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Not Biting the Hand that Feeds You: Public Accounting Firms and Conflicts of Interest

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COMMENT

NOT BITING THE HAND THAT FEEDS YOU:

PUBLIC ACCOUNTING FIRMS AND CONFLICTS OF INTEREST

INTRODUCTION

In recent years, the public became aware of the accounting misstatements of many major public companies.\(^1\) Instances such as the Enron and WorldCom debacles have eroded investor confidence.\(^2\) As a result, the financial markets have suffered.\(^3\) Between its peak on March 24, 2000, and December 31, 2002, there was a $7.4 trillion loss in the market.\(^4\) Since public accounting firms are responsible for reasonably assuring the accuracy of financial statements, a recurring question is, "where were the auditors?"

In explaining why some public accounting firms have not fulfilled their duty of assuring financial statement accuracy, critics have identified conflicts of interest among auditors as a central reason.\(^5\) There are two major types of conflicts of inter-

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\(^2\) McCoy, *e.g.*, *supra* note 1, at 989-90.

\(^3\) McCoy, *supra* note 1, at 989-90.

\(^4\) *Id.* (measuring the loss based on the Wilshire 5000 Total Market Index).

\(^5\) *See, e.g.*, S. REP. NO. 107-205, at 14-23 (2002).
est that public accounting firms face. They are external and inherent conflicts of interest. “External conflict of interest” refers to the practice of an accounting firm providing non-audit services to a client company concurrently with its audit services. “Inherent conflict of interest” refers to the situation in which a public accounting firm is hired, paid, and retained by the public company it is auditing. Both categories create conflicts of interest because the financial dependence present creates incentives to compromise independent judgment in favor of the client company. These two categories are discussed in more detail later.

Many professionals face conflicts of interest. The mere existence of conflicts of interest does not itself indicate that these professionals will compromise their duties. Most auditors live up to their financial statement assurance obligation in spite of the conflicts of interest they face. Some auditors, however, have knowingly failed to fulfill their obligations. Given the impact financial misstatements have on the markets in the form of lost investor confidence, some action is required.

In an effort to restore investor confidence in the wake of several accounting scandals, including Enron and its auditor, Arthur Andersen, Congress passed the Sarbanes-Oxley Act (hereinafter “The Act”) in 2002. The Act addresses a wide ar-
ray of issues, but a significant portion of the Act focuses on ensuring the independence of public accounting firms.\textsuperscript{17} This is an attempt to remove the conflicts of interest facing public accounting firms.

The Act, however, deals only with the external conflicts of interest problem.\textsuperscript{18} The Act essentially prohibits an accounting firm from performing most non-audit services, such as consulting services, for a client it is also auditing.\textsuperscript{19} In its rush to deal with the growing accounting scandals, it is perhaps understandable that Congress addressed the external conflicts of interest first, reserving for future deliberation whether and how to deal with the inherent conflicts of interest.\textsuperscript{20} The legislative history behind the Act makes it clear that Congress may take steps in the future to investigate and address the inherent conflicts of interest problem if the current legislation does not sufficiently achieve the desired results.\textsuperscript{21}

2001, was necessitated by Arthur Andersen and Enron having previously improperly categorized hundreds of millions of dollars as an increase, rather than a decrease, to Enron shareholder equity. \textit{Id.} The press release characterized numerous charges against income for the third quarter as “non-recurring” even though Arthur Andersen believed the company did not have a basis for the conclusion. \textit{Id.} Indeed, Arthur Andersen advised against using that term and documented its objections internally in the event of litigation, but did not report its objections or otherwise take steps to cure the public statement. \textit{Id.} Arthur Andersen had also been put on direct notice, by a current Enron and former Arthur Andersen employee, that possible fraud and other improprieties were taking place at Enron. \textit{Id.}

By Friday, October 19, 2001, Enron alerted Arthur Andersen that the SEC had begun an inquiry. \textit{Id.} at 3. The next morning, an emergency conference call among high-level Arthur Andersen management was convened, and it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the Arthur Andersen auditors. \textit{Id.} On October 23, 2001, Arthur Andersen’s Enron engagement team began a wholesale destruction of documents. \textit{Id.} Arthur Andersen personnel were called to a meeting and instructed to immediately destroy documentation relating to Enron and to work overtime if necessary to accomplish the destruction. \textit{Id.}

Over the next few weeks, the shredder at the Arthur Andersen office at the Enron building was used virtually constantly, and trunks of documents were also sent to Arthur Andersen’s main office to be shredded. \textit{Id.} A systematic effort was also undertaken and carried out to purge the computer hard-drives and E-mail of Enron-related files. \textit{Id.} Enron-related documents were also ordered destroyed by personnel working on Enron audit matters in Portland, Oregon; Chicago, Illinois; and London, England. \textit{Id.}

\begin{itemize}
\item \textsuperscript{17} \textit{Sarbanes-Oxley Act of 2002, see generally supra note 16.}
\item \textsuperscript{18} \textit{See id.}
\item \textsuperscript{19} \textit{See 15 U.S.C. § 78(j-1) (2002).}
\item \textsuperscript{20} \textit{S. Rep. No. 107-205, at 14.}
\item \textsuperscript{21} \textit{See id. at 21. See also 15 U.S.C. § 7232 (2002).}
\end{itemize}
If or when Congress decides to address the inherent conflicts of interest issue, what steps Congress may take is not entirely clear.\(^\text{22}\) One proposed solution is mandatory rotation every few years of the accounting firm performing the audit.\(^\text{23}\) The Act directs the Comptroller General to study this proposal to determine its potential effects.\(^\text{24}\) A mandatory accounting firm rotation requirement would limit the closeness created by a long-term relationship between the accounting firm and the public corporation, and it would limit the incentive to compromise disinterested independent judgment in an effort to retain a “perpetual” long-term client.\(^\text{25}\)

In addition to mandatory accounting-firm rotation, few other solutions have been offered.\(^\text{26}\) This Comment will discuss — as an alternative solution — creating a competitive bidding system overseen by the Securities and Exchange Commission (hereinafter “SEC”). Such a system would require a corporation to pay for auditing services.\(^\text{27}\) The SEC, not the audited corporation, however, would control the hiring and retention function.\(^\text{28}\) This would limit the incentive for an accounting firm to compromise its disinterested independent judgment to be hired and retained by a client.

Section I of this Comment will discuss the role and responsibilities of public accounting firms and provide a brief background of the Sarbanes-Oxley Act.\(^\text{29}\) Section II will explore the mandatory audit firm rotation and other proposals seeking to remedy the inherent conflicts of interest problem.\(^\text{30}\) Lastly, Section III proposes a competitive bidding system overseen by the SEC as a potential remedy for this problem.\(^\text{31}\)

\(^{22}\) S. REP. NO. 107-205, at 14, 21.
\(^{25}\) COMMISSION, supra note 23, at 39.
\(^{26}\) See infra at notes 159-68 and accompanying text.
\(^{27}\) See infra at notes 161-71 and accompanying text.
\(^{28}\) Id.
\(^{29}\) See infra at notes 32-133 and accompanying text.
\(^{30}\) See infra at notes 134-68 and accompanying text.
\(^{31}\) See infra at notes 169-71 and accompanying text.
I. BACKGROUND

A. WHAT IS THE ROLE OF A PUBLIC ACCOUNTANT?

Federal securities laws mandate a public company to prepare comprehensive financial statements certified by an independent certified public accountant. In explaining why Congress requires this certification, the Senate discussions state that:

Prior to SEC legislation...it was by no means unusual to encounter semi fraudulent distortions of corporate accounts...almost always for the purpose of making the results look better than they were, and it was generally associated with some scheme of stock-market manipulation in which the management was participating.

Michael Sutton, former chief accountant of the SEC, has explained the need for an independent audit:

Fundamental to the decision by the Congress in 1933 to require an independent audit was a recognition that the integrity of financial information provided to investors, and the public perception of the integrity, are critical to the effectiveness and credibility of our capital markets. Thus, it is the independent auditor's objective "second look" at the issuer's financial statements that gives investors confidence that those statements are reliable and provide a credible framework for investor decisions to buy or sell securities of public issuers. Both the fact and appearance of independence are necessary to maintain the confidence of the investing public.

An auditor's opinion serves to furnish investors with a critical assurance that rigorous examination is made of the financial statements by an impartial and skilled professional. Public accounting firms must reasonably assure investors that a public corporation's financial statements meet the Generally

32 S. REP. NO. 107-205, at 5-6 (stating that each of the federal securities laws — the 1933, 1934, 1935, and 1949 Acts — requires comprehensive financial statements that must be prepared, in the words of the Securities Act of 1933, by "an independent public or certified accountant").
33 Id.
34 SHAPIRO, supra note 11, at 177.
35 Id.
Accepted Accounting Principles (hereinafter "GAAP"). GAAP are a set of both broad and specific guidelines for companies to follow when measuring and reporting the information in their financial statements and related notes. While it is the responsibility of the corporation's management to prepare the financial statements, it is the auditor's responsibility to investigate and evaluate these statements to determine if the financial statements accurately depict the true financial position of the corporation. Because it is impractical to audit all of the financial records of a corporation, public accounting firms use methods, such as statistical sampling, according to the Generally Accepted Auditing Standards (hereinafter "GAAS"). GAAS are a set of guidelines that auditors are to follow when performing an audit. Audit methods performed in accordance with the GAAS do not ensure the absolute accuracy of financial statements. Their use, however, creates a reasonable likelihood that material misstatements and fraud will be discovered.

B. THE FIDUCIARY DUTY OF PUBLIC ACCOUNTING FIRMS IS OWED TO THE PUBLIC TRUST

One of the fundamental principles of fiduciary obligation is the duty of loyalty. This duty of loyalty requires the fiduciary to not be personally interested (referred to as being "disinterested"). The fiduciary is required to put the interests of those for whom the fiduciary acts or represents before the interests of the fiduciary or others. Although fiduciary obligations are present in numerous professions, public accounting firms are unique because their obligation to the public always trumps

38 See ARENS & LOEBBECKE, supra note 36, at 142-43.
39 Id. at 143-44.
40 Id. at 37.
41 Id. at 142-43.
42 Id. at 142.
43 SHAPIRO, supra note 11, at 92.
44 Id. at 92-93.
45 Id.
their obligations to their audit clients. The United States Supreme Court emphasizes in United States v. Arthur Young & Co., that the relationship between certified public accountants and their clients must be characterized by disinterestedness and absolute independence. The Court states, "by certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client." The Court characterizes the function of the accounting firm as that of a "public watchdog" that requires complete fidelity to the public trust.

This public trust responsibility may sometimes be highly burdensome, but it is certainly not without rewards. The Act's legislative history emphasizes that federal law requires a publicly-traded company to hire an independent accounting firm to perform an annual audit, essentially creating a shared public monopoly that does not exist for other kinds of professional services. This exclusive shared monopoly is a significant private benefit to public accountants, but is conditional on the accountants' assuming a public duty and obligation.

C. THE TRADITIONAL OVERSIGHT OF PUBLIC ACCOUNTING FIRMS

Traditionally, the accounting profession has been overseen by a hodgepodge of state and federal agencies, as well as numerous self-regulatory organizations. The SEC is the top regulatory organization in the United States. The SEC issues numerous accounting rules and interpretations that supplement those issued by private self-regulatory organizations.

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46 Many fiduciaries have obligations to the public that trump those to their clients. SHAPIRO, supra note 11, at 174. Doctors report certain communicable diseases, psychotherapists and lawyers report clients likely to harm others, and therapists may institutionalize clients against their will. Id. But auditors are unique in that their public duties always trump their obligation to clients. Id.
48 Id. at 817.
49 Id. at 818.
50 See S. REP. NO. 107-205, at 14.
51 Id.
52 Id.
53 SHAPIRO, supra note 11, at 186-87.
54 Id.
55 Id.
The SEC also brings civil, administrative, and criminal enforcement actions against accounting firms and accountants for violations of these rules. Historically, the SEC has acted as an overseer, deferring to various private self-regulatory organizations such as the American Institute of Certified Public Accountants (hereinafter "AICPA"). The AICPA would set accounting standards, issue policy and practice guidelines, oversee accounting firms, undertake mandatory peer review, develop and enforce codes of professional conduct, and impose disciplinary sanctions.

D. THE INHERENT CONFLICT OF INTEREST IN THE RELATIONSHIP BETWEEN PUBLIC ACCOUNTING FIRMS AND PUBLIC COMPANIES

As discussed above, the United States Supreme Court has clearly articulated that the fiduciary obligations of public accounting firms reside exclusively with the public trust. In writing securities legislation, however, Congress created an inherent conflict of interest between public accounting firms and the public companies they audit. Public accounting firms represent the interests of the investing public. They must be completely independent of the companies they audit, in fact and appearance. The securities laws, however, require that an accounting firm be hired, retained, and paid by the company being audited. The inherent conflict of interest is that the subject of the audit is the same entity upon which the accounting firm is financially dependent. To use the old cliché, the accounting firm faces the dilemma of whether to bite the hand that feeds it.

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56 Id.
57 Id.
58 Id. The AICPA, the largest professional organization of certified public accountants, has been the primary self-regulatory organization. Id. However, the Financial Accounting Standards Board (FASB), the stock exchanges, and the audit committees of the boards of directors of public corporations have also played a role. Id.
59 Arthur Young & Co., see supra note 47, at 817-18.
60 SHAPIRO, see supra note 11, at 177.
61 Arthur Young & Co., see supra note 47, at 817-18.
62 SHAPIRO, see supra note 11, at 177.
63 Id.
64 Id.
65 Id. at 179.
1. The Process of Hiring, Retaining, and Paying for an Audit Engagement

During this relationship, the public company must first decide which accounting firm to hire to perform its audit. In winning an audit engagement, accounting firms compete based on their reputation, fees, and expertise. For the large public corporations, reputation boils down primarily to "Big Four" status. In recent years, fees have become increasingly competitive. Some accounting firms often offer their services at a loss in the initial years of the relationship in an attempt to obtain a long term account. The problem is not that such market tactics are unethical; rather, the incentive to retain the client until the relationship has become profitable creates a conflict of interest. For instance, if an auditor issues an unfavorable opinion during the early years of the relationship, it risks losing the client even before the relationship has become profitable.

Public accounting firms often specialize in certain industries. This expertise can lower the cost and increase the quality of the audit, especially in complex or highly specialized industries. An unfortunate side effect is that public accounting firms sometimes use this specialized expertise to devise "innovative" accounting treatments for the client.

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66 MCCOY, supra note 1, at 994.
67 Id.
68 Id. The "Big Four," are the four largest certified public accounting firms in the United States. ARENS & LOEBBECKE, supra note 36, at 25. Consolidation of firms has led to a decline in the number of large firms. Id. For example, the "Big Six" became the "Big Five" in 1998 with the merger of Price Waterhouse and Coopers & Lybrand. Id. The "Big Five" then became the "Big Four" after the demise of Arthur Andersen. Id. The current firms are PricewaterhouseCoopers, Ernst & Young, Deloitte & Touche, and KPMG.
69 SHAPIRO, supra note 11 at 175 n.117. The current firms are PricewaterhouseCoopers, Ernst & Young, Deloitte & Touche, and KPMG.
70 Id. Fees have become increasingly competitive since the late 1970s when Congress began pushing for more competition in the public auditing arena. Id. At one time it was typical to bill junior auditors at a ratio of four times the cost of that employee. Id. Now it is common for this ratio to be less than two, and it is not uncommon for the ratio to fall below one when another firm is trying to "steal" the account. Id.
71 See id. at 181.
72 MCCOY, see supra note 1, at 995.
73 Id. at 994.
74 See id.
75 Id.
After the accounting firm is hired and has conducted the audit, it must decide whether to issue an unqualified opinion.\textsuperscript{76} If the accounting firm decides not to issue an unqualified opinion, the client — aware of the negative implications to follow — must decide whether to replace the accounting firm.\textsuperscript{77} This process is called "opinion shopping."\textsuperscript{78} The term "opinion shopping" refers to the practice of replacing the current accounting firm to prevent the issuance of a negative opinion.\textsuperscript{79} The SEC has tried to discourage this practice by requiring corporations to disclose publicly when they have changed accounting firms performing the audit.\textsuperscript{80} This requirement is at best an ambiguous red flag.\textsuperscript{81} Many legitimate factors besides "trying to escape from a truly independent auditor whose loyalty cannot be bought or extorted" can justify the decision.\textsuperscript{82} Furthermore, disclosing a change of auditor may be counter-productive.\textsuperscript{83} It only discloses the situations in which the auditor's disinterest-

\textsuperscript{76} See id. at 995. The opinions that may be issued are: Standard Unqualified; Unqualified with Explanatory Paragraph or Modified Wording; Qualified; or Adverse or Disclaimer. Arens & Loebbecke, supra note 36, at 47.

A Standard Unqualified opinion is issued when the following conditions are met: All statements — balance sheet, income statement, statement of retained earnings, and statement of cash flows — are included in the financial statements; the general auditing standards have been followed in all respects on the engagement; sufficient evidence has been accumulated, and the auditor has conducted the engagement in a manner that enables him or her to conclude that the field work standards have been met; the financial statements are presented in accordance with GAAP; and there are no circumstances requiring the addition of an explanatory paragraph or modification in the wording of the opinion. Id.

An Unqualified with Explanatory Paragraph or Modified Wording opinion is issued when a complete audit took place with satisfactory results and financial statements are fairly presented, but the auditor believes that it is important or is required to provide additional information. Id.

A Qualified opinion is issued when the auditor concludes that the overall financial statements are fairly presented, but the scope of the audit has been materially restricted or GAAP were not followed in preparing the financial statements. Id.

An Adverse or Disclaimer opinion is issued when the auditor concludes that the financial statements are not fairly presented (adverse), he or she is unable to form an opinion as to whether the financial statements are fairly presented (disclaimer), or he or she is not independent (disclaimer). Id.

\textsuperscript{77} McCoy, supra note 1, at 995.

\textsuperscript{78} Shapiro, supra note 11, at 179.

\textsuperscript{79} Id.

\textsuperscript{80} Id.

\textsuperscript{81} Id.

\textsuperscript{82} Id.

\textsuperscript{83} See id.
edness might have triumphed, leaving undisclosed those situations where the auditor caved to client pressures.\textsuperscript{84}

2. \textit{Conflicts of Interest of Individual Partners}

In addition to the inherent institutional conflicts of interest discussed above, there are often personal conflicts of interest for public accounting firm partners as well.\textsuperscript{85} This arises when the partner must choose whether to acquiesce to questionable or fraudulent accounting practices.\textsuperscript{86} In some quarters of the profession, there is a "lose-your-client-lose-your-job" philosophy.\textsuperscript{87} In these firms, partners who lose clients are often fired for being "nonproductive."\textsuperscript{88} The partner must decide whether to fulfill his or her fiduciary obligation to the public trust, or risk his or her employment with the accounting firm.\textsuperscript{89}

E. \textbf{EXTERNAL CONFLICTS OF INTEREST IN THE RELATIONSHIP BETWEEN PUBLIC ACCOUNTING FIRMS AND PUBLIC COMPANIES}

In an attempt to become more profitable, public accounting firms have, in recent years, began offering many non-audit services to their clients.\textsuperscript{90} In 2000, audit services were contributing, on average, less than a third to firm revenues.\textsuperscript{91} Some firms were even using audits as a loss leader to sell their other services.\textsuperscript{92} The Arthur Andersen/Enron relationship epitomizes the financial dependence of an accounting firm on its client.\textsuperscript{93} In the year before Enron's demise, Arthur Andersen had

\begin{itemize}
\item \textsuperscript{84} Id.
\item \textsuperscript{85} Id. at 179, n.123.
\item \textsuperscript{86} Id.
\item \textsuperscript{87} Id.
\item \textsuperscript{88} Id.
\item \textsuperscript{89} Id.
\item \textsuperscript{90} S. REP. NO. 107-205, at 14.
\item \textsuperscript{91} SHAPIRO, supra note 11, at 181.
\item \textsuperscript{92} Id. A loss leader is the practice of using an unprofitable product to aid in the selling of profitable ones to the same customer. \textit{See id}. Accounting firms would "sell" the audit services at a price less than the cost. \textit{See id}. But in conjunction with, or afterward, the accounting firm would sell the highly profitable non-audit services to these same clients. \textit{Id}.
\end{itemize}
earned $52 million in fees from their relationship.94 Many question providing non-audit services to the same public corporation that the public accounting firm is also auditing, since this creates additional external conflicts of interest.95 The more financially dependent an accounting firm becomes on its client, the greater the incentive to compromise its disinterested independent judgment.96

F. THE ACCOUNTING MISSTATEMENT REVELATIONS THAT BROUGHT THE ISSUE OF CONFLICTS OF INTEREST TO THE FOREFRONT

After the financial market began to fall from its late 1990 record highs, the public discovered that the financial statements of some public companies were not depicting their true financial position.97 Instead of making the GAAP-required full and adequate disclosures, some companies had carefully constructed financial statement footnotes in an apparent attempt to hide what probably should have been line items, or they simply left out information that should have been in the statement’s footnotes.98 Many of the techniques used by these public companies were not only aggressive, but unacceptable according to GAAP standards.99

On October 26, 2001, Enron announced that it would be taking a third quarter charge of $1.01 billion.100 This announcement caught the attention of not only the financial community, but Congress and the general public as well.101 Within two months of the announcement, Enron filed for Chapter 11 bankruptcy.102 Enron’s $13.15 billion bankruptcy filing was the largest of its kind in United States history.103 Enron had also disclosed that it would be restating prior financial

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94 Id.
95 See, e.g., S. REP. NO. 107-205, at 14.
96 See id.
98 Id.
99 Id.
100 BLOOMENTHAL, supra note 1, at 47-48.
101 Id.
102 Id. at 48.
103 Id. Many bankers estimated the actual amount to be $27 billion because Enron failed to include its off-balance sheet debt. Id.
statements that failed to follow the GAAP standards.\textsuperscript{104} This restatement would result in reductions of reported net income of approximately $96 million in 1997, $113 million in 1998, $250 million in 1999, and $132 million in 2000; increases of $17 and $5 million for the first two quarters of 2001; and a reduction of $17 million for the third quarter of 2001.\textsuperscript{105}

Although news of other alarming financial reporting irregularities preceded Enron's, none captured the same attention.\textsuperscript{106} Investor confidence further deteriorated after a series of revelations about other corporate accounting irregularities, and it became apparent that Enron was only the tip of the iceberg.\textsuperscript{107} The demise of the Arthur Andersen public accounting firm soon followed the Enron revelations.\textsuperscript{108} On March 7, 2002, the SEC obtained a grand jury indictment against Arthur Andersen for obstruction of justice in connection with its investigation of Enron.\textsuperscript{109}

Mistakes and fraud will sometimes go undetected by proper audit procedures.\textsuperscript{110} It is hard to believe, however, that these procedural errors account for many of the recently discovered financial misstatements. The Arthur Andersen incident supports the notion that some accounting firms were well aware of these mistakes and fraudulent accounting practices.\textsuperscript{111}

G. \textbf{CONGRESS REACTS BY PASSING THE SARBANES-OXLEY ACT}

In response to the numerous accounting scandal revelations, Congress rushed to investigate and enact legislation to prevent accounting misstatements from occurring in the future.\textsuperscript{112} A recurring issue raised was concern over accounting firm independence and conflicts of interest.\textsuperscript{113} Congress real-

\begin{footnotes}
\footnotetext{104} Id.
\footnotetext{105} Id.
\footnotetext{106} Id. at 50.
\footnotetext{107} Id.
\footnotetext{108} Id.
\footnotetext{109} Arthur Andersen LLP, \textit{supra} note 16. Less than nine months after its first disclosure that documents related to its audit of Enron had been improperly shredded, Arthur Andersen was out of the public accounting business, having lost all of its more than 1,200 public-company audit clients and most of its global network of 85,000 employees. \textit{Shapiro, supra} note 11, at 90.
\footnotetext{110} Arens & Loebbecke, \textit{see supra} note 36, at 143-44
\footnotetext{111} Arthur Anderson LLP, \textit{see generally supra} note 16.
\footnotetext{112} Bloomental, \textit{see supra} note 1, at 64.
\footnotetext{113} See id. at 63-67.
\end{footnotes}
ized that there is an inherent conflict by the mere fact that the auditor is paid by the same company it is independently auditing. Congress, however, felt the more immediate concern was that in the last 15 years, the rapid growth in non-audit services offered by the major accounting firms has further eroded the independence that the auditor must bring to the audit function.

Both houses of Congress proposed legislation attempting to prevent material financial misstatements in the future. The House version was the Oxley Bill, and the Senate version was the Sarbanes Bill. On June 25, 2002, after WorldCom confessed its $3.8 billion accounting fraud, the fate for financial fraud reform legislation was sealed. The Senate deleted the House version and used the language of the Sarbanes Bill. The Act was signed into law on July 30, 2002.

1. **A Significant Part of the Act’s focus is on Auditor Independence**

The Act covers a broad spectrum of investor confidence issues. The issue of auditor independence, however, is a centerpiece of the legislation. This is because public accounting

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115 Id.
116 BLOOMENTHAL, see supra note 1, at 64-66.
117 Id. By March 8, 2002, there had been over 30 Enron inspired bills introduced in Congress. Id. at 64. The serious legislative process that eventually led to the Sarbanes-Oxley Act did not begin until Representative Oxley introduced his bill to the House of Representatives on February 14, 2002. Id. The bill passed the House on April 24, 2002 by a vote of 334-90. Id. at 64-65.

The Senate bill began as a draft bill in the Senate Banking Committee, chaired by Senator Sarbanes. Id. at 65. The Committee’s action followed ten hearings on the accounting and investor protection issues raised by the revelations involving Enron and other public companies. Id. On June 18, 2002, the Senate Committee considered the “Public Company Accounting Reform and Investor Protection Act of 2002,” which was reported favorably by a vote of 17-4. Id. at 65-66. The Sarbanes Bill was passed by the Senate on July 15, 2002, by a vote of 97-0. Id. at 66.

The Act was passed by the House of Representatives on July 25, 2002 by a vote of 423-3, and on the same day passed the Senate by a vote of 99-0. Id. at 67. The President signed it into law on July 30, 2002. Id.
118 Id. at 66.
119 Id. (The joint Conference Committee agreed to what was primarily the Senate version designated as the Sarbanes-Oxley Act of 2002).
120 Id. at 67.
121 SARBANES-OXLEY ACT OF 2002, see supra note 16.
122 Id.
firms are an essential part of investor confidence. Financial statement integrity rests on the independence of the audit. As a result, the accounting profession is a main target of the Act's regulations.

2. The Act Focuses on Limiting External Conflicts of Interest and Centralizing Regulation Rulemaking and Enforcement

The Act takes several different approaches in an effort to increase the independence of public accounting firms performing an audit. First, the Act explicitly codifies eight non-audit services that a registered public accounting firm may no longer perform contemporaneously with its audit of a public company. Second, the Act creates a new agency to oversee the public accounting firms and enforce the Act. This agency is titled the Public Company Accounting Oversight Board (hereinafter "PCAOB"). Essentially, the PCAOB's primary function is to assume the role previously assumed by the AICPA, and bring together various issues and responsibilities that have in the past been subject to what has been characterized as "a bewildering array of monitoring groups" under the auspices of the accounting profession. Third, the Act provides that if a firm under the Act may perform non-audit services for an audit client other than those listed above, including tax services, only if approved in advance by the audit committee of the issuer. Id.

125 BRATTON, supra note 123, at 1024.
126 These eight non-audit services are: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; and legal services and expert services unrelated to the audit. 15 U.S.C. § 78j-1.
128 The PCAOB is responsible to "oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." Id.
129 S. REP. NO. 107-205, at 4-5. The main responsibilities of the PCAOB are to: register public accounting firms; establish or adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports; conduct inspections of registered public accounting firms; and conduct investigations and disci-
company executive was employed by the accounting firm the previous year, and participated in any capacity in that company's audit, the accounting firm cannot provide its audit services. 130

In addition to the above-mentioned steps that the Act takes, public accounting firms are also required to regularly interface with the company's audit committee. 131 The auditors now report to the audit committee instead of to management. 132 The accounting firm must inform the audit committee of those aspects of the audit that represent critical accounting policies, aggressive accounting positions, alternative treatments, and the substance of the audit findings. 133

II. SOLUTIONS THAT HAVE BEEN PROPOSED TO REMEDY THE INHERENT CONFLICTS OF INTEREST PROBLEM

A. MANDATORY AUDIT FIRM ROTATION

As previously mentioned, Congress may take steps necessary to deal with the inherent conflicts of interest problem with the relationship between public accounting firms and public corporations. 134 During the Senate hearings, various witnesses recommended mandatory audit firm rotation. 135 In response, Congress authorized the Comptroller General of the General Accounting Office to require that public accounting firms rotate their auditors at least once every five to seven years. 136

131 Id.
132 WARDELL, see supra note 97 at 939. Sarbanes-Oxley requires that the board of directors of public companies have an audit committee, and that the audit committee be independent. 15 U.S.C. § 78(j-1). This means that a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, do the following: accept any consulting, advisory, or other compensatory fee from the issuer; or be an affiliated person of the issuer or any subsidiary thereof. Id.
135 Id. at 20. Former SEC Chairman Arthur Levitt proposed "that consideration be given to requiring companies to change their audit firm...every 5-7 years to ensure that fresh and skeptical eyes are always looking at the numbers." Id. John Whitehead, former Co-Chairman, Goldman Sachs & Co., recommended requiring "term limits of 8-10 years." Id. And Lynn Turner, former SEC Chief Accountant, recommended requiring "mandatory rotation (5-7 years)." Id.
Accounting Office to study and review potential effects of mandatory audit rotation.\textsuperscript{136}

1. \textit{The Arguments That Have Been Made in Favor of and Against Mandatory Audit Firm Rotation}

The Conference Board Commission on Public Trust and Private Enterprise (hereinafter “Commission”) views that an audit firm rotation would provide a useful tool in building shareholder confidence in the integrity of the audit and of the company’s financial statements.\textsuperscript{137} One benefit of audit firm rotation is that an incoming accounting firm would provide a fresh look at the company’s finances, accounting practices, and the former firm’s audit.\textsuperscript{138} The Commission further states that mandatory audit firm rotation would reduce the financial incentives for audit firms to compromise their judgment on the borderline issues.\textsuperscript{139} The audit engagement would no longer be perceived as permanent.\textsuperscript{140} The Commission states that in disagreeing with management, auditors would no longer risk losing a “perpetual” stream of revenues.\textsuperscript{141}

The argument against mandatory audit firm rotation is that such a requirement would not improve the quality of audits and, therefore, would not be in the public’s best interest.\textsuperscript{142}

\textsuperscript{136} 15 U.S.C. § 7232. \textit{BLACK'S LAW DICTIONARY} 1405 (7th ed. 1999) (defining General Accounting Office as “the federal agency that provides legal and accounting assistance to Congress, audits and investigates federal programs, and settles certain contract claims against the United States”).

\textsuperscript{137} \textit{COMMISSION}, \textit{supra} note 23, at 39 (The Conference Board convened a 12-member commission in June 2002 to address the causes of declining public and investor trust in companies, their leaders and America’s capital markets. The members include prominent leaders from business, finance, public service, and academia. The Commission is co-chaired by Peter G. Paterson, Chairman of The Blackstone Group and Chairman of the Federal Reserve Bank of New York; and John W. Snow, Chairman and CEO of CSX Corporation and former Chairman of the Business Roundtable).

\textsuperscript{138} \textit{Id.}

\textsuperscript{139} \textit{Id.}

\textsuperscript{140} \textit{Id.}

\textsuperscript{141} \textit{Id.}

For instance, such a requirement would dramatically increase the costs for firms, clients, and the public, and it would increase the likelihood of poor audits by depriving auditors of their most valuable tool: experience with a client and the resulting comprehensive knowledge of its business and operations.\textsuperscript{143} Groups that have studied the mandatory audit firm rotation conclude that the costs greatly outweigh the perceived benefits.\textsuperscript{144} Such studies have indicated that audit failures occur as much as three times as often when the audit firm is performing its first or second audit of the company.\textsuperscript{145} Former SEC Chairman Manuel Cohen stated:

In a study of cases of substandard performance by auditors, several of the problem cases were first- or second-year audits. While not conclusive, this indicates the higher peril associated with new audit clients. Once an auditor becomes well acquainted with the operations of a client, audit risks are reduced. If a relationship between audit failures and new clients does exist, rotation would increase the problem and be detrimental to users.\textsuperscript{146}

Furthermore, opponents of mandatory audit firm rotation argue that each time a rotation occurs, management will be faced with a disruptive, time-consuming, and expensive process by having to select a new accounting firm and familiarize it with the operations, procedures, systems, and industry environment of the company.\textsuperscript{147}

2. **A Comparative Analysis of Audit Quality Failures and Fiduciary Obligation Failures**

An important element critics of mandatory audit firm rotation ignore is the cost associated with using an accounting firm that is compromising its judgment because of its lack of independence.\textsuperscript{148} These critics view the core benefits of mandatory audit firm rotation as being only a fresh look at the company's

\textsuperscript{143} AICPA, supra note 142, at 2-3.
\textsuperscript{144} Id. at 3.
\textsuperscript{145} Id.
\textsuperscript{146} Id.
\textsuperscript{147} Id. at 4.
\textsuperscript{148} See supra notes 1-4 and accompanying text.
finances, accounting practices, and former firm’s audit. They compare this against the costs of first- or second-year audit failures. If the only problem were the deficiency of audits, the costs of mandatory audit firm rotation would clearly outweigh the benefits. The core concern, however, is (or should be) the cumulative cost of audit firms failing to fulfill their fiduciary duties.

As a result of public accounting firms’ failure to fulfill their fiduciary duties, there is an erosion of public trust in the capital market. The indictment and conviction of Arthur Andersen is evidence that many financial misstatements were not primarily the result of substandard or incomplete audits. Instead, they were the result of accounting firms knowingly compromising their independence and engaging in or acquiescing in questionable or outright fraudulent accounting practices in order to hang onto lucrative business relationships. The cost of first- or second-year audit failures is certainly a significant issue. The high cost on the capital market resulting from erosion of public trust, however, is arguably more important.

3. The Shortfalls of Mandatory Audit Firm Rotation in Remedying Conflicts of Interest

Mandatory audit firm rotation would remedy some of the conflict of interest problems that critics of the current system seek to eliminate. Most importantly, it would likely reduce the incentive for accounting firms to compromise their independent judgment in the hope of continuing a profitable client relationship for an extended or indefinite period of time. Mandatory audit firm rotation would not, however, eliminate an accounting firm’s incentive to compromise its independent judgment in order to bring in and retain client relationships, even if the relationships last for only five to seven years.

149 AICPA, supra note 142, at 3.
150 Id.
151 See supra notes 1-4 and accompanying text.
152 Id.
153 Arthur Andersen LLP, see generally supra note 16.
154 Id.
155 See supra notes 1-4 and accompanying text.
156 S. REP. NO. 107-205, at 21.
157 COMMISSION, see supra note 23, at 39.
158 Cf. id.
B. FEDERALIZING THE PUBLIC ACCOUNTING PROFESSION

While mandatory audit firm rotation may fall short of completely eliminating the inherent conflicts of interest that arise in an audit, some alternatives are either extreme or unworkable. There has been a suggestion to federalize the public accounting profession. Few advocates, however, favor creating a new federal bureaucracy with public accountants becoming federal employees.

C. A COMPETITIVE BIDDING SYSTEM

A competitive bidding system is one middle-ground solution proposed by the Commission. The Commission recommends that the audit committees of public companies use a bidding process for selecting an accounting firm to conduct their audits. According to the Commission recommendation, every five to seven years, an audit committee should engage in a review process for the audit engagement. During this review process, proposals from current and other qualified accounting firms would be solicited and submitted. Despite the fact that the current accounting firm may be retained, the Commission views the competitive bidding process as important. Such a process would emphasize to external auditors that they report to the audit committee, rather than to management.

One potential downfall of the competitive bidding system proposal is that the hiring and retention process would still be made by an arm of the company. Although now required by the Act to be independent, the audit committee’s loyalty still essentially resides in its company. To truly remove the inherent conflicts of interest in the relationship between a public

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160 Id.
161 COMMISSION, see supra note 23, at 40.
162 Id.
163 Id.
164 Id.
165 Id.
166 Id.
167 Cf. id.
168 Id.
accounting firm and a public company, the hiring and retention decisions must be removed from the audited company’s control.

III. AN ALTERNATIVE SOLUTION: A MANDATORY COMPETITIVE BIDDING SYSTEM, OVERSEEN BY THE SEC

A mandatory competitive bidding system overseen by the SEC would eliminate the audited company’s participation in the selection and retention of its auditor. Furthermore, such a system would keep auditing costs at reasonable levels. With the bidding process monitored by the SEC, the public company would provide detailed relevant information to the SEC concerning matters such as size, type of business, and detailed internal controls descriptions. Such information would be required for accounting firms to make an accurate bid proposal. The SEC would then collect bids from accounting firms and award the contract. This process would be open to all qualified public accounting firms. The implication of stringent requirements would ensure that accounting firms competing for the business are qualified and meet the minimum requirements for quality auditing.

After ensuring compliance with all the qualification and bidding requirements, the contract would be awarded to the lowest bidder. Basing an award solely on price is not without flaws. One problem is that it could lead to a decline in the quality of the audit. Ancillary steps would be required to ensure that audit quality be maintained at satisfactory levels. Many of these steps already exist in the regulatory system. Penalties for audit-quality deficiencies are enforced through judgments, settlements, and fines paid to plaintiffs and government authorities. These sanctions can be buttressed either with the threat of losing the opportunity to compete in the next bid for the client’s business, or even more broadly, in bids to perform work for other companies. This threat to future revenues would greatly reduce the incentive to perform incomplete audits, under-staff audits, or staff audits with cheaper, inexperienced auditors in a quest to lower costs. Any benefit derived from lowering the quality of the audit would be offset

\[169\] McCoy, supra note 1, at 1002.

\[170\] Id.
by the risk of large financial costs to the accounting firm in the form of lost future business. Cost savings would be encouraged to come from strategic moves and technological and managerial innovations on the part of the accounting firms, rather than from cutting essential elements of the audit process that might compromise the quality of the audit. Another attractive aspect of a competitive bidding process is that the awarded contract would be for a fixed-term with no right to terminate without cause. This fixed-term requirement would be beneficial for two reasons. First, a fixed-term contract is important for calculating a bid price. The accounting firm would be able to calculate the cost savings that go along with repeat audits of the same client, structuring its pricing system accordingly without risk of being let go. This long-term relationship, without the risk of premature termination, would lessen the accounting firm's temptation to compromise its independent judgment during the early years.

Second, a fixed-term contract would prevent the audited company from engaging in opinion shopping. Since an audited company would have no right to dismiss an accounting firm at will, the company would be forced to comply with the GAAP standards. A remedial procedure, however, would be required for companies that genuinely disagree with an auditor's opinion, similar to an appeals process. Such a process would require the company to prove that the accounting firm was wrong in its assessment of the company's financial statements. An SEC review board could easily accomplish this procedure. Unlike the current disclosure requirements when a company changes audit firms, an SEC review board would be able to evaluate the evidence presented and determine if the company has a legitimate complaint. An SEC board would have the authority to resolve the disagreement or sanction the company for bringing a frivolous complaint.

A. SUCH COMPETITIVE BIDDING DOES POSE A RISK TO AUDIT QUALITY

A potential disadvantage of a competitive bidding system is the possibility of lower profits for public accounting firms. It is questionable whether a substantial decline in profitability
would occur, since the current market is already highly competitive. In the event of lowered profit margins, a possible result could be that the public accounting profession would be faced with the problem of not being able to attract some highly qualified auditors. This result may occur due to a reduction in the anticipated income from becoming a partner. To truly understand the actual impact on the public accounting profession, independent studies would have to be conducted to determine how many qualified persons might leave or choose not to enter the profession. While some qualified accountants would shift to the private sector for larger salaries, it seems unlikely that the public accounting industry would not be able to attract qualified persons to fill the void.

B. IS THERE ENOUGH COMPETITION FOR A COMPETITIVE BIDDING SYSTEM?

Another potential problem with implementing a competitive bidding system is that in order for the bidding system to work properly, there must be a sufficient amount of competitors. Currently, the majority of public corporations are audited by the Big Four, and it is questionable whether so few competitors would create enough competition. Under a competitive bidding system, smaller qualified accounting firms might be able to enter the market, from which they have historically been excluded. Smaller firms could make strategic moves into the market through niche expertise or by concentrating on specific geographical areas.

IV. CONCLUSION

Because of the important role that public accounting firms play in ensuring investor confidence in the financial market, it is imperative that auditors meet their fiduciary duty to the public trust. Conflicts of interest create incentives for accounting firms to compromise their independent judgment. While many auditors live up to their public trust duties, those

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171 See supra notes 69-70 and accompanying text.
172 See supra notes 1-4 and accompanying text.
that have not, or do not, pose a significant risk to the financial markets.\textsuperscript{173}

The Sarbanes-Oxley Act addresses the external conflicts of interest that have become common in recent years.\textsuperscript{174} The Act, however, does not deal with the inherent conflicts of interest present in the relationship between public accounting firms and public companies. To further the independence of public accounting firms, these inherent conflicts of interest may be addressed by Congress in the future.\textsuperscript{175} A competitive bidding process overseen by the SEC would remove the inherent conflicts of interest that other proposals fail to eliminate.

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\textsuperscript{173} See supra notes 1-4 and accompanying text.
\textsuperscript{174} \textit{SARBANES-OXLEY ACT OF 2002}, see supra note 16.
\textsuperscript{175} \textit{S. REP. NO. 107-205}, at 21.

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