AUDITOR INDEPENDENCE POST SARBANES-OXLEY: THE CASE FOR INCREASED SELF-REGULATION

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> *The independent public auditor assumes a public responsibility ... [The auditor] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog'function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. ...*" [1]

Consider the following scenario. You need a babysitter to watch over your young children. Let us say you have decided that the best method of babysitter selection is for your children to choose and pay the sitter out of a babysitting budget that is built into their allowance. The children have a limited selection of teenagers, but they may choose one with whom they have a friendly relationship. You have also given the children the option of hiring that same sitter to do other jobs for them out of the allowance money, for example tutoring, driving them to social engagements, and cleaning their rooms for them. Let us also assume that these other jobs are much more profitable than is babysitting, making them very attractive opportunities for the sitters. Can you trust your children to choose the most responsible babysitter? Will the teenager your children select choose to be tough enough with them, knowing that the more lucrative jobs will be doled out by the children themselves?

The analogy to publicly traded companies selecting their auditors is clear. The audit is not of direct benefit to the client company, but instead is most needed by the investing public and more generally to support the integrity of the capital markets. But to make its shares attractive in the securities market, the client company desires a favorable audit - irrespective of its accuracy or tendency to mislead - and the client company pays the accounting firm for the audit. Clients also select accounting firms for other work, for example tax and consulting services, both of which are more lucrative to the accounting firms than are the audits.[2] Somewhat counter-intuitively, then, clients have quite a bit of power over their auditors.[3] Most

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[1] United States v. Arthur Young & Co., 465 U.S. 805,817-18 (1984).

[2] *See* Janet Kidd Stewart & Andrew Countryman, *Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices In Question,* CHI. TRIB., Feb. 24, 2002, at Cl. Stewart and Countryman surveyed the 100 largest (based on market capitalization) corporations in the Chicago area, finding that the consulting fees paid to auditors were more than three times as much as the audit fees. At the extreme, Motorola Corp. paid accountants sixteen times the amount of its audit fee in consulting services. *Id.*

[3] *See* Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC s Pursuit of Managerial Accountability,* 79 WASH. U. L.Q. 449, 485-86 (2001) (discussing biases that auditors have in favor of the corporate managers who hire them and interact closely with them). "Nonaudit sources of income from the firm being audited can surely alter the mix of financial incentives that accountants face. *Id.* at 485; *see also* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes- Oxley Act of 2002,* 28 J. CORP. L. 1, 52 (2002), at 13 ("Even the largest accounting firm may have an incentive to overlook misconduct from a client from which it makes significant fees for consulting and other nonaudit work.").

scholars and other commentators opine that the sale of non-audit services to audit clients is bound to affect auditor independence and the integrity of audits.[4]

While it is unlikely that we would allow our children to select their own babysitter, our capital markets system permits client companies to do just that. While the analogy may not be perfect, it exposes the inherent conflict of interest presented when a party is charged with supervising the one who pays the bill and hence the enormous challenge of achieving auditor independence.[5] Indeed, commentators including the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA) have called auditor independence issues "difficult and longstanding."[6]

This article analyzes this conflict of interest, ultimately concluding that, despite recent restrictive legislation, further and increased self-regulation is needed in today's market. Section I is an exposition of the history of auditor independence to the first few years of the new millennium. Section II follows by explaining the provisions of the Sarbanes-Oxley Act of 2002 that implicate auditor independence, as well as the changes to exchange listing rules, new administrative regulations, and professional ethical standards promulgated in that statute's wake. Section III details new auditor independence problems that have surfaced since the enactment of Sarbanes-Oxley. Section IV concludes by making the argument for increased selfregulation by the accounting industry.[7] The alternative is heightened public and

[4] *See, e.g.,* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms,* 84 B.U. L. REV. 301, 322-23 (2004) (describing the substantial non-financial costs to publicly traded companies of changing auditors, and the fact that other consulting services rendered by the auditor's firm provide a "low visibility" means for the client to threaten the accountants); Matthew J. Barrett, *In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley - A Critical Review Symposium Issue: "Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes- Oxley,* 2004 MICH. St. L. REV. 463 (2004) (arguing that tax consulting services ought not be provided by the same accounting firm that audits a publicly traded company). However, at least one scholar has suggested that the sale of non-audit services to audit clients does not affect audit quality at all. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* 114 YALE L.J. 1521, 1536 (2005). And Professor Rick Antle of Yale School of Management has made economic efficiency arguments in favor of permitting audit firms to also provide consulting services. United States Securities & Exchange Commission, Hearing on Auditor Independence, July 26, 2000, Session 3, transcript *available at* www.sec.gov/rules/extra/audmin.htm#session_3 (last viewed Sept. 27,2006).

[5] Professor Coffee suggests that the systemic conflict of interest presented by the fact the client (and not the user of the information) pays the auditor's bill is not particularly problematic in his very description of the traditional role played by the market's "gatekeepers." In ordinary circumstances, these gatekeepers have many clients, no one of which is worth risking the reputational capital carefully built up over decades. Coffee, *supra* note 4, at 308.

[6] "Independence Standards Board to Cease Operations After Making Major Contributions to the Resolution of Difficult and Longstanding Auditor Independence Issues," Press Release 2001-72, July 17, 2001, www.cpaindependence.org (last viewed July 21, 2005).

[7] This is critical given the various and urgent calls for greater liability for accountants, for restructuring the profession even further or for removing the audit function altogether from the purview of public accounting. *See, e.g.,* Peter K.M. Chan, *Breaking the Market's Dependence on Independence: An Alternative to the "Independent" Outside Auditor,* 9 FORDHAM J. CORP. & FIN. L. 347 (2004) (advocating removing the outside audit of publicly traded companies from the private sector); Barrett, supra note 4, T 487 (arguing that "auditors for public companies should focus exclusively on auditing" and should not also provide consulting services, particularly tax consulting, for auditing clients); Coffee, supra note 4, at

media scrutiny, and a stage set for crippling or lethal legal liability and potentially greater government regulation than would be desirable if accomplished from within.

I. History and Auditor Independence[8]

The concept of auditor independence dates back to the 19th Century, when it was based on the British premise that the principal duty of auditors was to oversee the investments of absentee owners in the British Colonies. Auditors were not advocates for the audited entities and were not permitted to invest in or be regular employees of the entities they audited. Interestingly, though, at that time British law permitted auditors to keep the books and prepare the financial statements of the entities they audited.[9]

All that had changed by the early Twentieth Century, which marked the rise of American industry - mining, railroads, energy, communications such as it was (telephone and telegraph) - and the establishment of the stock exchanges. By 1932, Berle and Means's influential work on the agency implications of separate corporate ownership and management had been published,[10] and the role of the accountant was generally accepted to be that of valuing the collective proprietary interest of the corporation so as to serve its needs, rather than those of a specific absentee owner." While banks and wealthy investors usually represented the collective proprietary interest, the general public was gradually becoming more involved in stock

346-48 (suggesting bounded strict liability for audit failures). Admittedly other alternatives, less painftil to auditors, have been suggested. One such proposal is the concept of financial statement insurance as a substitute for traditional financial statement auditing. The accountants would still have their audit franchise, they would just be beholden to a different master, the insurance carrier, whose interests are more aligned with investors'. *See* Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, Boston College Law School Faculty Papers, Paper 16 (2004), *available at* lsr.nel!co.org/cgi/viewcontent.cgi?article=1018&context=bc/bclsfp. Another scholar has suggested that less liability for auditors might encourage more accurate financial statements. *See* A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 LEWIS & CLARK L. REV. 19 (2006). The profession itself is lobbying for some kind of legislated liability cap or, in the alternative, the right to negotiate liability caps with clients. *See* David Reilly, *Booming Audit Firms Seek Shield From Suits*, Wall St. J., NOV. 1, 2006, at Cl. The merits of any of these proposals are outside the scope of this article.

[8] For a more complete discussion of the history of auditor independence issues, *see generally* Sean M. O'Connor, *Be Careful What you Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741 (2004).

[9] This is consistent with the so-called "proprietorship" theory of accounting and auditing, under which view book-keeping is an accounting by the proprietor for his own property. *See* A. C. LITTLETON, ACCOUNTING EVOLUTION TO 1900,191 (3rd ed., 1988).

[10] Adolph Berle and Gardiner Means, The Modern Corporation and Private Property (1932) (rev. ed. 1968).

[11] This is the "entity" theory of accounting. LITTLETON, *supra* note 9, at 191.

ownership.[12] At that time, auditor independence concepts were not formalized into any specific guidelines or rules.[13]

The role accountants were to play in assuring the integrity of the stock market as we now know it would not become cemented until several decades later. But the roots of today's auditor independence concerns had already grown. New corporate and income tax laws in 1909 and 1913 had resulted in burgeoning tax work for both corporations and individuals. Tax accounting thus became the first of the so- called "non-audit" or consulting services that are now so vociferously decried.[14]

Following the enactment of the 1933 Securities Act and the 1934 Securities Exchange Act, the auditors had won their franchise. A major premise of the disclosure-based system enacted in 1933 and 1934 was that the financial statements of public corporations were independently audited.[15] In light of the federal securities laws and the creation of the Securities and Exchange Commission (SEC), auditor independence - at least in principal - took on a whole new meaning. Because of the SEC's efforts to establish standards for financial reporting and auditing, auditor independence now meant objectivity and neutrality in reporting the financial position of the audited entity and the results of its operations, rather than auditing on behalf of a particular interest, whether collective or individual.[16]

Notions of auditor independence in the days following the enactment of the federal securities laws derived from a single SEC regulation that attempted to define what constituted an "independent public accountant,"[17] and from the profession itself. In fact, its self-regulating body, the American Association of Public

[12] C. Richard Baker, *The Varying Concept of Auditor Independence: Shifting With the Prevailing Environment*, CPA J. (Aug. 2005).

[13] Debbie Freier, *Compromised Work in the Public Accounting Profession: The Issue of Independence*, Good Work Project Report Series, No. 35 (July 2004), at 5, *available at* pz.web.harvard.edu/eBookstore/PDFs/GoodWork35.pdf (last viewed Sept. 24, 2006, copy on file with authors).

[14] O'Connor, *supra* note 8, at 783-85.

[15] Section 13 of the 1934 Act, 15 U.S.C. § 78m(a)(2), requires public companies to file annual reports "certified ...by independent public accountants." Registration statements filed pursuant to the 1933 Act must be accompanied by financial statements certified by an independent public accountant or certified accountant. 15 U.S.C. § 77aa(25), (26).

[16] Baker, *supra* note 12.

[17] 17 C.F.R. 210.2-01 (2006) (regulating accountant qualifications). The rule originally promulgated by the FTC before the SEC was given rulemaking authority, provided as follows:

> The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or to whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function.

Freier, *supra* note 13 at 5, *citing* R. G. Berryman, *Auditor Independence: Its Historical Development and Some Proposals for Research*, in H.F. STETTLER (ED.), CONTEMPORARY AUDITING PROBLEMS: PROCEEDINGS OF THE 1974 ARTHUR ANDERSEN/UNIVERSITY OF KANSAS SYMPOSIUM ON AUDITING PROBLEMS, at 1-15 (1974).

Accountants, had been formed in 1887 and was succeeded by the American Institute of Accountants (AIA) in 1917. In 1921, the American Society of Certified Public Accountants, a federation of state societies, was formed. That entity merged with the AIA in 1936, forming the American Institute of Certified Public Accountants (AICPA) we know today.[18] For years, this body set all professional and technical standards for CPAs, including auditor independence standards and Generally Accepted Accounting Principles (GAAP).[19]

After the Great Depression, the profession grew quickly. By 1945, the AICPA had grown to approximately 9500 members (from approximately 1150 in 1916). In 1947, the AICPA adopted the following statement on independence: "Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."[20] Also in 1947, the AICPA Committee on Auditing Procedure promulgated the following oft-quoted general standard on independence, "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors" as part of its Tentative Statement of Auditing Standards.[21]

So, for decades, the focus on an auditor's independence was solely on his or her "mental attitude" - his or her *actual* independence. As time wore on, the SEC in particular[22] began to concern itself with more than just actual independence; it also grew concerned with the *appearance* of independence. It stands to reason that, while instances of actual lack of independence can harm individual market participants, lack of a perception of independence (regardless of whether actual independence exists) shakes investors' confidence and harms the larger market in the form of increased cost of capital.[23] Beginning in the early 1970s, the SEC took an active role in assuring that accountants maintained not only independence in fact, but also independence in appearance.[24]

[18] The AICPA defines itself as "the national, professional organization for all Certified Public Accountants," and states its mission as "to provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients." AICPA, *AICPA Mission Statement, available at* www.aicpa.org/about/mission.htm (last viewed July 12, 2006).

[19] AICPA, *Summary of AICPA Operations*, History of AICPA www.aicpa.org/about/summary.htm (last viewed Sept. 20, 2006).

[20] John L. Carey, The Rise of the Accounting Profession: To Responsibility and Authority, 1937-1969, 182(1970)

[21] Freier, *supra* note 13 at 7.

[22] According to William O. Douglas, Chairman of the Securities and Exchange Commission in the late 1930s and later an Associate Justice of the Supreme Court, the SEC is the investor s advocate. *Douglas Wants A Free Market, He Tells Press*, WASH. POST, Sept. 23, 1937, at 3. This motto has stayed with the agency to the current day.

[23] For a somewhat more detailed treatment of this rationale, *see* Ann M. Olazabal & Elizabeth D. Aimer, *Independence and Public Perception: Why We Need to Care*, 191 J. ACCT. 69 (April 2001).

[24] *See* Guidelines and Examples of Situations Involving the Independence of Accountants Accounting Release No. 126, [1937-1982 Transfer Binder] FED. SEC. L. REP. (CCH) 1)72,148, at 62,306 (July 5, 1972). From that date, the SEC staff began to issue detailed "interpretations," setting forth its views on the issue of the appearance of an auditor's independence. SEC's published guidance on t is issue is quite substantial. *See* Financial Reporting Series, Section 600, Matters Relating to Independent Accountants, 7

In 1973, the Financial Accounting Standards Board (FASB) was created[25] to take over with GAAP standard setting.[26] By then, the AICPA had grown tenfold to 95,000[27] and accounting firms had moved beyond just tax services to consulting in the areas of management and information technology.[28] Congress commissioned a study of auditor independence, concerned that audit firms with lucrative consulting relationships at stake might not be as tough on their clients as they should be.[29] In 1976, the AICPA's blue ribbon investigative commission, led by retired SEC chair Manuel Cohen, recommended that accountants be banned from providing non-audit services to the companies they audited.[30] But its recommendations were never adopted. In 1978, the chairman of the House subcommittee that oversaw the securities industry introduced legislation, the Moss Bill, which would have created an independent, federally chartered commission to oversee accountants that audited public companies. The Moss bill also proposed to increase auditor liability. The bill never got out of the House.[31] The profession so far was successful in beating back any significant oversight on the question of independence.

By 1980, the AICPA had well over 150,000 members.[32] The then-"Big Eight" - Price Waterhouse, Arthur Andersen, Arthur Young, Ernst & Whinney, Peat, Marwick, Mitchell, Coopers & Lybrand, Touche Ross, and Deloitte, Haskins & Sells - were the only firms big enough to audit multinational companies. They held a "comfortable oligopoly," unconcerned by competition from smaller accounting firms, and reluctant to compete with one another.[33] But this did not last forever. In 1977, the Federal Trade Commission, together with the Justice Department, investigated whether the profession's self-imposed ban on advertising violated the

FED. SEC. L. REP. (CCH) 1)1(73,251-73,323 at 62,881-62,930 (1997) (recodifying older releases on auditor independence issues).

[25] FASB was created after the Wheat Commission determined that the old Accounting Principles Board (part of AICPA) was not sufficiently independent. For a cynical view on the sufficiency of FASB's independence, *see* ALEX BERENSON, THE NUMBER 61 (2003).

[26] Thereafter, the AICPA continued to set standards in such areas as auditing, professional ethics, attest services, firm quality control, tax practice, and financial planning practice, until the creation of the Public Company Accounting Oversight Board was created as part of Sarbanes-Oxley in 2002. *See infra* notes 55, 69-80 and accompanying text.

27 BERENSON, *supra* note 25 at 113.

[28] In fact, as early as the mid-1950s, some firms were providing "management advisory services," and "administrative services" before the term "consulting" had been coined. *See* Freier, *supra* note 13 at 9.

[29] A 1976 Senate report on accounting found that consulting work "creates a professional and financial interest by the independent auditor in a client's affairs which is inconsistent with the auditor's responsibility to remain independent." BERENSON, *supra* note 25 at 116.

[30] *Id.* at 62, 116.

[31] *Id.* at 63.

[32] MARK Stevens, The Big Eight 8-9 (1981).

[33] BERENSON, *supra* note 25 at 111-113.

antitrust laws. In the face of a possible suit by the FTC, the AICPA repealed many of its marketing prohibitions.[34]

As competition heated up among the Big Eight, the firms swiped each others' clients, cut their fees, and raced to grow their non-audit businesses.[35] By the mid-1980s, consulting revenues had grown to 20% at most of the Big Eight, and 30% at Arthur Anderson. A decade later, consulting services accounted for more than 50% of revenues at several of the Big Eight firms, while audit revenues at some of the firms were down to a paltry third.[36] Auditing was becoming a "loss leader" to more profitable consulting services.[37] Throughout this era, many openly wondered again whether auditor independence would suffer.[38]

The Big Eight became the Big Six.[39] According to some, these were no longer professional accounting firms with consulting arms, but instead "professional service organizations, using audits as a way to sell consulting and tax advice."[40] The cultural change that came with the transition from self-regulated professional partnerships to competitive industry behemoths was inevitable. While partners were not explicitly told to sacrifice their neutrality to win business, the prevailing compensation structures clearly rewarded rainmakers, relationship men, and crosssellers of consulting services.[41]

In June of 1997, the SEC joined with the Big Six and the AICPA to form the Independence Standards Board ("ISB").[42] The ISB was charged with review of the existing independence regulations and with promulgation of standards for determining auditor independence via a public process.[43] Rather than identifying any standards, though, that body - which was composed of four accounting members and four public members - instead developed a "framework" for auditor independence. This was a "threats and safeguards" approach that recognized certain conduct as

[34] *Id.* at 114.

[35] Lee Berton, *Total War: CPA Firms Diversify, Cut Fees, Steal Clients in Battle for Business - 'the White Gloves are Off as Revenue is Squeezed.* Wall St. J., Sept. 20, 1985, at A1.

[36] Berenson, *supra* note 25 at 117.

[37] Barrett, *supra* note 4 at 469.

[38] Berenson, supra note 25 at 117, quoting a 1987 FORBES magazine article as follows: "When a company lavishes huge consulting and advisory fees on its accountants for services unrelated to the actual auditing of financial statements, the accounting firm may be less likely to ask tough questions about a client's financial health." *See also* Berton, *supra* note 35 (reporting that "many in the profession, government, and the academic world ... worry that firms may get so cutthroat that they will fall down on what many see as their primary duty: independently auditing the books of publicly held companies. The biggest potential loser is the public, these critics argue.")

[39] Arthur Young sold itself to Ernst & Whinney, forming Ernst & Young, and Price Waterhouse merged with Coopers & Lybrand to form PricewaterhouseCoopers.

[40] BERENSON, *supra* note 25, at 119. *See also* Coffee, *supra* note 4 at 321 (2004) (describing the practice, prevalent in the Big Five in the 1990s, of using the audit function "principally as a portal of entry into a lucrative client.")

[41] *See, e.g.*, BARBARA LEY TOFFLER, FINAL ACCOUNTING 51,59 (2003).

[42] Commission Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence, SEC Financial Reporting Release No. 50 (Feb. 17,1998).

[43] William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L. Q. 519, 522 (2002); Paul Brown *et al., Administrative and Judicial Approaches to Auditor Independence*, 30 SETON HALL L. REV. 443, 445-46 (2000).

threatening independence but did not prohibit it as long as certain safeguards were in place.[44]

The SEC did not adopt the ISB's recommended framework, instead choosing to revise its own auditor independence rule.[45] Revised Rule 2.01 of Regulation S-X[46] established a non-exhaustive list of services that, if performed by auditors, would constitute a *per se* impairment of their independence, with some exceptions. These include bookkeeping services, financial information systems design and implementation, appraisal or valuation services, fairness opinions, actuarial services, internal audit services, management functions *(i.e.*, acting either temporarily or permanently as a director, an officer or other employee, or otherwise in a managerial decision-making, supervisory, or ongoing monitoring function); recruiting and other human resources functions, underwriting or promotion of a company's securities, and legal services.[47] Notably, the amendments to the rule did not prohibit tax consulting.[48]

In any event, the horse was already out of the bam. By the turn of the millennium, shoddy auditing practices from the late 1990s were revealed and financials restated, all to the detriment of shareholders.[49] The market bubble ultimately burst with the spectacular implosions of Enron and WorldCom.[50] Former SEC chairman Arthur Levitt attributed these failures (and the ensuing damage to the public and investor confidence) to auditor conflicts of interest, summing up the profession's independence problem in the context of Enron's failure:

[44] Allen & Siegel, *supra* note 43, at 523-540 (describing the ISB's Conceptual Framework for Auditor Independence).

[45] The ISB was dissolved effective July 31, 2001, apparently having fulfilled its mission. The stated mission of the ISB had been "to initiate research, develop standards, and engage in a public analysis and debate of auditor independence issues." *Independence Standards Board to Cease Operations After Making Major Contributions to the Resolution of Difficult and Longstanding Auditor Independence Issues*, Press Release 2001-72, July 17,2001, *available at* www.cpaindependence.org/ (copy on file with authors).

[46] SEC, Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,039.

[47] ARTHUR LEVITT, TAKE ON THE STREET 128 (2002)

[48] William R. McLucas *et al., The Battle Over Auditor Independence and the SEC's Recent Rule Proposal,*

2 32ND ANN. INST, on Sec. Reg. 459,467 (2000).

[49] *See* Levitt, *supra* note 47 at 139 (opining that "Accountants are now in the embarrassing position of having to explain Enron's bankruptcy, Arthur Andersen's disintegration, and the record $10 million fine Xerox agreed to pay in 2002, without admitting or denying guilt, for overstating revenues by more than $2 billion from 1997 to 2000. That's just for starters."). *See also* Coffee, *supra* note 4 at 312-315 (analyzing several studies on restatements and concluding that "the magnitude of financial restatements increased, both in absolute terms (nearly doubling) and as a percentage of the issuer's rapidly increasing market capitalization" during the period 1997 to 2001-02, and that this was the product of acquiescence by auditors and other gatekeepers in aggressive accounting policies favored by management of publicly traded companies). For a more colorful description of the epidemic of restatements during that period, see Arianna Huffington, PIGS at THE trough 174 (2003) (describing the many restatements of financials of publicly traded companies between 1997 and 2003 as the "Ebola virus of corporate America.")

[50] *See generally,* ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2002).

> I think it's fair to say that Andersen's independence was compromised. Andersen had been acting as Enron's internal auditor, as well as its independent, outside auditor. This meant that Arthur Andersen was, at times, reviewing its own work rather than acting as an impartial check on the accuracy of the client's figures.
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> And, whereas Andersen was paid $25 million for its audit work, it received even more than that - $27 million for nonaudit services. According to internal memos, Anderson expected total Enron fees eventually to grow to $100 million, making Enron its largest client by far. Finally, many Andersen employees over the years became Enron employees, working in the auditing and finance departments. Andersen auditors, then, were reviewing the work of former bosses and friends.
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> As bad as this [$60 billion in investor losses and 5000 lost jobs at Enron, while Enron executives profited by over $1.2 billion in stock options cashed in prior to the company's collapse] is, the loss of investor confidence in audited numbers is much worse.[51]

Lengthy congressional hearings in the summer of 2001 into the causes of the series of stunning frauds suffered by the market at that time resulted in the passage of the Sarbanes-Oxley Act on July 30, 2002 ("SOX").[52]

With the demise of Arthur Andersen following its criminal prosecution related to Enron's collapse,[53] the Big Five were now the Big Four we know today: Deloitte Touche Tomatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers. The current landscape is marked by fewer players and more regulation vis-à-vis auditor independence. Accountants auditing publicly traded companies are now governed not only by AICPA's professional ethics and SEC regulations, but also by explicit provisions of SOX and its attendant new regulations, changes to the exchange listing rules, and the rules of the Public Company Accounting Oversight Board (PCAOB), all of which are more folly discussed in the next section.

II. Auditor Independence *Post* Sarbanes-Oxley

The legislative history of SOX identifies the statute s auditor independence provisions as being "at [its] center."[54] SOX affects auditor independence in two primary ways. First, it contains substantive provisions and related regulations and rule changes. Second, it effected some structural reform by creating the Public

[51] LEVITT, *supra* note 47, at 142-43

[52] Public Company Accounting Reform and Investor Protection Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of the '33 and '34 Acts).

[53] *See* Arthur Andersen **LLP** v. U.S., 544 U.S. 696 (2005).

[54] *See* S. Rep. No. 107-205, at 14 (2002).

Company Accounting Oversight Board (PCAOB), a private not-for-profit institution, to oversee the provision of audit services to publicly traded companies.[55]

SOX's substantive provisions related to auditor independence were aimed at auditors of publicly traded companies, as well as directing the SEC to establish rules that affect the listing requirements of the stock exchanges related to the audit process. The targeted provisions in SOX relate to (1) prohibited services by auditors (2) public company audit committees and pre-approval requirements, (3) audit partner rotation and conflicts of interest. These SOX-related changes to auditor independence rules are discussed more fully below. Subsequent subsections discuss the SEC's implementing regulations and the inroads the PCAOB has made regarding auditor independence.

A. *Substantive Provisions of SOX Affecting Auditor Independence*

1. Prohibited Services

SOX prohibits the auditor of a public company from also providing any of a list of non-audit services contemporaneous with the audit.[56] These prohibited services include financial information systems design, management services, and legal services, but significantly, the list does not prohibit the audit firm from providing non-audit related tax consulting.[57]

2. Audit Committees & Pre-approval Process

SOX as a whole places much emphasis on the role of the board of directors of the publicly traded company in improving corporate transparency and protecting investors. Indeed, in the area of auditor independence, consistent with the tenor of the legislation generally, SOX emphasizes the role of the audit committee of the board of directors of the securities issuer who is the audit client. First, SOX requires the SEC to prohibit the securities exchanges (and NASDAQ) from listing companies that do not have a separate audit committee on their board of directors.[58] Further, SOX focuses on the composition of the audit committee, requiring that each member of the audit committee be "independent."[59] Independence of audit committee

[55] *See* SOX § 301, codified at 15 U.S.C. § 78j-l(m). The SEC issued final rules on April 9, 2003, and approved the new listing standards promulgated in accordance therewith on Nov. 4, 2003. *See* Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18,788 (April 16, 2003): Self Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141), 68 Fed. Reg. 64,154 (Nov. 12, 2003).

[56] *See* SOX § 201, codified at 15 U.S.C. § 78j-1 (g).

[57] *See id.*

[58] *See* SOX §301.

[59] Audit committees composed of outside directors as a way to strengthen auditor independence had been recommended as early as 1972. Accounting Series Release No. 123; Securities Act Release No. 5237 (March 23, 1972).

members is defined as "not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof."[60] Additionally, SOX mandates that the audit committee have responsibility for the selection, compensation, and oversight of the company's audit firm.[61]

SOX also requires auditors for public companies to report to the company's audit committee in a timely fashion about any critical accounting policies and practices affecting the company's financial statements, any and all alternative treatments within generally accepted accounting principles that the auditor has discussed with management, any accounting disagreements between management and the auditor, and any other material written communications between the auditor and management.[62]

Finally, it is the audit committee that must pre-approve both audit and nonaudit services provided by the auditor to its public company client.[63] In addition to satisfying SOX's pre-approval requirements, issuer clients must disclose the amounts they paid to their auditors for the various types of services.[64]

3. Audit Partner Rotation and Conflict of Interest Provisions

In an effort to avoid entrenchment and to reduce possible conflicts of interest - either in fact or appearance - SOX requires the lead partner and reviewing partner of the auditor to rotate at least once every five years.[65] And, in a related vein, SOX dictates that a number of top officers of the client company not have been

60 *See id.*

[61] *See id.* SOX also mandates that the exchanges' standards require listed companies to establish procedures for their audit committees to handle complaints about accounting, internal accounting controls, or auditing matters; to authorize the audit committee to retain independent counsel and other advisors; and to provide appropriate funding to pay for the independent audit and to compensate any advisors. SOX § 301, codified at 15 U.S.C. § 78j-l.

[62] SOX § 204, codified at 15 U.S.C. § 78j-l(k).

[63] *See* SOX § 201, codified at 15 U.S.C. §§ 78j-l. In this regard, SOX follows up the SEC's efforts in 2000 that would have required companies, among other things, to report in their proxy disclosures aggregate audit and non-audit related fees. *See* Final Rule: Revision of the Commission s Auditor Independence Requirements, 65 Fed. Reg. 76,009 (Dec. 5,2000).

[64] *See* SOX § 202, codified at 15 U.S.C. § 78j-l(i)(2).

[65] *See* SOX § 203, codified at 15 U.S.C. § 78j-l(j). SOX directed the Comptroller General to study the potential effects arising from requiring mandatory audit firm rotation *See* SOX § 207, codified at 15 U.S.C. § 7232. Following the enactment of SOX, the General Accounting Office submitted a comprehensive report summarizing its survey of CFOs of more than 1,150 public companies, the au it committees at those companies, and more than 600 auditing firms. *See* U.S. GEN. ACCTG. OFFICE, PUBLIC Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216, at 3, 4, 8 (2003), *available at* www.gao.gov/new.items/d04216.pdf (last visited Nov. 12, 2005; copy on file with authors). Interestingly, the GAO report concludes that costs of increased audit fees due to loss of institutional knowledge acquired by a public company s previous au itor are likely to outweigh any benefits of enhanced auditor independence achieved by mandatory audit firm rotation. *See id.*

employed by its auditor within the year preceding the audit. These include the company's CEO, Controller, CFO, and Chief Accounting Officer.[66]

B. *The SEC's Implementing Regulations*

On February 5, 2003, the SEC promulgated its final regulations implementing SOX's auditor independence provisions as described above. The SEC's new rules also included a provision that an accountant would not be independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review, and attest services.[67] This appears to mirror the provisions that prohibit securities analysts from being compensated for attracting investment banking business.[68]

C. *The PCAOB*

SOX created the PCAOB for purposes of establishing "ethical standards to be used by registered public accounting firms in the preparation and issuance of audit reports."[69] The stated mission of the PCAOB is to be "a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports."[70]

The PCAOB initially adopted the independence standards of both the AICPA and the ISB on an interim basis.[71] This is significant, because it shows that, except for some minor adjustments, the PCAOB merely maintained standards developed by the AICPA and the ISB, which was itself an AICPA-controlled organization. These were the same standards that were in place as Arthur Anderson audited Enron and when many other audit-related scandals occurred. They apparently did nothing to prevent or discourage improper relationships and harmful behavior.

[66] *See* SOX § 206, codified at 15 U.S.C. § 78j-l(l).

[67] 68 Fed. Reg. 6006 (2003).

[68] *See* SOX § 501, codified at 15 U.S.C.A. § 78o-6.

[69] PCAOB Briefing Paper "Board Considers Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees," July 26, 2005, *available at* www.pcaobus.org/Rules/Docket_017/- 2005-07-26_Adopting_Brief.pdf (last viewed Sept. 15, 2006.

[70] PCAOB website, www.pcaobus.org

[71] Public Company Accounting Oversight Board Bylaws and Rules - Rules - Professional Standards; Rule 3600T Interim Independence Standards (as of Sept. 8, 2004). www.pcaob.org/Standards/- InterimStandards/index.aspx

Thereafter, in July 2005, the PCAOB enacted new rules regarding ethics and auditor independence.[72] These were approved and adopted by the SEC effective April 19,2006.

The PCAOB's new rules do further restrict auditor activities that will be permitted, while still allowing for an audit firm to be considered independent of a particular client. However, the audit firm may still offer tax consulting to its clients, with some restrictions. Auditors will not be considered independent if they provide tax services on a contingent fee basis;[74] if they provide marketing, planning, or opinions in favor of the tax treatment of a confidential transaction or an aggressive tax position;[75] or if they provide tax services to a person who is in a client's financial reporting oversight role or an immediate family member of such a person.[76]

In an attempt to strengthen firm independence, PCAOB Rule 3524 places additional requirements on registered public firms[77] in connection with the SOX- mandated audit committee pre-approval of permissible tax services. Accounting firms must describe the proposed tax engagement in writing, discuss potential effects of the services on firm independence with audit committees, and document those discussions.[78]

The PCAOB also has dictated that persons associated with a registered public accounting firm should not cause the firm to violate relevant laws, rules, and professional standards due to an act or omission that the person knew, or was reckless in not knowing, would directly and substantially contribute to such violation.[79] Another rule includes a general obligation requiring audit firms and auditors to be independent of firm clients.[80] These provisions together appear to

[72] PCAOB, *Board Adopts Standard on Remediation of Material Weaknesses, Rules on Auditor Independence and Tax Services,* News and Headlines, July 26, 2005, *available at* www.pcaob.org/- News_and_Events/News/2005/07-26.aspx (last viewed Sept. 15,2006).

[73] SEC Release No. 34-53677, *available at* www.sec.gov/rules/pcaob/2006/34-53677.pdf (last viewed Sept. 25, 2006).

[74] PCAOB Rule 3521, Contingent Fees, *available at* www.pcaob.org/Rules/Rules_of_the_Board/- Section_3.pdf (last viewed Sept. 15, 2006).

[75] PCAOB Rule 3522, Tax Transactions, *available at* www.pcaob.org/Rules/Rules_of_the_Board/- Section_3.pdf (last viewed Sept. 15, 2006).

[76] PCAOB Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles, *available at* www.pcaob.org/Rules/Rules_of_the_Board/Section_3.pdf (last viewed Sept. 15, 2006).

[77] A "registered public accounting firm" is "a public accounting firm registered with the Board in accordance with this Act." Sarbanes-Oxley Act of 2002, Sec. 2(aX12); Public Company Accounting Oversight Board Rules, Rule 1001(r)(i), *available at* www.pcaob.org/Rules/Rules_of_the_Board/- Section_l.pdf (last viewed Sept. 15, 2006). It is "unlawful for any person that is not a registered accounting firm to prepare or issue, or to participate in the preparation or the issuance of, any audit report with respect to any issuer." SOX § 102(a).

[78] PCAOB Rule 3524, Audit Committee Pre-Approval of Certain Tax Services, *available at* www.pcaob.org/Rules/Rules_of_the_Board/Section_3.pdf (last viewed Sept. 15, 2006).

[79] PCAOB Rule 3502, Responsibility Not to Cause Violations, *available at* www.pcaob.org/Rules/- Rules_of_the_Board/Section_3.pdf (last viewed Sept. 15, 2006).

[80] That rule provides: "A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement pen . _

Rule 3520, Auditor Independence, *available at* www.pcaob.org/Rules/Rules_of_the_Board/Section_3.pdt (last viewed Sept. 15, 2006).

operate as a catchall to prevent any other violations that are not already specifically enumerated.

IV. CONTINUED AUDITOR INDEPENDENCE CONCERNS

Altogether, these new rules and increased scrutiny are necessary and appropriate, but they fall far short of repairing investor confidence. Auditors lost most if not all of their substantial and longstanding reputational capital during and just following the stock market bubble of the 1999-2002 era.[81] And they have done precious little to date to regain it. This is evidenced by the fact that, despite additional rules, regulations, and changes to listing requirements and the creation of a new private watchdog entity, auditor independence and non-audit related scandals continue to be revealed on a regular basis.

This is the subject of this section, which discusses the remaining impact of old (pre-2000) audit problems and auditor independence violations, new (post-2000) violations of auditor independence, and other scandals that have surfaced in the last few years that are not directly related to auditor independence, but create at least an appearance of impropriety with respect to the accounting profession. The fact that accountants have yet to learn their lesson with respect to the need for independence in both fact and appearance, coupled with the regulatory status quo and continued cross-selling of consulting services by auditors, build the argument for immediate, tough, and very public self-regulation in the area of independence.

A. *Old Audit Problems and Independence Issues Still in the News*

Despite of all of this new regulation surrounding auditor independence, the reverberations of the audit misdeeds and auditor independence violations that bred the scandals of the turn of the millennium continue to be felt. For example, in May 2004, PricewaterhouseCoopers agreed to pay $50 million to settle claims relating to its role as outside auditor of Raytheon Company in a securities-fraud class-action suit arising out of its having issued a clean audit opinion for 1998 financial statements.[82] In October 2004, KPMG settled with the SEC charges of improper professional conduct in the audit of Gemstar-TV Guide International, Inc.[83] According to the SEC's investigative findings, KPMG performed inadequate verification and also allowed Gemstar to record revenue in the absence of actual customer agreements, both clear audit violations. The firm agreed to pay Gemstar investors $10 million and to increase training for auditors. The SEC suspended the KPMG accountants who worked on that audit. In a separate matter that same month,

[81] *See* Coffee, *supra* note 4, at 326 (concluding that this is the case for one of two reasons: either they risked and lost it in order to capture extraordinary gains in the short run, or it simply ceased to matter in a bubble market because investors are less skeptical and gatekeepers are viewed as mere formalities).

[82] News From the Office of the New York State Comptroller, Press Release, May 25, 2004, *available at* www.osc.state.ny.us (last viewed Aug. 14,2005).

[83] Jonathan Weil, *KPMG is Censured in Gemstar Matter,* WALL ST. **J.,** Oct. 21, 2004, at A3.

KPMG and its affiliate in Belgium agreed to pay $115 million to settle a shareholder lawsuit in connection with a defunct Belgian company.[84]

Ernst & Young (E&Y) was sanctioned by the SEC in April 2004 for compromising independence by entering into a joint venture with PeopleSoft Inc. while serving as that entity's outside auditor in the late 1990s. The SEC issued a cease-and-desist order, barred the firm from adding new clients for six months,[85] and assessed a fine of $1,686,500.[86] Additionally, the SEC ruling required E&Y to retain an independent consultant to implement procedures and policies to remedy the violations, as well as to become compliant with the Commission's rules on auditor independence.[87] Interestingly, the chief administrative law judge of the SEC who wrote the decision noted that E&Y's "National Director of Independence," Edmund Colson, was the chief accountant of the SEC before joining E&Y.[88]

B. *New Auditor Independence Violations Garner Substantial Media Coverage*

Worse yet, new blatant auditor independence violations are being reported all too often.

For example, in October 2004, Ernst & Young reported to federal regulators that the firm had found at least seven new possible conflict-of-interest violations in its audit practice.[89] This Big Four international accounting firm has admitted that it continues to violate auditor independence regulations despite numerous sanctions, shareholder lawsuits, and increased regulation. The SEC is investigating whether Ernst & Young's independence was impaired when it paid $377,500 to a consultant who was also serving on the boards of three companies it audited.[90] The fees were paid from December 2002 through April 2004."

In August 2004, the SEC reported that KPMG had accepted tax fees from audit clients on a contingency basis, creating a potential conflict of interest. Under SEC rules, auditors are barred from entering into such fee arrangements with audit clients. The SEC's chief accountant, in a letter to Bruce Webb of the AICPA and then again at a PCAOB Roundtable in June 2004, warned the major audit firms to stop charging contingency fees for tax work.[91] [92]

84 Id.

85 SEC, Initial Decision Release No. 249, In the Matter of Ernst & Young LLP, April 16, 2004, *available at* www.sec.gov/litigation/aljdec/id249bpm.htm (last viewed Sept. 27, 2006).

86 *Id.* at Section VII.B.

87 *Id.* at Section VII.C.

88 *Id.* at Section III.

89 Shire Ovide & David Enrich, *Ernst Find Possible Infractions,* Wall St. J., Oct. 8, 2004, at A7.

90 Joann S. Lublin & Jonathan Weil, *Ernst & Young Faces Informal SEC Inquiry of Consultant s Pay,* Wall St. J., June 8, 2004, at Cl.

91 *Id*

92 Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission,.*Opening at the PCAOB Auditor Independence Roundtable on Tax Services,* Washington, DC., July 14, *available at* www.sec.gov/news/speech/spch071404dtn.htm (last viewed Sept. ,)•

In an almost incredible display of hubris, even after being warned twice regarding the contingent fee issue, KPMG misrepresented the SEC's position to its clients. The SEC's chief accountant chastised KPMG's chief executive for misquoting him in a public statement that the firm mailed to all KPMG clients in August 2004. KPMG incorrectly told its clients that as long as the firm complied with certain rules regarding contingent fee arrangements, the SEC would not challenge independence in the arrangement. The SEC chief accountant stated in his letter to KPMG,

> I made no such statement. Furthermore, the Commission has not made a decision regarding its position on these matters in respect of auditing firms. I expect that you will convey the substance of this letter to your clients and correct any misunderstanding or misperception resulting from your statement.[93]

This is just a sample of the auditor independence problems currently plaguing public accounting as the profession continues to shrug off media scrutiny and the threat of additional regulation, steadfastly refusing to accept that appearances may be just as important as reality when it comes to auditor independence.

C. *Other Accounting Public Relations Nightmares*

In another major scandal, in early 2004, three of the Big Four accounting firms were discovered to have profited by seeking travel reimbursements from private clients greater than the actual amounts expended. When challenged, the firms initially denied the behavior; when sued by investors, they fought back, trying to block the suit from becoming certified as a class-action.[94] E&Y eventually settled its part in the case for $18 million and changed its policy to billing for actual travel expenses only.[95] PricewaterhouseCoopers settled for an astounding $54.5 million,[96] while KPMG and its consulting unit, Bearing Point, settled for $34 million.[97] The Justice Department undertook a separate civil investigation.[98] And, in early 2006, Ernst & Young, KPMG, Bearing Point, and another large consulting firm, Booz Allen Hamilton, paid over $25 million to settle claims that the firms overcharged the government for travel expenses.[99]

[93] Diya Gullipalli, *KPMG is asked by SEC Auditor to Correct Statement to Clients*, WALL St. J., Sept. 21, 2004.

[94] Jonathan Weil, *Moving the Market: KPMG and Former Unit to Settle Travel-Bill Suit for $34 Million*, Wall St. J., Apr 5, 2004. at C.3 (hereinafter "KPMG to Settle").

[95] Jonathan Weil, *Ernst & Young Agrees to Settle Travel-Billing Suit*, WALL St. J., Sept. 16, 2004, at C3 (hereinafter "Ernst & Young to Settle").

[96] *PwC Settles Travel Billing Case*, The Practical Accountant, Vol. 37, Issue 2, Feb. 2004, at 6.

[97] Weil, KPMG to Settle, *supra* note 94.

[98] Weil, Ernst & Young to Settle, *supra* note 95.

[99] Bloomberg News, *4 Big Accountants Settle Federal Suits*, N.Y. TIMES (Jan. 6, 2006) at C2 (briefly describing the federal qui tam suit initiated by a whistleblower).

In July 2004, KPMG's chief financial officer and former head of tax operations resigned during a probe by the IRS and Justice Department into the allegations KPMG sold an illegal tax-shelter strategy to WorldCom (now MCI) and other investors in the 1990s.[100] Ernst & Young and PricewaterhouseCoopers also profited from similar aggressive tax schemes, but those firms settled with the government early in the investigation.[101] KPMG decided instead to resist, initially believing that even a deferred prosecution agreement was a serious threat to its reputation.[102] The ensuing legal battle lasted from 1999 until August 2005[103] and was widely covered in the popular business press.

Ultimately, KPMG settled with federal prosecutors over criminal charges arising out of the marketing and sale of fraudulent tax shelters and related obstruction of justice by the firm. The deferred prosecution agreement required the firm to pay $456 million in penalties[104] and to admit the fraudulent conduct. The firm also agreed to be monitored by a former SEC chairman, to continue to cooperate with ongoing investigations related to the matter, and to comply with restrictions on its tax practice. In exchange, the firm will not be indicted for obstruction of justice or for tax fraud as long as there is no violation of the agreement.[105] Ironically, the firm's biggest concern apparently was the *appearance* of impropriety (no doubt informed by the Arthur Andersen story) that would result from a mere indictment on charges of obstruction of justice.

Though KPMG still faces a heavy docket of civil suits filed by clients who purchased the tax shelters and later had the deductions disallowed,[106] the firm was relatively lucky. Concerned about the devastation that the recent ruin of Arthur Andersen caused so many innocent employees, prosecutors were relatively easy on

[100] Jonathan Weil, *KPMG's Chief of Finance Quits as Probes Go On,* WALL St. J., July 7,2004, A3.

[101] Lynnley Browning, *How an Accounting Firm Went from Resistance to Resignation,* N.Y. TIMES ONLINE, Aug. 28, 2005, *available at* www.nytimes.com/2005/08/28/business/28kpmg.html?ei=5094&en- =5236fd64b73c63f8&hp=&ex=l 125201600&partner=homepage&pagewanted=print (last viewed Sept. 27, 2006, copy on file with authors).

[102] John Wilke, *KPMG Faces Indictment Risk on Tax Shelters,* WALL ST. J, June 16, 2005, at A1.

[103] Browning, *supra* note 101.

[104] The fine imposed on the firm is relatively small, amounting to approximately $276,000 per partner, while the average partner's after-tax income for just one year of operations (2004) was $470,000. Allan Sloan, *KPMG Partners Lucked Out - Thanks to Enron and Arthur Andersen,* WASH. POST, Sept. 6, 2005 at D2, *available at* www.washingtonpost.eom/wp-dyn/content/article/2005/09/05/AR2005090501333- _pf.html (last viewed Sept. 27, 2006).

[105] Jonathan D. Glater, *Settlement Seen on Tax Shelters by Audit Firm,* N.Y. TIMES ONLINE, Aug. 27, 2005, *available at* www.nytimes.com/2005/08/27/business/27kpmg.html?pagewanted=pnnt (last viewed Sept. 27,2006).

106. See, e.g.. Chew v. KPMG, No. 3:04CV748BN, 2006 U.S. Dist. LEXIS 879 (Jan. 9,2006).

KPMG.[107] Several of the firm's partners did not fare so well: three were indicted for their conduct in connection with the scheme.[108]

D. *No Reduction in the Activity that Creates the Biggest Conflict of Interest*

Finally, accounting firms continue to collect substantial non-audit fees. In 2001, non-audit services accounted for more than 70% of fees collected by accounting firms from companies in the Dow Jones Industrial Average. In 2002, the percentage had dropped to 55%, but that figure is still very high. The industry percentage finally fell below 50% in 2003.[109] Research offers conflicting evidence regarding the correlation between the volume of non-audit services and either of the two factors of auditor independence violations or auditor objectivity and discretionary accruals.[110]

It is noteworthy that the reported drop in consulting fees is not what it seems. Because new rules have expanded the definition of "audit fee" for purposed of measuring audit versus non-audit fees, the percentages from year-to-year are not comparable. Previously, the audit fee only included the amount paid for the annual audit itself and reviews of annual and quarterly financial statements. The definition of audit fees has been expanded to include audits, reviews of documents filed with the SEC, and tax and accounting consultations. This serves to move some of the fees out of the non-audit category and into the audit category, confounding the percentages. Additionally, the firms are charging higher audit fees than they have in the past. All of these factors effectively destroy any comparisons among recent years.[111] Therefore, it appears that, despite new regulations designed to improve auditor independence, consulting revenues and their proportion to audit revenues - and the inherent conflict of interest they bring - are just as strong as ever.

[107] Attorney General Alberto Gonzales stated that the reason the settlement with KPMG involved only a deferred prosecution agreement with KPMG "reflects the reality that the conviction of an organization can affect innocent workers and others associated with the organization, and can even have an impact on the national economy." Jonathan Weil, *Nine are Charged in KPMG Case on Tax Shelters*, WALL St. J., Aug. 30, 2005, at Cl.

[108] *See* United States v. Stein, 435 F. Supp. 2d 330, 338 (S.D.N.Y. 2006) (describing the investigations of the IRS and the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs that resulted in the indictments of KPMG partners). The criminal trial, which has been called the "largest ever U.S. criminal tax case," was delayed to Nov. 2006. Reuters, *Judge Postpones KPMG Fraud Trial*, L.A. TIMES, July 20, 2006, at C4.

[109] Phyllis Plitch & Michael Rapoport, *Moving the Market: Nonaudit Fees Fell Below Half of Auditor Payment*, WALL St. J., July 8, 2004, at C3.

[110] Hollis Ashbaugh, *Ethical Issues Related to the Provision of Audit and Non-Audit Services: Evidence from Academic Research*, 52 J. Bus. ETHICS 143 (June 2004); J. KENNETH REYNOLDS *et al.*, 23 AUDITING, Issue 1, at 29 (March 2004).

[111] Plitch & Rapoport, *supra* note 109, at C3.

IV. CONCLUSION

As we have seen, the concern over whether tax and other non-audit fees compromise auditor independence long predates the massive tum-of-the-millennium scandals and the passage of SOX. Despite all of these scandals and the new ones that have surfaced in the past few years, and despite new professional ethics and the PCAOB's efforts, consulting still is not prohibited. SOX and related regulations allow registered accounting firms to provide extremely lucrative tax consulting services to audit clients as long as those services do not impair the auditor's actual independence. The imposition of minor restrictions in this regard seems to indicate that tax and other forms of non-audit consulting for audit clients are here to stay.

The fundamentals have not changed. The auditor/consultant situation continues to be fraught with potential independence problems and abuses. "Independent" auditors still are not really independent because they are hired and paid by the people they are required to police. They owe a fiduciary duty to the users of the financial statements, yet are paid by clients. Consulting fees paid by clients only further taint the appearance of independence, if not actual independence in every instance.

Of course, public company clients could solve the problem themselves, by electing to separate audit services from all other tax and consulting services for corporate governance reasons. These clients would also benefit from avoiding the appearance or temptations of impropriety. But relying on client companies is "pie in the sky"; that is the reason independent registered auditors were selected as securities issuers' watchdogs in the 1930s. History has demonstrated over and over again that the investing public cannot and should not rely on publicly traded companies and their managers to police themselves all or even most of the time. Rigid uniform independence policies adopted by the accounting profession would resolve the issues and enhance the profession's reputation.

In an ideal world, auditor independence would be entirely an internal quality, one that touches upon the auditor's state of mind, not one that is prompted only by external stimuli such as government regulation. Voluntary restrictions adopted by the profession would be a visible indication of honest intentions that would go a long way toward restoring investor confidence. Unfortunately, external restrictions do not necessarily prevent audit tainting, dishonesty, and collusion with clients, especially when the incentives are great and the risk and cost are both relatively low. Additional regulation, while it might serve to clarify the level of independence expectations and perhaps ease investor fears, would also offer stronger bases for investor lawsuits and criminal charges. Presumably, the accounting profession does not want this. Instead, this article suggests that the profession be proactive in filling in the gaps so as to regain its reputational capital. That will undoubtedly be the quickest and least painful way for auditors to regain their value- added in the marketplace and to avoid substantial externally imposed restrictions.

SOX and its related "fixes" are merely patches on a broken, conflict-fraught system. As the SEC, the PCAOB, the investing public, and Congress continue to encounter auditor independence violations, increased regulation may become

inevitable. The accounting profession has a short window of time within which to repair its reputation through increased self-regulation. Audit independence is an important foundation of our stock market. If the investing public cannot depend on financial statements as a basis for investing decisions, the cost of capital may grow out of reach. Moreover, investors and the government will abide only so much abuse before demanding further externally imposed regulation. By continuing to sit idly by, hoping for the storm to blow over, the accounting profession is inviting further, potentially draconian regulation and perhaps even a completely revamped system, one in which someone other than accountants certifies the accuracy of corporate financials.