that has an interest in presenting a smoother earnings record, such as was sought by the management at Freddie

Mac,<sup>64</sup> would like an auditor that concurs in the host of accounting choices management makes in reporting the firm's financial performance and position. Similarly, a firm that wishes to report eye-popping double digit earnings growth, such as, Enron (and too many others that have now filled the headlines), will also think a 'good' audit is one with a minimum of second guessing of management's accounting decisions. As seen earlier, when the accountant has a relationship with the client that is seriously bounded with a valuable financial relationship, and especially when that relationship has a low reporting profile such that terminating that relationship is not a reportable event, the relationship necessarily poses a dire risk of impacting the degree of the auditor's independence. Unscrupulous managers, as well as managers who wish accounting decisions that place the best possible spin on the company's financial performance and position, each find a market for audit services that is not professionally independent. In a sense, this dynamic transformed audits from a service that was distinctly tailored to the needs of a client into a commodity. What was standardized was not the audit service, but the attestation that the audit provided. That is, evidence during the last two decades reflects that auditors did not raise their audit fees to assure reasonable staffing of audits. Instead, audit fees were secondary to the pursuit of non-audit revenues. One can only conclude that independence on the part of the auditor was not a valued commodity by either the auditor or its client; clean audit opinions were valued and that was what was sold to the clients.

Not all public companies have engaged in restatements or had their executives accused of cooking the firm's books. And, not all firms retained their auditors to provide consulting services or recruited their auditors to their managerial ranks. We can thus speculate that there might have been a market for a truly independent auditing firm if one wished to step forward by defining itself by what its rivals were not. But no accounting firm stepped forward to claim this niche market. Each of the big accounting firms followed the same course and with great reward to itself. One would have expected that in a competitively structured industry that one area of competition would be on the cornerstone of auditing, the appearance of independence from the client. That did not exist and suggests the strength of the cartel.

<sup>64</sup> In 2003, Freddie Mac announced a forthcoming restatement of approximately \$4.5 billion. The restatement corrected accounting errors from the misapplication of reporting derivatives in 2001 and 2002. Management at Freddie Mac had structured financial transactions for the purpose of smoothing volatility in the firm's earnings. Through the misuse of Treasury securities—falsely characterizing them as derivatives and accounting for them as hedging transactions—Freddie Mac lowered its reported hedging costs. At the end of 2002, it held approximately \$16 billion in Treasuries as debt hedges. Federal regulators later fined Freddie Mac \$125 million for its accounting abuses. See generally, Dwyer and Miller (2003); Barta and McKinnon (2003).



V. THE REGULATORY RESPONSE: ARE WE ON THE RIGHT TRACK?

The procedures and practices to be followed by auditors of public companies have customarily been established by a body within the American Institute of Public Accounting (AICPA), the Public Oversight Board (POB). However, in May 2000, confidence in self-regulation was seriously shaken when the POB was thwarted in its effort to examine the impact on the auditor's independence vis-a-vis its client when the auditors were also providing to their clients substantial non-audit services, such as consulting, tax advice, or computer systems management. In response to this initiative, the AICPA cut off its funding to its POB.<sup>65</sup> Concern for the accounting profession's influence over both accounting principles and auditing standards prompted Congress to include in Sarbanes-Oxley authorization for the Public Company Accounting Oversight Board (PCAOB). Indeed, the formal name of the act includes 'Public Company Accounting Reform.'

Section 101 of Sarbanes-Oxley creates a five-person nonprofit corporation, the PCAOB, that will be led by five individuals who are appointed by the SEC (with the concurring approval of the Secretary of Treasury and Chairman of the Federal Reserve System).<sup>66</sup> Among the duties assigned to the PCAOB is overseeing the registration of public accounting firms (accounting firms cannot audit the financial statements of a reporting company unless the accounting firm is registered with the PCAOB), to establish or adopt rules regarding auditing procedures including auditor independence standards, and to conduct inspections, investigations and disciplinary proceedings. The PCAOB should enjoy greater independence than the predecessor POB because it is funded from a share of filing fees paid by public companies and registered accountants.<sup>67</sup> Incidentally, Congress was also concerned about the independence of the Financial Accounting Standards Board (FASB), the private sector's major authority for accounting principles (i.e., GAAP). Hence, Sarbanes-Oxley provides that a Self-Regulatory Organization (SRO) (here, read FASB) will no longer be considered an authoritative body with respect to GAAP unless, among other features, its funding

<sup>65</sup> The SEC practice section (SECPS) of the AICPA threatened to discontinue funding in May 2000. Following the receipt of its announcement, SEC Chairman Arthur Levitt stated (2000): 'This development is a significant setback to self regulation. Indeed, it raises serious questions as to the profession's commitment to self-regulation.' A storm of protest ensued and the AICPA reinstated funding for the POB. In doing so, the AICPA explained that it did not intend to cut funding for special reviews; it only intended to suspend work until an agreement between the SEC, the POB, and the SECPS was reached. See Tie (2000).

<sup>66</sup> See Sarbanes-Oxley Act, 15 U.S.C. § 7211(e) (4).

<sup>67</sup> See 15 U.S.C. § 7219.

comes solely from filing fees collected by the SEC.<sup>68</sup> The FASB hence has taken its cue and is funded by the fees of SEC registrants.

The PCAOB carries out annual reviews ('inspections') of audit work performed by accounting firms registered with it (an exception exists for once every three years for firms auditing 100 or fewer reporting companies). Copies of the report from each inspection is filed with the SEC as well as state accountancy boards. These reports provide the first basis in the history of the profession for collecting information relative to the quality, and hence deserved reputation, of the major accounting firms. As a self-regulatory organization, the PCAOB has the power to discipline its registrants and, hence, the power to carry out investigations for the purpose of possibly disciplining a registered accounting firm.<sup>69</sup> It may also refer a matter to the SEC for further investigation and enforcement action.<sup>70</sup> Section 107 provides the SEC with oversight responsibility for the PCAOB so that none of its rules become effective without the prior approval of the SEC, and the SEC may amend any existing PCAOB rule.<sup>71</sup>

In the hearings that preceded the enactment of Sarbanes-Oxley, several witnesses testified that the auditing process may be compromised because auditors view their responsibility as serving the company's management and not the full board of directors or, for that matter, the shareholders (US Senate 2002: 31). Auditors who have this perspective of their relationship pose two important concerns. Auditors who understand that their future retention depends on the same managers whose financial statements they are to review will behave accordingly. They cannot be expected to pose strong challenges to the accounting decisions made by management without knowing that by doing so they jeopardize their continuing relationship with the client. Also, auditors who view their professional relationship to be with the company's managers, and not its directors or stockholders, are more likely to view inquiries put to the auditors by the outside directors to be intrusive or simply irrelevant to their engagement.

Concerns related to the independence of the auditors from the company's managers are central to the Sarbanes-Oxley.<sup>72</sup> A key provision of the Act anchors the accountant's relationship in the audit committee

<sup>68</sup> See 15 U.S.C. § 7215 ((c)(4)(6).

<sup>69</sup> See also Public Oversight Board (2003).

<sup>70</sup> See 15 U.S.C. § 7215(b)(4)(B). The SEC's authority to discipline accountants who practice before it coexists with the PCAOB's disciplinary authority; indeed, the SEC's authority in this respect was affirmed in Sarbanes-Oxley. See Securities Exchange Act Section 4C, 15 U.S.C. § 78d-3, added by § 202 of Sarbanes-Oxley Act.

<sup>71</sup> [to come.]

<sup>72</sup> Notably, reform efforts have focused not on the substance of reporting obligations, but on strengthening the financial reporting culture to achieve better compliance with reporting standards. See generally Bratton (2003); Seligman (2002).

and not management.<sup>73</sup> The Act further buttresses its separation of the auditor from the managers by tightening the definition of independence for audit committee members from that embraced just a few years earlier by the Blue Ribbon Committee, mandating that audit committees maintain procedures to address complaints regarding the issuer's accounting, internal controls or other auditing related matters, and empowering audit committees to engage as necessary independent advisors at the issuer's expense.<sup>74</sup> Pursuant to authority set forth in a companion provision, the SEC has adopted criteria for a member of an audit committee to be considered a 'financial expert' and reporting companies are now required to disclose whether its audit committee includes a financial expert, and if not, the reasons for not having such a person on the committee.<sup>75</sup> The importance of financial expertise on the audit committee is supported by a comprehensive study of governance criteria linked to earnings restatements. The study found that mere independence of the board or the audit committee was unrelated to likelihood of a company engaging in an earnings restatement; however, the probability of an earnings restatement are significantly negatively correlated with the audit committee composed of those with an accounting or finance background (Agrawal and Chadha 2002).<sup>76</sup>

<sup>73</sup> See Sarbanes Oxley § 301 (amending § 10A of the Exchange Act, 15 U.S.C. 78f, mandating that the SEC direct that the exchanges and the NASD adopt rules that provide that the audit committee 'shall be directly responsible for the appointment, compensation, and oversight of the work' of the company's auditor). A few months before Sarbanes-Oxley was enacted, both the NYSE and Nasdaq tightened several of their governance requirements in areas that were later dealt with by Sarbanes-Oxley. For example, the proposed listing changes for both bodies' require that audit committees must have the authority to retain and terminate the auditor. This requirement is, as seen above, now reflected in Sarbanes-Oxley.

For the view that anchoring the relationship in the audit committee may not be sufficient, see Cunningham (2004) who provides a thoughtful analysis of the benefits and burdens of auditors being retained by the reporting company's insurance carrier; Ronen (2002) provides a less refined model of the relationship recommended by Professor Cunningham.

Professor Bratton (2003: 482–84) argues the auditor's relationship should be developed from a positive law perspective and not narrowly on the shareholder primacy model so that the accountant's fidelity is to a system of fair, even conservative, reporting as contrasted with an agency model (anchored in the shareholders) where accounting choices are made to present a optimistic image of the firm's financial performance and position.

<sup>74</sup> See Sarbanes Oxley § 301 [?](barring any compensation to the audit committee member except director fees, whereas previously independence existed so long as the amount received did not exceed \$60,000). The SEC does, however, have authority to grant exemptions as it deems appropriate (*ibid.*).

<sup>75</sup> See Section 407 (listing criteria for consideration); Item 401(h) of Reg. S-K, 17 C.F.R. § 229.401(h) (establishing a two-part test for financial expert); Item 309 of Reg. S-K, 17 C.F.R. § 229.309 (requiring disclosure of whether the audit committee includes a 'financial expert'). Investors appear to value financial expertise on the part of audit committee members. Davidson, Xie and Xu (2004) study 136 small public companies that announced appointments to audit committee found significant positive stock price reaction when the new members had financial expertise.

<sup>76</sup> The authors' data also show that the negative correlation is strengthened further if the audit committee includes the company's chief financial officer. They explain the puzzling

Importantly, the SEC's new rules, as well as the listing requirements of the NYSE and Nasdaq, impose a dialogue between the audit committee and the outside accountants for the purpose of eliciting any warning signs in the reporting system or management's disclosure policies and practices. The auditor is to report, among other factors, on material issues that have surfaced in its assessment of the firm's internal controls as well as any discussions it has had with management regarding the firm's internal controls. The auditors must also share with the audit committee written communications it has had with management regarding 'critical' accounting decisions with management as well as identifying 'critical' areas of the financial reports where an accounting estimate or principle change would affect the quality of the presentation.<sup>77</sup> The NYSE and Nasdaq listing requirements also mandate a discussion between management and the audit committee covering a range of topics, including a review of the quarterly and annual reports, earnings press releases, and earnings guidance given to analysts.<sup>78</sup>

Sarbanes-Oxley also restricts the revolving door through which the accountant's staff moved themselves into the managerial ranks of its audit clients. The pervasiveness of the steely eyes of the CFO looking into the glazed eyes of her former *protégé*, now auditor, is reflected in a study that found that among nearly 700 former Arthur Andersen clients one in five had at least one former employee of a major audit firm in the top executive ranks and, upon the demise of Arthur Andersen nearly one-half of the executives of firms formerly audited by Arthur Andersen who previously were themselves formerly in public accounting chose their former accounting firm to become their company's new auditor.<sup>79</sup> The Act, however, fell short of more sweeping steps to secure the accountant's independence. The Act does not bar all consulting for audit clients. Instead it forbids certain consulting to be engaged in and conditions other types of consulting on obtaining prior approval from the audit committee. Furthermore, the Act does not sunset the client-auditor relationship by requiring periodic rotation of audit firms.

result with respect to the CFO being a member of the audit committee as the CFO providing a convenient channel for the flow of pertinent information that enables the committee to be more effective. For further evidence of the positive effects of financial expertise on the audit committee, see Davidson, Xie and Xu, (2004).

<sup>77</sup> See Rule 2-07 of Reg. S-X, 17 C.F.R. § ( ).

<sup>78</sup> For example, the listing requirements of the NYSE call for the audit committee to 'discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.' NYSE Rule 303A.07(c)(iii)(C). See also Nasdaq Marketplace Rule 4350(d).

<sup>79</sup> See Countryman (2002).

VI. THE LIFE OF THE ACCOUNTANT: POST-SARBANES-OXLEY

So what has changed after the enactment of Sarbanes-Oxley Act of 2002? The most tangible measure of change is that audit fees have increased.<sup>80</sup> This is no doubt due to a variety of forces that include increased disclosure demands ushered in by Sarbanes-Oxley and SEC regulations (not all of which are compelled by the Act), greater litigation exposure on the part of accountants due to a post-Enron morality, and a need to replace reduced consulting revenues. As seen, post-Sarbanes-Oxley the accountants have a narrower field of consulting services they can provide their audit clients. Sarbanes-Oxley bars accountants from providing certain non-audit services to their clients and mandates pre-approval by the audit committee for those non-audit services not barred that are to be performed for the client. Nevertheless, reports confirm that auditors continue to earn from their audit clients significant consulting revenues. For example, the *Wall Street Journal's* tally for the thirty companies that make up the Dow Jones Industrial Average showed that in 2002 that 62 per cent of the revenues received by the auditors from their clients were for non-audit services (Bryan-Low 2003c).<sup>81</sup> The reported amount is down slightly from the year before figure of 75 per cent; however, it is unclear what portion of the decline can be attributed to a stagnant economy or, for that matter, an increase in charges for auditing. More recently, consulting fell slightly in 2003 from its year earlier level, but the 2003 decline could also reflect the effects of the first year effects of the SEC's more liberal definition of audit fees, examined later.<sup>82</sup> Investor concerns have caused some companies to terminate consulting projects with their auditors (Bryan-Low 2003b). One front where there is very little evidence that public companies are questing greater independence

<sup>80</sup> See Kimmel and Vasquez (2003) report an average increase of 27% in 2002 for audit fees among Standard and Poor's 500 companies; Glass Lewis & Co. (2004) report overall fees increased 16% from 2002 to 2003, based on information in the proxy statements of 2250 sample companies compared to assets of the sample firms increasing 10% and inflation increasing at 2.3%. It should be noted that audits in 2003 do not report one of the full effects of Sarbanes-Oxley: the heightened disclosures related to internal control evaluations that are mandated by § 404 of the act which do not become effective until 2004.

<sup>81</sup> It should be noted that three of the Final Four accounting firms have spun off their consulting operations. Only Deloitte Touche Tohmatsu has not, recently canceling its efforts to do so because of the inability to finance the spin-off of its consulting operations (Frank and Solomon 2003). The spinning-off of a firm's consultants does not mean that the auditing firm does no consulting. The spin-off involves a range of practice areas, but not all areas are spun-off. The most obvious practice area that continues within the auditing firm is the provision of tax advice.

<sup>82</sup> Plitch and Rapoport (2004) cite a study carried out by Investor Responsibility Research Center of 1652 companies that included most of the Fortune 500 firms that found that in 2003 non-audit fees represented 42% of total fees received by accountants from their audit clients. Weil (2004) reports data for 21 of the 30 companies making up the index, audit fees increased 18% whereas total payments to auditors declined 11%; nonetheless, 48.5% of total revenues paid accountants was due to non-audit services.

in their auditors is on their willingness to change auditing firms periodically. There is yet to appear evidence of a broad movement toward regular rotation of accounting firms. The relationship between auditor and client therefore continues to reflect a perpetuity so that the value of that relationship continues to pose its own challenge to the auditor's independence.

The subject of auditors providing consulting services to their clients is the most sensitive when the focus is tax services. Neither SEC nor PCAOB regulations prevent auditors from providing significant tax consulting services to their audit clients. The sensitivities of this consulting relationship arise on two fronts. First, tax consulting is a significant revenue source for accounting firms with much of that being derived from their audit clients. This consulting service matters a lot to accounting firms. Secondly, there is ample reason to believe that tax services pose a serious threat of compromising the auditor's independence.<sup>83</sup> Although broad SEC requirements warn that auditors are not independent when attesting on their own work,<sup>84</sup> this is a red light easily run by the accountants in the context of tax advice provided to their audit clients. The threat to their independence is particularly significant when accounting firms market 'off-the-rack' tax shelter products to their audit clients and subsequently attest that, among other items, the financial statements fairly present the client's tax expenses and liabilities. As a recent congressional study (US Senate 2003: 15–16) of the US tax shelter industry reported,

KPMG's decision to market tax products to its own audit clients . . . created a conflict of interest. . . [because] the KPMG auditor reviewing the client's financial statements is required, as part of that review, to examine the client's tax return and its use of unusual tax strategies. In such situations, KPMG is, in effect, auditing its own work.

To what extent members of the audit committee have changed their behaviour in the post-Enron era, or in the shadow of the new requirements ushered in by Sarbanes-Oxley, remains to be seen. As seen

<sup>83</sup> Mr Michael Hamersley, a senior audit manager of KPMG LLP, testified before the US Senate Finance Committee that he was placed on administrative leave when he refused to 'sign off' on questionable tax transactions engineered by KPMG's tax consultants. See Bryan-Low (2003c). At that hearing, PCAOB Board Chair, William McDonough, testified that the PCAOB was examining whether the provision of tax services to audit clients compromised the accountant's independence and whether to restrict the tax services an auditor could provide clients (*ibid.*).

<sup>84</sup> SEC (2000) identifies the following four overarching principles to guide determinations of whether an auditor is independent: has the client relationship (a) created a mutual or conflicting interest; (b) call for the accountant to audit its own work; (c) result in the accountant acting as a manager or employee of the client; or (d) place the accountant in an advocacy position for the client?

earlier, the relative percentage of the total revenues auditors garner from their audit clients from consulting has declined in the last few years. However, the decline may not be as great as it first appears. First, as discussed below, the disclosure requirements for non-audit fees became more relaxed in 2003 than they were in 2002, thereby permitting many former non-audit services to be now classified as audit or audit-related services. Secondly, the decline may be a change in scale and not a substantive change in how auditors view their relationship to the audit committee or the firm's shareholders. We might find some solace in the continuing increase in the number of earnings restatements: 2002 marked a record number of earnings restatements, with the number of restatements that year reaching 330, a 22 per cent increase over those for the preceding year (Huron Consulting Group 2003)<sup>85</sup> and only a slight decline to 323 for 2003, with a 28 per cent increase in 2004 to 414 reported restatements (*ibid.* 2005).<sup>86</sup> The restatements may well portend both greater diligence on the part of the auditors as well as a stiffening of their resolve.<sup>87</sup> Each, of course, would be hopeful signs of an improved financial reporting culture.

Post-Enron, the metrics for financial reporting have been strengthened on many fronts. As is now well understood, Enron concealed significant liabilities by its deft and sometimes impermissible treatment of transactions carried out by special purpose entities (SPEs). To address these abuses, the Financial Accounting Standards Board in 2003 issued its interpretation No. 46 'Consolidation of Variable Interest Entities' (FIN 46). The short history of FIN 46 suggests that the reporting culture on this matter remains as disturbing as it was in Enron. One study of more than 500 large companies' financial reports found substantial evidence of non-compliance with the heightened disclosures called for by FIN 46 or a demonstrative lack of transparency in the reporting of their financial

<sup>85</sup> Surprisingly, the number of companies with over \$1 billion in revenues nearly doubled over the number in 2001 (*ibid.*).

<sup>86</sup> Huron argues the rise in restatements for 2004 is likely due to the intense focus by reporting companies and their auditors on the registrant's internal controls as a result of complying with the new internal control reporting requirements mandated by § 404 of Sarbanes Oxley; Huron Consulting Group (2004: 4). Accounting restatements carry their own pain for investors. Palmrose, Richardson and Scholz (2004) study 403 restatements between 1995–9 and find an average negative return of 9% in the two days following the announcement with even greater reaction for restatements involving fraud. A GAO study (2002: 24–26) of 689 earnings restatements between 1 January 1997 and 26 March 2002 found an average three-day market decline following the announcement of 10% which translates to an average \$139 million decline for each of the firms or \$95.6 billion for all 689 firms.

<sup>87</sup> Professor Bratton (2003b: 487) provides the most acute description of the source of restatements: the restatements follow less from regulatory arbitrage than from strategic noncompliance—action under an interpretation of the law in conflict with the stated interpretation of the regulator.

relationship with their SPEs.<sup>88</sup> This should not surprise us since sitting CFOs continue to be under substantial pressure to meet analysts' expectations and report favorably on the firm's stewards, even if this masks the true financial position of the firm. The study's data complements the results of a recent survey of portfolio and fund managers. The survey asked the money managers to rate financial reporting by public companies. They gave financial reporting a weak C+ (AIMR 2003: 1). The survey also identified information about off-balance sheet assets and liabilities as their highest valued disclosure item (*ibid.*: 3). The survey appears to reflect the neglect that FIN 46 has suffered in the executive suites of CFOs.

One area showing no change is that of the politics of accounting and particularly the eagerness with which CEOs and CFOs are willing to exercise their considerable political muscle to shape their disclosure obligations. A key provision of Sarbanes-Oxley seeks to assure that the FASB is independent of the auditor's clients.<sup>89</sup> The Act therefore mandates that no standard-setter can be an authoritative source for accounting standards used in SEC filings unless its funding was derived from fees imposed by the SEC on its registrants.<sup>90</sup> This unquestionably is the most important development in the history of accounting standard-setting. The obvious hope of this provision is that the FASB's agenda or its pronouncements would no longer be influenced by its funding sources as had occurred in the past when the FASB received its funding from a trust that appointed its members to raise funding largely from the accounting profession. Earlier, these purse strings were held by the accounting firms and were the conduit through which their audit clients influenced the FASB's agenda as well as the content of audit standards. But influence from the regulated, certainly at the national level, can come from many levels. Thus, consider the on-going developments in the Congress.

The FASB has announced its intent to adopt a standard requiring the expensing of stock options.<sup>91</sup> Currently, the grant of a stock option is reported only in the footnotes of a firm's financial statements, where disclosure of the estimate value of the option to its recipient is disclosed. The option's value to its recipient is, on the other hand, a cost to the company since this reflects lost opportunity to the company to sell the option to a third party. The FASB has announced that it believes stock

<sup>88</sup> See Glass, Lewis & Co. (2003a)(finding that some companies are keeping the financial items for which they are responsible off their balance sheets via SPEs through liberal interpretation of FIN 46).

<sup>89</sup> See generally Cox (2003).

<sup>90</sup> See Sarbanes-Oxley Act 15 U.S.C. § 7218(b)(1)(iii).

<sup>91</sup> See FASB (2004): options issued by a company are to be reflected at their fair value on its financial statements.



options should be reflected as a charge, i.e., expense, on the company's financials statements. This essentially moves the estimated expense to a more prominent position; the estimates that are currently buried among the firm's financial statements under the standard proposed by the FASB will appear as an expense within the body of the firm's income statement thereby reducing the firm's reported net income for that fiscal period.<sup>92</sup> In adopting this new position, the FASB would be following the position recently taken by the International Accountings Standards Board which recently called for the expensing of stock options.<sup>93</sup>

Reflecting the view that an independent standard-setter is not in everyone's interest, a large group of executives (a significant portion being from the high tech industry)<sup>94</sup> have mobilized their financial muscle to secure passage—by nearly a three to one margin—in the US House of Representatives of HR 3574, 'The Stock Option Accounting Reform Act.' In broad overview, HR 3574 overrides any pronouncement that may be adopted by the FASB with respect to stock options that would require the expensing of stock options except with respect to the CEO and the next four most highly compensated executives. Thus, no expensing would be reported for options given to other employees (i.e., not the five most senior). Importantly, the magnitude of the amount to be reflected as an expense reduced by, among other provisions of the bill, by assuming no volatility in the stock's price. Moreover, small public companies need not expense their options and those that have recently become public enjoy a three-year grace period in reporting the costs of their executives' options. Independent of the social welfare of expensing or not expensing stock options, HR 3574, and more particularly the large congressional support it has gathered (including one of its sponsors, Congressman Oxley himself), raises an even larger issue: the significant compromise to the independence and authority of the FASB should HR 3574 be enacted appears beyond peradventure. The recent experience

<sup>92</sup> The issues that surround this debate are nicely summarized in a letter (Ciesielski 2004) recently directed to the sponsors of H.R. 3574, discussed later in the text: 'The issue of recognizing option compensation expense has been cloaked in many false garbs; options can't be valued properly, jobs will be lost to foreign countries, the stock market will fall if the expense is recognized. At the end of the day, it all comes down to executive compensation that's been shielded from investors' view. You manage what you measure: the stock compensation of the past decade has been not measured well, nor managed well (if at all, in some cases). Putting an expense figure into the income statement for stock compensation enables the markets to monitor the way shareholders' funds are being employed or wasted – not the sort of relevant information that managements would like to see shared freely. You can dress it up in all kinds of arguments about harm to various constituencies, but the bottom line is management resistance to any kind of effective governance by the markets when it comes to compensation.'

<sup>93</sup> See IASB (2004): the fair value of securities granted to employees must be reported as an expense reflecting the value of the securities.

<sup>94</sup> Incidentally, the industry group supporting HR 3574 is the same industry group who provide the momentum to pass the Private Securities Litigation Reform Act of 1995.

with HR 3574 reflects that Sarbanes-Oxley's call for independent funding of the financial reporting standard-setter has not removed the FASB from the political pressures that audit clients can bring to bear on the standard-setting process. To be sure, one positive feature of Sarbanes-Oxley is it has made those pressures more visible. Those exercising influence over financial reporting standards must now do so in a more open setting than heretofore. Nonetheless, the message is the same, namely that significant rents can be collected by politicians willing to support the reporting standards desired by their constituents. The advent of HR 3574, and particularly the executives that support it, is consistent with the fear that when it comes to financial reporting too many executives do not see independence as a desideratum.<sup>95</sup>

Sadly, it appears that Congress is not the lone rent seeker with respect to reporting issues post-Sarbanes-Oxley. The SEC appears also to be influenced by the desires of those it regulates. In January 2003, the SEC amended its disclosure requirements for registrants to disclose (either in the firm's proxy statement or its annual reporting form) the professional fees paid their independent accountants.<sup>96</sup> The 2003 amendments expanded the disclosure categories from three to four categories—(1) audit fees; (2) audit related fees; (3) tax fees; and (4) all other fees—and required disclosure for each of the two most recent fiscal years not just the most recent fiscal year as had been the requirement per its first regulatory foray into this area in 2000.<sup>97</sup> At first blush this appears to be very pro-regulatory since the provisions appear to call for more refined disclosure of the sources of fees paid to a company's auditor. However, several questionable features appear within the details of the 2003 amendments. First, the amendments expanded the definition of items included within 'audit fees,' so that the audit fee rubric thereafter will include all fees relevant to the accountant's discharging their responsibilities pursuant to 'generally accepted auditing standards.' This seems tame enough until one realizes that what is included is not just the fees that are 'billed ... for the audit' but also includes 'services that are normally provided by the accountant in connection with statutory or regulatory filings or engagements.'<sup>98</sup>

<sup>95</sup> Importantly for the position of this chapter, the Big Four accounting firms oppose the legislation and, thus, do not align themselves with many of their clients in opposing the changes the FASB proposes. See Nally *et al.* 2004.

<sup>96</sup> See SEC (2003).

<sup>97</sup> See 15 C.F.R. § 240.14a-101 Item 9 (2003).

<sup>98</sup> See SEC (2003: note 233): '[W]e are expanding the types of fees that should be included in this category to include fees for services that normally would be provided by the accountant in connection with statutory or regulatory filings or engagements. In addition to including fees for services necessary to perform an audit or review in accordance with GAAS, this category also may include services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission.'

The breadth of this is appreciated when compared with the disclosure requirements that preceded the 2003 amendments; between 2000 and early 2003 the audit fee category included only:

aggregate fees billed for professional services rendered for the audit of the registrant's annual financial statements ... and reviews of the financial statements included in the registrant's quarterly reports filed with the SEC.<sup>99</sup>

The 2003 amendments broadened the audit fee category to include comfort letters and consents and assistance with and reviews of documents filed with the SEC.<sup>100</sup>

Secondly, the 2003 amendment adds a new category, 'audit-related fees' that includes professional charges for professional assurances and related services provided by the auditor that traditionally have been carried out by the auditor such as employee benefit plan audits, due diligence related to acquisitions, accounting consultations, audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation, and consultation concerning financial accounting and reporting standards. Prior to the 2003 amendments these charges were set forth under the 'all other fees' rubric.<sup>101</sup> Thus, the 2003 amendments usher in two deregulatory changes for disclosing the relationship the auditor has with its client. First, it expands the 'audit fees' category to include services that are not specifically part of the audit and, secondly, it creates a mongrel category, 'audit-related fees': so that it significantly reduces the number of fees swept into the 'all-other-fees' category. In combination, these changes have provided an opening for important circumvention of Sarbanes-Oxley's pre-approval requirements for non-audit services. With respect to this fear, consider the reaction of a Big Four accounting firm following the 2003 amendments. Ernst & Young's manual instructs its audit clients that for items falling within either the audit or audit-related:

a minimal level of consideration [by the client's audit committee] relating to pre-approval [is required] because they have not been thought to raise independence concerns'.

Ernst & Young further opines for its clients that audit-related services that 'generally improve audit quality and do not impair independence' and are,

<sup>99</sup> See 15 C.F.R. § 240.14a-10-101 (2002).

<sup>100</sup> See block quote above, note [ 1].

<sup>101</sup> See 15 C.F.R. § 240.14a-10-101 (2002).

by definition not the types of 'consulting services' that have given rise to concern about non-audit services in recent years.<sup>102</sup>

We might well question why there should be concern that some of professional fees will be labeled outside the all-other-fees category. Consider the implications of characterizing as 'audit-related fees' due diligence services performed by an auditor in connection with its acquisition of another company. For example, as a step toward approving its acquisition of another company, the client asks its auditor to carry out a due diligence review of the target firm. The auditor's review includes an evaluation of the worth of that firm's assets and the existence, quantity and quality of its earnings and cash flow. Post-acquisition, the same auditor might—in connection to its annual audit—discover that misjudgments or other errors were committed in its earlier due diligence investigation so that absent correction, the financial performance or position of the client will be materially misstated. The purpose of the pre-approval procedures for non-audit services is to allow the audit committee members to assess this risk independently. The purpose of highlighting the cost of these services in the firm's proxy statement or Form 10-K is both to reinforce the seriousness of the audit committee's pre-approval and to alert investors to risks of their auditors carrying out a task that might later pose a conflict of interest that adversely impacts the quality of the company's financial reports. By sweeping such due diligence reviews within the more neutral 'audit-related fees' without separately disclosing the function for which the fees were paid, as would be required for material items within the 'all-other-fees' category, the objectives of both pre-approval and disclosure are weakened.

It remains early in the life of Sarbanes-Oxley and today's reconstituted audit committees. Sarbanes-Oxley and the heightened listing requirements are unquestionably steps that have improved the financial reporting process by strengthening the independence of the auditor.<sup>103</sup> The evidence gathered in Part VI at least raises serious questions whether the reforms have gone far enough. The next section explores what more needs to be done.

<sup>102</sup> See Consumer Federation of America (2003).

<sup>103</sup> Unfortunately, little attention has been focused on whether strong social and psychological forces may prevent the audit committee from rising to the level of detached independence envisioned in today's reforms. For a review of many of these forces and skepticism that the audit committee will fulfill the reforms' objectives, see Beecher-Monas (2003).

VII. SOME STEPS TOWARD IMPROVING THE OLIGOPOLIST AS  
A GATEKEEPER

Part of the solution to improving the trustworthiness of financial reporting is reducing the avenues the accountant can pursue to cheat on the standards otherwise pursued by the accounting industry. Herein is the irony posed by the accounting profession as an oligopoly. In the more typical situation, competition within an oligopoly manifests itself by the cheater reducing its price or providing a superior service for the same price charged by its competitors. The evidence gathered in Part VI suggests that members of the accounting profession could not engage in product quality competition because of difficulties of their client's determining *ex ante* differences in the quality of services provided or because some members of the industry enjoyed an unerodable advantage in terms of expertise and reputation for carrying out audits within certain broad industry classifications. Their real competition was in the more competitive environment of consulting services where they faced each other as well as many non-accounting vendors of consulting services. Here the auditor enjoyed—and could well have exploited—a competitive edge that its consulting competitors could not rival: a pre-existing relationship with the client that afforded it an exploitable commercial advantage because its familiarity with the client's business and potential compromising of its independence in evaluating the quality of the client's financial reporting.

Because of the difficulty of assessing just how significant the information advantage the auditor enjoyed with respect to a consulting project offered by its client, or even the extent it could leverage compromises to its independence so as to reap consulting revenues, it was not possible for competing audit firms to engage in any behaviour except to mimic with their own clients the practices of their competitors. By doing so it did not behave any industry member to pursue a course different from the other big accounting firms and abstain from becoming a consultant to its audit clients.

There is reason to believe that auditing will now play a more important role in revenue growth of the accounting industry in the future. This is because many of the services once provided by the independent accountant are now proscribed by Sarbanes-Oxley, and all but one of the Big Four firms having divested certain features of their consulting services falling within these proscribed categories. The accountants still carry out a wide variety of services that swell their non-audit-related fees to levels greatly in excess of those falling within either the current 'audit' and 'audit-related' categories. Moreover, Sarbanes-Oxley has added a number of significant features to financial reporting so that audit responsibilities and their allied tasks have greatly

expanded. With these rising costs and reduced flexibility to trade off audit quality for consulting, it is propitious to consider whether the cartel problem can be a virtue in the context of financial reporting.

Recall the dilemma each cartel member faces when it learns that a rival is cheating. A key feature to the cartel responding to a cheater is accurate information regarding deviance by a member of the oligopoly. Here we might consider whether the trustworthiness of financial reporting is advanced with more or less information respecting the cost of the audit provided by the auditor. Under the classic formulation, Auditor A who learns that its rival, Auditor B, is selling a product to a client for less than the going price can discipline Auditor B by, for example, matching the price or taking some disciplinary step. As seen earlier, this response is not likely in the case of audit services due to the lack of uniformity of the service offered, the competitive advantage of a pre-existing knowledge of the audit client, and expertise that appears imbedded within some accounting firms with respect to certain important industries.

The solution may be to impose discipline outside the cartel, namely market forces related to the pricing of the audit client's securities. Assuming that markets are sensitive to relationships that might compromise the accountant's independence, enhanced disclosure of those relationships likely will have positive social welfare implications. Comparing the cost of audits with the overall revenues garnered by the accountant from its audit client would better appraise investors and the audit committee of the risks non-audit service revenue poses to the independence of the attest function. This benefit itself should justify returning to the pre-2003 disclosure guidelines regarding disclosure of the composition of the auditor's income from its audit client.

A further weakening of the bond that non-audit services provide to management is to place the award, renewal, or discontinuation of material non-audit services to a reporting company's auditor on the same level as terminating its accountant. If the termination of the auditor as auditor and the termination or engagement of the auditor as consultant were each subject of being reported on Form 8-K it would remove some of the differential advantages non-audit services confers on managers vis-a-vis audit services in its bargaining with the accountants. Because of the additional friction this would pose to public companies, it may well open the consulting opportunities to other accounting firms. This could be the means for the issuer to gain confidence in another accounting firm so that changing accounting firms would be a less daunting task. This could also change the perspective of the company's current auditor so that it may cease viewing its relationship as a perpetuity so that it would have increased concern for its reputation and less for the relationship itself. Audit committees, as seen earlier, have sole responsibility for retention and renewal of the outside accountant. The audit committee is

also charged with evaluating the inputs that produced the financial reports. Sarbanes-Oxley and the listing requirements of the NYSE and Nasdaq in combination seek to mandate a dialogue between the accountant and the committee's members for the purpose of assuring that the audit committee is fully engaged in carrying out this process. For example, the accountant is required to identify the critical accounting estimates and choices used in preparing the financial statements. A significant gap in the audit committee's engagement with the accountant is a standard by which they must measure their compliance with Sarbanes-Oxley and the firm's listing organization. Certainly, more should be required of the committee members than to receive a recitation of the critical accounting choices and estimates. By so limiting the obligations any hoped-for deliberations and conversation with the auditor are vacuous. For the CEO and CFO, the law now demands that they certify in reports filed with the SEC that the financial statements fairly present the firm's financial position and performance. This goes to the heart of financial reporting: the financial statements should reflect the economic realities and achievements of the firm.<sup>104</sup>

Given the temptations that some executives face, one might be cynical regarding the significance executive certifications will be in deterring rogue executives from cooking the books. This explains, in part, the prominent role cast for the audit committee by contemporary corporate governance requirements. A good audit committee will not be satisfied only with a recitation of just what were the critical accounting judgments and estimates. The 'why' and the 'effects' of those judgments will be examined by its members. Such inquiry should be a requirement for all audit committees of reporting companies who should be tasked to satisfy themselves that the choices and judgments made as identified by the auditor result in combination to a fair presentation of the firm's financial performance and position. With this requirement being added to the SEC's regulations, it provides the litmus for the committee members' understanding why they are to inquire as to the firm's critical accounting estimates and judgments. Moreover, it provides a more acute basis for the committee to assess the independence of the auditor. The PCAOB can complete the circle by requiring that part of the auditor's attest function be a separate report that explains why the *critical* accounting choices and estimates that have been made in preparing the financial statements 'fairly present' the company's financial performance and position.<sup>105</sup>

<sup>104</sup> The full significance of this is reflected in the classic case, *United States v Simon*, 425 F.2d 796 (2d Cir. 1969), which holds that mere compliance with generally accepted auditing standards and generally accepted accounting principles do not alone assure that the financial statements are not materially misleading.

<sup>105</sup> This idea was first advanced by Professor Elliot Weiss (2003: 512–14) and calls upon the auditor to (1) identify the critical accounting judgments; (2) describe the factors the auditor

Related to the auditor's independence is the role tax services provided by the auditor might have in compromising the accountant's independence. Recall that fees paid to the auditor for tax services are now separately reported. These fees are significant and continue to be a source of concern both because of their size as well as that they may relate to advice provided on transactions that are also the focus of the attest function.<sup>106</sup> The SEC has broadly proscribed auditors providing consulting services on transactions which auditors will later have to review in discharging a statutory audit. There continues to be concern that this standard is too general so that auditors may turn a blind eye to the possibility that their audit of a transaction is compromised by their earlier providing tax advice for that transaction.<sup>107</sup> While one response is a bar to accounting firms providing tax consulting to their audit clients, this may not be politically possible.<sup>108</sup>

An intermediate solution is to require the accountant to file a report as part of the registrant's proxy statement or annual report describing the five largest (in terms of revenues) tax consulting items provided the audit client and why its audit was not compromised by it having provided such advice. There would be a requirement that the audit committee acknowledge that it had received the report and had reviewed the report with the auditor. In combination, this would provide some useful oversight and caution to the accountant and its client in undertaking this side relationship.

It should be noted that none of the above suggested approaches will induce competitive responses from other members of the accounting industry. They rely upon strengthening the independent voices within the corporation, its audit committee, and facilitating market responses that can discipline issuers by raising their cost of capital. With the product of the accounting industry being a service tailored to the special systems and culture of the client, price competition and quality competition are less visible components. Moreover, the cartel problem may have the

considered in making its assessment of those accounting judgments; and (3) describe how the financial statements are sensitive to those judgments. Forty years ago, then Big Eight firm Arthur Andersen & Co. sought to decouple the fair presentation standard from the requirement that the financial statements be prepared in conformity with GAAP; this change would have permitted the firm to certify financial statements not prepared in accordance with GAAP when the auditor believed GAAP did not fairly present the firm's financial performance or position (Zeff 1992).

<sup>106</sup> Fees paid for tax work in 2003 by Fortune 500 firms represented 43% of audit fees (Glass Lewis & Co. 2003b).

<sup>107</sup> See e.g., Public Oversight Board (2004b): advising PCAOB of the need to develop rigorous standards addressing conflicts of interest that can be posed by tax services provided to audit clients.

<sup>108</sup> See Public Oversight Board (2004c): not preventing the auditor from carrying on substantial tax services for its clients with the major restriction being that it not promote to its clients questionable tax shelters or be rewarded by fees contingent on an outcome, such as favorable treatment by the IRS [?].



perverse effect of causing competitive responses that will lower the quality of the audit or, weaken auditor independence. If either of these were the competitive response then competition would be harmful. Nevertheless, disclosure of the presence or absence of questionable relationships and steps to assure independence of its audit staff may have favorable reputation effects for the practicing firm. To this end, enhanced disclosure can facilitate competition on this basis which would be a positive development. With truly independent and informed audit committees it might be possible for meaningful competition on the quality of services to occur. Certainly, a committee charged with responsibility for overseeing the quality of a firm's financial reporting would not be immune to competing presentations.

The above are but small steps that may well improve the overall quality of financial statements. Even more profound steps in improving the auditor's independence and the concomitant quality of financial reporting would occur if public companies were also required to rotate auditing firms periodically, for example every seven years, and by imposing an absolute bar to non-audit services. Opponents to mandatory rotation assert that this would visit unnecessarily high expenses on reporting companies.<sup>109</sup> A new audit team would face a steep learning curve that could only be surmounted by greater staffing and higher costs than would have been required if the audit were carried out by the auditing firm with a historical relationship with the client. This undoubtedly is true. But these concerns may well be overstated. In 2003 alone, approximately 900 companies engaged new auditors and did so as a matter of choice.<sup>110</sup> For the vast number of these changes, no reason was stated. With there being approximately 17,000 reporting companies, this reflects not less than 5 per cent of those companies changing auditors every year. A mandatory requirement of rotation every seventh year would call for this number to be tripled. We might ask whether such a requirement is such a significant change in scale. Although the number making changes slightly exceeds 5 per cent of all reporting companies, it suggests that a large number of firms can change auditors with no apparent harm to investors. It should be noted that if all firms were required to rotate auditors every ten years that the number of changes in any single year would be roughly double the number that occurred in 2003. Such rotation can be expected to lead to much less concentration within industries. The dominant position that individual Big Four firms

<sup>109</sup> GAO (2004) concludes that prudent course is to monitor and evaluate the effects of Sarbanes-Oxley and other reform efforts on the financial reporting process before incurring the costs and related uncertainties related to mandatory rotation of audit firms.

<sup>110</sup> See Glass, Lewis & Co. (2004). No reason was given for making the change of auditors for two-thirds of the companies. By mid-summer of 2004, the number of public companies changing auditors had already reached the level of 2003 (i.e., 900 companies) (Plitch and Wei 2004).

hold with respect to certain industries would be challenged by other firms realizing that a forced change in auditors provides each with the potential to obtain the business that historically belonged to another firm. This would cause rivals to raid each other's stable of audit partners with the desired experience so as to develop the necessary expertise and critical mass to be a credible competitor.

Removing non-audit revenues from the auditors income from their audit clients would have the salutary effect of forcing auditors to compete on price and quality of their audit services. Competition on quality will be possible by publicly available information that arises from the PCAOB's frequent inspection reports. Audit committees should become students of the results of PCAOB reports, certainly any that are focused on their auditor. Any disclosed systemic weaknesses in the quality of the firm's auditor is a clarion call for the audit committee to assure itself that those weaknesses do not recur with the audit being performed for it. If all accounting firms earn equally qualified or even weak reports, the audit committee's response is not to hide in the complacent bliss that one cannot do better. The correct response is to extract assurances from its auditor that those found weaknesses will not occur with its audit. These foci will introduce competition among accounting firms based on quality and quality assurances, a most healthy and long overdue development.

#### VIII. CONCLUSION

The recent financial and accounting scandals reflect that the accounting industry has performed badly. Not all of its problems are due to its oligopolistic structure. However, its oligopolistic structure facilitated consciously parallel action on the part of large accounting firms that caused each to pursue a strategy of transforming itself into a business that also provided auditing services. True reform of the industry requires sensitivity to how its concentration contributed to its ills. This chapter has set forth both an explanation of the cause and the cures for what ails this gatekeeper.

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