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Addressing the Auditor Independence Puzzle: Regulatory Models and Proposal for Reform

Law Working Paper N° 479/2019
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Abstract

Auditors play a major role in corporate governance and capital markets. Ex ante, auditors facilitate firms' access to finance by fostering trust among public investors. Ex post, auditors can prevent misbehavior and prevent financial fraud by corporate insiders. In order to fulfill these goals, however, in addition to having the adequate knowledge and expertise, auditors must perform their functions in an independent manner. Unfortunately, auditors are often subject to conflicts of interest, for example, resulting from the provision of nonaudit services but also because of the mere fact of being hired and paid by the audited company. Therefore, even if auditors act independently, investors may have reason to think otherwise. Policymakers and scholars around the world have attempted to solve the auditor independence puzzle through a variety of mechanisms, including prohibitions and rotation requirements. More recent proposals have also included breaking up audit firms and the empowerment of shareholders. This Article argues that none of these solutions is entirely convincing. Drawing from corporate governance, law and economics, and accounting literature, this Article proposes a new model to solve the auditor independence puzzle. Our proposal rests on four pillars. First, this Article argues that, in the context of controlled firms, auditors should be elected with a majority-of-the-minority vote. Second, while auditors in many jurisdictions are subject to certain temporal prohibitions to be hired by previous clients, the Article proposes that the length of these temporal prohibitions should be extended. Moreover, regulators should also restrict the type of services potentially provided to the audit client. Third, policymakers must pay closer attention to the internal governance and compensation systems of audit firms. The Article argues that increased transparency of audit firms is essential to enhance the independence of auditors. Finally, studies have shown that audit committees often fail to perform their monitoring functions, a major reason being the influence of corporate insiders on the committee. For this reason, we propose to increase the power and presence of public investors in the audit committee.

Keywords: auditing, accounting, Big 4, Enron, Sarbanes-Oxley, EU Audit Directive, EU Audit Regulation, gatekeepers, quasi-rents, auditor rotation, non-audit services, majority-of-the-minority approval, auditor compensation, transparency reports, audit firm governance

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ABSTRACT

Auditors play a major role in corporate governance and capital markets. Ex ante*, auditors facilitate firms' access to finance by fostering trust among public investors.* Ex post*, auditors can prevent misbehavior and prevent financial fraud by corporate insiders. In order to fulfill these goals, however, in addition to having the adequate knowledge and expertise, auditors must perform their functions in an independent manner. Unfortunately, auditors are often subject to conflicts of interest, for example, resulting from the provision of nonaudit services but also because of the mere fact of being hired and paid by the audited company. Therefore, even if auditors act independently, investors may have reason to think otherwise. Policymakers and scholars around the world have attempted to solve the auditor independence puzzle through a variety of mechanisms, including prohibitions and rotation requirements. More recent proposals have also included breaking up audit firms and the empowerment of shareholders. This Article argues that none of these solutions is entirely convincing. Drawing from corporate governance, law and economics, and accounting literature, this Article proposes a new model to solve the auditor independence puzzle. Our proposal rests on four pillars. First, this Article argues that, in the context of controlled firms, auditors should be elected with a majority-of-the-minority vote. Second, while auditors in many jurisdictions are subject to certain temporal prohibitions to be hired by previous clients, the Article proposes that the length of these temporal prohibitions should be extended. Moreover, regulators should also restrict the type of services potentially provided to the audit client. Third, policymakers must pay closer attention to the internal governance and compensation systems of audit firms. The Article argues that increased*

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TABLE OF CONTENTS

I. INTRODUCTION 789
II. THE LAW AND ECONOMICS OF AUDITOR INDEPENDENCE 791
  A. *Auditing and Capital Markets* 791
  B. *Auditors as Gatekeepers* 795
  C. *Quasi-rent Theory and Auditor Selection* 798
    1. The Auditor's Incentive to Retain a Client 798
    2. Dangers to Auditor Independence and the Selection of the Auditor 799
  D. *Gatekeeper Reputation and the Market Impact of Quasi-Rents* 802
III TRADITIONAL RESPONSES TO THE AUDITORS' INDEPENDENCE PUZZLE (AND WHY THEY ALL FAIL) 805
  A. *Introduction* 805
  B. *Rotation Models* 806
  C. *Prohibition of Nonaudit Services* 808
IV. RECENT PROPOSALS TO DEAL WITH THE AUDITORS' INDEPENDENCE PUZZLE 812
  A. *Break-Up of Audit Firms* 812
  B. *Empowerment of Shareholders* 813
V. GOING FORWARD: NEW PROPOSALS FOR AUDITOR INDEPENDENCE 815
  A. *Majority-of-the-Minority Approval in Controlled Firms* 816
  B. *Enhancing the Role and Composition of the Audit Committee* 818
  C. *Enhancing the Internal Governance of Audit Firms* 820
VI. CONCLUSION 826

Electronic copy available at: https://ssrn.com/abstract=3476683

I. INTRODUCTION

Auditing has long been understood as an important element of corporate governance. Both US securities law[1] and European Union (EU) Company Law[2] have long required financial statements of publicly traded corporations to be reviewed by independent professionals, and EU law (and the law of its member states), as well as other jurisdictions in Asia and Latin America, has extended this requirement also to larger privately held firms.[3] Virtually all major jurisdictions provide for a mandatory audit of the financial statements of publicly traded firms.

The external audit, performed by a professionally trained Certified Public Accountant (CPA), is intended to provide another layer of review in order to ensure the accuracy of a firm's financial statements, thus facilitating a more information efficient pricing of the firm's securities in the capital market and enabling investors to gain sufficient confidence to purchase the company's securities.[4] Over the past thirty years, however, public confidence in auditors has repeatedly received severe blows in the public eye: many major jurisdictions have seen accounting scandals involving fraudulent conduct by management that auditors did not discover. The most

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1. Securities Exchange Act of 1934, 15 U.S.C. § 78m(a)(2) (2018) (requiring "such annual reports (and such copies thereof), *certified if required by the rules and regulations of the Commission by independent public accountants*, and such quarterly reports (and such copies thereof), as the Commission may prescribe."); Rule 14a-3(b), 17 C.F.R. § 240.14a-3 (1968) (requiring the disclosure of audited financial statements with proxy statements of an issuer); Form 10-K, 17 C.F.R. § 249.310, Item 8 (1992) (requiring financial statements in accordance with regulation S-X); Regulation S-X, 17 C.F.R. § 210.1-02(a)(1) (2002) (defining the audit report required by the SEC).

2. Directive 2013/34/EU, of the European Parliament and of the Council of 26 June 2013 on the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Types of Undertakings, Amending Directive 2006/43/EC, of the European Parliament and of the Council and Repealing Council Directives 78/660/EEC and 83/349/EEC ("Codified Accounting Directive"), art. 34, 2013 O.J. (L 182) 19 (requiring financial statements of certain companies to be audited, and replacing older directives with identical requirements).

3. In Asia and Latin America, audits are usually required of both public companies and large private companies. In Singapore, for example, sections 201(8) and 205 (C) of the Companies Act requires companies to audit their financial statements unless an exemption for 'small company' applies. Similar requirements have been adopted in Hong Kong since the enactment of a new Companies Ordinance in 2014. In Latin America, for example, *see* Law No. 11638/07, amending the Brazilian Corporations Law No. 6404/76 of 1976 (imposing audit obligations for large private companies), art. 203 of the Colombian Commercial Code (requiring audited financial statement for all companies), and art. 13, para. 2, of the Law 43/1990 (establishing exemptions for small companies).

4. *See, e.g.*, John Armour, Gérard Hertig, & Hideki Kanda, *Transactions with Creditors*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 122 (John Armour et al. eds., 3d ed. 2017) [hereinafter Armour et al., *Transactions with Creditors*] (discussing how auditors lower costs of capital by screening financial statements).

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famous examples are Enron and WorldCom, which blew up in the United States in 2001 and 2002 and led to the Sarbanes-Oxley Act of 2002.[5] In Europe, the Parmalat scandal in Italy became known in 2003, where auditors had failed to uncover massive tunneling transactions between the firm and members of the family controlling it.[6] The European Union responded to this and other scandals with a completely new Audit Directive in 2006,[7] which was occasionally dubbed "Euro-SOX" because it took considerable inspiration from US law.[8] Its requirements were expanded with a major amendment in 2014[9] and supplemented with an EU Audit Regulation[10] applying to publicly traded firms and some others.[11]

Auditing thus remains in a state of perennial reform. This Article attempts to shed light on the trajectory of these reforms across countries and suggests a number of new avenues policymakers might explore in the coming years, drawing mainly from the debates in the United States and Europe. Part II describes the economics of auditor independence, drawing on two models developed in the law and

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5. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as U.S.C. §§ 7201–7266 (2018)); *see, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1544–45 (2005).

6. JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 89–90 (2006) [hereinafter COFFEE, GATEKEEPERS]; Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case, in* AFTER ENRON 159 (John Armour et al. eds., 2006); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the US and Europe Differ*, 21 OXFORD REV. ECON. POL'Y 198, 206–07 (2005) [hereinafter Coffee, *Corporate Scandals*]; Andrea Melis, *Corporate Governance Failures: to What Extent is Parmalat a Particularly Italian Case?*, 13 CORP. GOV. 478 (2005).

7. Directive 2006/43/EC, of the European Parliament and the Council of 17 May 2006 on Statutory Audits of Annual Accounts and Consolidated Accounts, Amending Council Directives 78/660/EEC and 83/349/EEC and Repealing Council Directive 84/253/EEC, 2006 O.J. (L 157) 87 [hereinafter EU Audit Directive 2006]. The original Audit Directive or Eighth Company Law Directive of 1984 had essentially only set forth minimum qualification standard for members of the accounting profession. Directive 84/253/EEC of April 10, 1984, 1984 O.J. (L 126) 20.

8. *See, e.g.*, Anne-Marie Anderson & Parveen P. Gupta, *Corporate Governance: Does One Size Fit All?*, 24 J. CORP. FIN & ACCT. 51, 52 (2013).

9. Directive 2014/56/EU, of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on Statutory Audits of Annual Accounts and Consolidated Accounts, O.J. (L 159) 196 [hereinafter EU Audit Directive 2014]. All references to Audit Directive will be to the consolidated version that incorporates the 2014 amendments.

10. *See, e.g.*, Clyde Stoltenberg et al., *A Comparative Analysis of Post-Sarbanes-Oxley Corporate Governance Developments in the US and European Union: The Impact of Tensions Created by Extraterritorial Application of Section 404*, 53 AM. J. COMP. L. 457, 481 n.155 (2005).

11. Regulation (EU) No 537/2014, of the European Parliament and of the Council of 16 April 2014 on Specific Requirements Regarding Statutory Audit of Public-Interest Entities and Repealing Commission Decision 2005/909/EC, art. 1, 2014 O.J. (L 158) 77 (defining its scope of application) [hereinafter EU Audit Regulation]; EU Audit Directive 2014, *supra* note 9, at art. 2(13) (defining "public-interest entities" as including publicly traded firms, banks, insurance companies, and some others).

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economics literature and the accounting literature, concluding with theoretical explanations of why audits sometimes fail, and why the audit industry needs to be regulated. Part III evaluates traditional responses to the auditor independence puzzle. Part IV discusses proposals that have been discussed recently. Part V highlights proposals that so far have received little attention and suggests some new ideas for reform. Part VI summarizes and concludes.

II. THE LAW AND ECONOMICS OF AUDITOR INDEPENDENCE

A. *Auditing and Capital Markets*

At least in theory, auditing serves a simple and useful purpose in publicly traded firms. If auditing increases the confidence investors have in the fact that financial statements fairly represent a company's financial position, they will put a premium on securities by issuers providing audited financial statements. Correspondingly, companies seeking to tap capital markets should seek to commit to their investors by voluntarily providing audited financial statements to investors in order to reduce their cost of capital.[12] Auditing thus fits neatly into the agency model of the firm: agency cost is created by the conflict of interest between the manager and the outside shareholder.[13] In classic agency theory, there are three types of costs: monitoring cost, bonding cost, and the deadweight loss resulting from the (remaining) information asymmetries.[14] Within this relationship, an audit could be seen as a monitoring mechanism implemented by the principal.[15] Given that auditors are usually selected by management, auditors can be seen as a bonding mechanism introduced by the agent to credibly testify that they are doing their job well and reduce agency cost.[16] Managers should benefit from this, given that it is typically in their interest to lower the firm's cost of capital.[17] Indeed, historically, precursors to auditing existed in medieval merchant's guilds, the earliest overseas trade joint stock companies, and coalesced into a profession dealing with the financial statements of publicly traded

12. Ross L. Watts & Jerold L. Zimmermann, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence,* 26 J.L. & ECON. 613, 614–15 (1983); *see also* Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1595 (2010).

13. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312 (1976).

14. *Id.* at 308.

15. Rick Antle, *The Auditor as an Economic Agent*, 20 J. ACCT. RES. 503, 512 (1982).

16. *See* Jensen & Meckling, *supra* note 13, at 338–39; Watts & Zimmerman, *supra* note 12, at 613–15.

17. *See, e.g.*, Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOK. L. REV. 1051, 1052 (1987).

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firms in the United Kingdom and the United States in the late nineteenth century *before* legal requirements were enacted.[18] Even today, firms not subject to a mandatory audit sometimes voluntarily submit to one, for example at the behest of creditors.[19] A credible audit can send a signal to investors that a firm's financial statements fairly present its financial position. Theory suggests that, in the absence of a credible commitment mechanism, all firms will have an incentive to overinflate their earnings.[20] In light of this rationale, one would suspect that under market conditions, auditing as an institution should develop organically and evolve to an efficient design.

So much for the theory. Auditing, however, is not a neutral technology because the auditor is an independent economic actor reacting to his own incentive structure. Thus, the auditor in turn creates agency costs.[21] First, the auditor might "shirk" (i.e., by not conducting the audit with the thoroughness demanded by generally accepted auditing standards (GAAS)).[22] In this case, the problem is one of what is called "audit quality" in accounting terminology.[23] Second, the auditor might collude with management to the detriment of outsiders[24] (e.g., by failing to report a violation of generally accepted accounting principles (GAAP)). In this case, the issue is one of "auditor independence."

Investors may recognize these problems and act accordingly. Without corrective mechanisms in place, they might not trust financial statements, and the firm's shares would trade at a discount. One might argue that firms should, therefore, have the incentive to hire only auditors that comply with independence standards suitable to the

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18. Watts & Zimmermann, *supra* note 12, at 613, 616–33; *see also* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1086 (1995).

19. *See, e.g.*, Elisabeth Dedman et al., *The Demand for Audit in Private Firms: Recent Large-Sample Evidence from the UK*, 23 EUR. ACCT. REV. 1, 12–13 (2014) (analyzing a comprehensive sample of privately-held firms that were no longer required to have an audit, the majority of which still retained one).

20. *See, e.g.*, Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. Rev. 916, 922, 927 (1998).

21. *See* Antle, *supra* note 15, at 512.

22. However, note that US courts have not considered compliance with GAAP to be a safe harbor shielding auditors from liability, in spite of protestations to the contrary from the accounting profession. United States v. Simon, 425 F.2d 796, 805 (2d Cir. 1969). *See* Fred Kuhar, *The Criminal Liability of Public Accountants: A Study of United States v. Simon*, 46 NOTRE DAME L. REV. 564, 593–94 (1971) (listing eight defense witnesses drawn from the leadership of the accounting profession).

23. Jere R. Francis, *What Do We Know About Audit Quality?*, 36 BRIT. ACCT. REV. 345, 346 (2004) (describing audit quality as a failure to meet "minimum legal and professional requirements").

24. *See, e.g.*, Daron Acemoglu & Miles B. Gietzman, *Auditor Independence, Incomplete Contracts and the Role of Legal Liability*, 6 EUR. ACCT. REV. 355, 356 (1997); *see also* Linda Elizabeth DeAngelo, *Auditor Independence, 'Low Balling', and Disclosure Regulation*, 3 J. ACCT. & ECON. 113, 115 (1981) [hereinafter DeAngelo, *Auditor Independence*].

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specific firm. Arguably, the existence of various market failures seems to justify the regulation of auditors.[25] First, investors might not effectively punish audit firms for malpractice, even when trust is both the goal of, and the basis for, the audit business.[26] Audit firms that do not fully internalize the costs of their decisions will be subject to moral hazard.[27] Second, the existence of asymmetries of information, rational apathy, and collective action problems faced by outside investors may also reduce the incentives potentially faced by audit firms to take steps to minimize *ex ante* the risk of committing misbehavior or providing poor-quality work.[28] Third, the fact patterns creating independence problems for auditors and reducing their incentives to do a good job are often highly complex and hard to understand for investors.[29] Sophisticated investors will surely recognize that an audit is generally beneficial, but they may not be able to see through independence issues in all cases, given that the complexity of the relationship between the auditor and the audited firm may at times be difficult to understand. For example, a repeated engagement of the same audit firm with a particular client may compromise the auditor's independence. At the same time, audit quality might benefit from the auditor's greater familiarity with the client. While sophisticated investors are likely

25. *See* JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 51–52 (2016) (defining market failures as situations where markets do not achieve the economically efficient outcomes with which they are generally associated, and discussing that where such failures arise, there is a *prima facie* case for actions to be taken to correct the failures, provided the benefits of regulation exceed its costs); *see also id.* at 55–61 (suggesting that financial regulation is justified as a response to those market failures existing in financial markets, particularly asymmetries of information, imperfect competition, public goods, and negative externalities).

26. Regarding the (often lacking) effectiveness of reputational sections, *see infra* notes 44–58 and accompanying text.

27. *See, e.g.*, Stavros Gadinis & Coby Mangels, *Collaborative Gatekeepers*, 73 WASH. & LEE L. REV. 798, 817–20 (2016) (discussing the low probability of detection of gatekeeper wrongdoing).

28. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526–29 (1990) (surveying reasons for shareholder passivity, rational apathy, and collective action problems). *But see* Anita Anand & Niamh Moloney, *Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives,* 5 EUR. BUS. ORG. L. REV. 223, 236–40 (2004) (arguing for a greater role of institutional investors in auditor selection).

29. On the issue of "information overload" among investors, which may apply to complex questions of auditor independence, *see, e.g.*, Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation,* 81 WASH U. L.Q. 417, 444–49 (2003); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 160–63 (2006); *see also* Alex Edmans, Mirko S. Heinle, & Chong Huang, *The Real Costs of Financial Efficiency When Some Information Is Soft*, 20 REV. FINANCE 2151, 2152–53 (2016) (suggesting that the presence of soft, unverifiable information may result in inefficiencies and distortions in decision-making); Julia M. Puaschunder, *Nudgitize Me! A Behavioral Finance Approach to Minimize Losses and Maximize Profits from Heuristics and Biases*, 18 J. ORGANIZATIONAL PSYCHOL. 46, 53–54 (2018).

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aware of both effects, they will not necessarily know how these costs and benefits compare in the specific case, given that this assessment would require considerable information about the firm. Overall, since the auditor's work can affect firms' access to finance and the development of capital markets, and markets are not likely to price the benefits of audit services accurately, there are powerful reasons to regulate auditors.

In addition, the failure of audit firms to properly perform their job may create some negative externalities, not only as the result of the money potentially lost by investors but also—and perhaps more importantly—for the lack of trust generated in the system. After a financial scandal, investors may be more skeptical about investing in public companies in general.[30] The information disclosed in financial statements has public good character, meaning that the issuer and its investors do not fully internalize its benefits.[31] Because of network effects resulting from the comparison of financial statements and the integrity of the system overall, without mandatory rules the amount of information produced will likely be smaller than socially optimal.[32] Likely, firms would therefore not have the incentive to give full weight to independence when selecting an auditor. This may help explain why auditor independence regulation has long attempted to err on the side of caution by addressing not only "independence in fact" but also mere "independence in appearance."[33]

The proposal in this Article thus follows the conventional wisdom that considerable regulation of auditor independence is desirable. It seems important to remain cognizant of the fact that there may not be a single right solution for the tradeoffs inherent in the regulatory

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30. Stephanie Yates Rauterkus & Kyojik "Roy" Song, *Auditor's Reputation and Equity Offerings: The Case of Arthur Andersen*, 34 FIN. MGMT. 121, 121–35 (2005) (showing the negative reaction of Arthur Anderson's worsening reputation on seasoned equity offerings, compared to those of non-Andersen clients. Namely, the authors found that the median firm in their sample lost $31.4 million more than a non-Andersen client.). *See generally* Sharad Asthana et al., *Audit Firm Reputation and Client Stock Price Reactions: Evidence from the Enron Experience* (Working Paper, 2003) (showing that Andersen's clients suffered significant value losses).

31. *See, e.g.*, Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81 (2007); *see also* Luca Enriques et al., *Corporate Law and Securities Markets*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, *supra* note 4, at 243, 246–47; Holger Daske et al., *Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences*, 46 J. ACCT. RES. 1085 (2008); Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over the Counter Market*, 36 J. LEGAL STUD. 213 (2007).

32. *See* Luca Enriques & Sergio Gilotta, *Disclosure and Financial Market Regulation*, *in* THE OXFORD HANDBOOK OF FINANCIAL REGULATION 511, 521–22 (Niamh Moloney et al. eds., 2015); Merritt Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQ. LAW 563 (2001); Enriques et al., *supra* note 31, at 246.

33. *See, e.g.*, Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom*, 95 GEO. L.J. 1843, 1882 (2007).

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choice across all firms. In addition to addressing highly obvious conflicts of interest, the proposal outlined in Part V thus emphasizes the role of the audit committee and disclosures intended to reduce market failures inhibiting private choice.

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Understanding auditor independence requires an analysis of incentives faced by auditors. Law and economics theory and accounting theory have each developed models exploring the incentives of the auditor in this context. While the gatekeeper model (from law and economics) would at first glance seem to suggest that auditors have an incentive to perform audits independently, the quasi-rent model (from accounting theory) illustrates the incentives of an auditor to retain a client, and hence an inherent danger to independent audits. Each of the two models will be discussed below (subpart IIB describes the gatekeeper model, and IIC the quasi-rent model), and subsequently a reconciliation between the two models is given (subpart IID). This synthesis provides a better basis for policy issues related to auditing.

B. *Auditors as Gatekeepers*

The legal literature has long described auditors as "gatekeepers."[34] This term was originally coined by Reinier Kraakman, who used it more generally to describe intermediaries—third parties—"who are able to disrupt misconduct by withholding their cooperation from wrongdoers" in a business law context.[35] Shareholders and other users of financial statements expect financial statements to provide a fair presentation of the financial position of the company and rely on them when making an investment decision. The firm's top managers ultimately bear the responsibility for drawing up financial statements, but often have incentives to shed a particularly favorable light on their company's financial situation, including managerial compensation and the evaluation of their performance by the market and investors.[36] A

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34. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) [hereinafter Coffee, *Gatekeeper Failure*]; Tamar Frankel, *Accountant's Independence: The Recent Dilemma,* 2000 COLUM. BUS. L. REV. 261 (2000); Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 424 (2008).

35. Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) [hereinafter Kraakman, *Gatekeepers*].

36. Under the semi-strong version of the efficient capital markets hypothesis, publicly available information such as financial statements is reflected by the stock price. *See* Martin Gelter, *Global Securities Litigation and Enforcement*, *in* GLOBAL SECURITIES LITIGATION AND ENFORCEMENT 1, 69–70 (Pierre-Henri Conac et al. eds., 2019); ARMOUR ET AL., *supra* note 25, at 102–05 (2016).

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number of mechanisms seek to balance these incentives and to keep management honest. Most of all, securities law provides for civil liability, regulatory enforcement actions, and criminal penalties, which in combination aim at rectifying inaccurate disclosures and at deterring managerial wrongdoing.[37] However, the more dire the situation in the firm becomes, and the stronger the incentives for managers to lie to investors by embellishing their financial statements, the less likely they are to set appropriate incentives to report truthfully. It is not always possible to deter wrongdoing with penalties.[38] For example, the likelihood of detection may be very small, and managers who are obviously biased analysts of their own firm's financial situation may underestimate it further. Penalties may be uncertain and implemented with low probability, and far in the future.

The key point in the gatekeeper strategy is that the auditor (or other gatekeeper) does not have the same high-powered incentives as the person with the primary obligation.[39] Because the auditor's payment or career does not hinge on the same incentives as the managers', potential sanctions will dissuade an auditor more easily than a manager because she has a lot to lose but little to gain from wrongdoing.[40] A gatekeeper strategy is effective when there is a large difference in relative cost of deterrence (i.e., when the firm's managers are hard to deter compared to the auditor).[41]

Gatekeeper theory tends to emphasize two deterrent factors:[42] First, a gatekeeper can be held liable by the intended beneficiaries of her activity.[43] Second, and possibly more importantly, the literature often defines gatekeepers as reputational intermediaries.[44] As repeat players, gatekeepers vie for additional professional engagements.[45] Once the beneficiaries of the gatekeeper's activity learn that a

37. *See* Gelter, *supra* note 36, at 33–39, 46–51, 51–96 (surveying regulatory, criminal and civil enforcement of securities law around the world).

38. *See, e.g.*, Choi, *supra* note 20, at 920 ("third-party screening for fraud has the most value when substitute antifraud mechanisms are at their weakest"); Coffee, *Gatekeeper Failure*, *supra* note 34, at 308, 309–10.

39. *See, e.g.*, Sharon Hannes, *Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay*, 98 CALIF. L. REV. 385, 407 (2010) ("gatekeepers are unaffected by the same perverse incentive structures that drive corporate insiders").

40. Kraakman, *Gatekeepers*, *supra* note 35, at 70.

41. *See* John C. Coffee, Jr. *Understanding Enron: It's About the Gatekeepers, Stupid*, 57 BUS. LAW. 1403, 1405 (2002) [hereinafter Coffee, *Understanding Enron*]; Choi, *supra* note 20, at 920.

42. John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* 1, 8 (Columbia Law Sch. Ctr. of L. & Econ. Stud., Working Paper No. 191, 2001) [hereinafter Coffee, *Acquiescent Gatekeeper*].

43. Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 891 (1984); Kim, *supra* note 34, at 426–27.

44. *See, e.g.*, Gadinis & Mangels, *supra* note 27, at 809–10; Kim, *supra* note 34, at 423–24.

45. Kraakman, *Gatekeepers*, supra note 35, at 94.

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gatekeeper lacks integrity, her report will lose much of its value.[46] Some studies have in fact identified a negative impact on the stock prices of clients audited by accounting firms involved in well-publicized accounting scandals.[47] A rational gatekeeper should therefore be incentivized by the desire to keep their reputation pristine.[48] The risk of losing a large number of clients[49] and maybe even one's entire professional standing should in theory vastly outweigh anything a dishonest client might be able to offer to a corrupt, wealth-maximizing auditor.[50]

The exit of an accounting firm from the market due to scandal is an extreme version of loss of reputation. Famously, Arthur Anderson, one of the "Big 5" accounting firms at the time, collapsed during the Enron crisis.[51] After its initial conviction for obstruction of justice, the firm was no longer allowed to audit publicly traded firms because of the felony conviction.[52] Consequently, despite the subsequent reversal of the conviction by the U.S. Supreme Court, the firm had lost its reputational basis as well as its staff that had migrated to other firms,[53] and it was facing securities class actions.[54] However, it is not clear if a large firm has ever left the market *exclusively* because of loss of reputation. Laventhol & Horvath, a large firm in the second tier just below what was then the "Big 8," exited because of money damage

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46. Coffee, *Acquiescent Gatekeeper*, *supra* note 42, at 9; *see also* Watts & Zimmerman, *supra* note 12, at 615 (pointing out that the probability of breaches being reported needs to be greater than zero for the audit to reduce agency costs of management).

47. *See* William R. Baber et al., *Client Security Price Reactions to the Laventhol and Horwath Bankruptcy*, 33 J. ACCT. RES. 385, 388–90 (1995) (showing price reactions to the Laventhol bankruptcy); Paul K. Chaney & Kirk L. Philpich, *Shredded Reputation: The Cost of Audit Failure*, 40 J. ACCT. RES. 1221 (2002) (showing reactions of market prices of Anderson other than Enron). *But see* Mark DeFond & Jieying Zhang, *A Review of Archival Auditing Research*, 58 J. ACCT. & ECON. 275, 297 (2014) (noting that the market reaction may have been influenced by oil price changes).

48. Coffee, *Gatekeeper Failure*, *supra* note 34, at 309–10; Gadinis & Mangels, *supra* note 27, at 811 (noting the limited role of regulatory sanctions in light of reputational incentives according to the theory); Tuch, *supra* note 12, at 1596.

49. Arthur Anderson had 2,300 audit clients prior to Enron. *See* Coffee, *Gatekeeper Failure*, *supra* note 34, at 310.

50. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 282 (1991).

51. Kathleen F. Brickey, *Andersen's Fall from Grace*, 81 WASH. U. L.Q. 917, 917 (2003).

52. SEC Rules of Practice, 17 C.F.R. § 201.102(e) (2004).

53. Prosecutors indicted Anderson for obstruction of justice on a single count of witness tampering in March 2002. Then the US Supreme Court reversed the conviction in May 2005. Arthur Andersen, LLP v. United States, 544 U.S. 696 (2005). *See* Eric L. Talley, *Cataclysmic Liability Risk among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1663–64 (2006); Brickey, *supra* note 51, at 919–21 (providing a timeline of events in the case).

54. Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1701 (2006).

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awards following a scandal during the savings and loans crisis in 1991.[55] KPMG, one of the remaining "Big 4," avoided a noisy exit in 2005 when prosecutors decided to go after individual partners rather than the firm in a criminal tax shelter scheme.[56] It appears that in all cases the outcome was driven by the interplay between legal and reputational consequences.

Gatekeeper theory provides an attractive analytical framework, but it cannot explain the conduct of audit firms alone. First, in light of the strong deterrent effect the reputational capital of a (former) Big 5 firm should exert in theory, one might expect the occasional minor audit failure to happen, but not extremely costly scandals such as Enron or WorldCom.[57] Otherwise, the Big 4 would have lost numerous clients due to major and minor scandals involving firms they were auditing in recent years.[58] Second, reputation may not always disseminate through the market, and perceptions of impropriety in the case of alleged malfeasance may differ.[59] Third, reputation is at best a "noisy signal."[60] The theory helps little in determining how strong exactly the deterrent effect of a possible loss of reputation is, or how strong it needs to be.

C. *Quasi-rent Theory and Auditor Selection*

1. The Auditor's Incentive to Retain a Client

To analyze auditor independence, the accounting literature theory sometimes uses the "quasi-rent model," whose original form was presented by Linda Elizabeth DeAngelo in 1981.[61] "Quasi-rents"

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55. *See id.* at 1700–01.

56. *See id.*

57. Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 113 (2003); Kim, *supra* note 34, at 424–25; *see also* Coffee, *Understanding Enron*, *supra* note 41, at 1405 ("experience over the 1990s suggests that professional gatekeepers do acquiesce in managerial fraud").

58. These collapses or financial scandals include BHS (PwC), Carrillion (KPMG), Rolls-Royce (KMPG), and Quindell (KPMG) in the United Kingdom, Abengoa (Deloitte) and Bankia (Deloitte) in Spain, the National Australian Bank (EY) in Australia, Satyam (PwC) and Infrastructure Leasing and Financial Services (Deloitte and KPMG) in India, Toshiba (EY) in Japan, Petrobras (PwC) in Brazil, and Xerox (KPMG) and Kmart (PwC) in the United States. Other incidents should have also affected the reputation of audit firms such as, *see, e.g.*, the illicit use of PCAOB data and cheating on training exams that led KPMG to a $50 million penalty. *See* Press Release, U.S. Sec. & Exch. Comm'n, KPMG Paying $50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams (June 17, 2019) (on file with U.S. Sec. & Exch. Comm'n).

59. Tuch, *supra* note 12, at 1614.

60. Kraakman, *Gatekeepers*, *supra* note 35, at 97.

61. *See* Linda Elizabeth DeAngelo, *Auditor Size and Quality*, 3 J. ACCT. & ECON. 183 (1981) [hereinafter DeAngelo, *Auditor Size*]; DeAngelo, *Auditor Independence*, *supra* note 24; *see also* DeFond & Zhang, *supra* note 47, at 311 (surveying the literature on quasi-rents).

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represent the present value for an auditor to be rehired in future years after an initial audit engagement.[62] An incumbent auditor enjoys an advantage over competing audit firms because an audit requires a start-up cost.[63] Members of the audit team have to familiarize themselves with the company's accounting procedures and check the initial figures in the balance sheet, while in future years they can rely on this client-specific experience and knowledge.[64] Since other auditors have not made these start-up expenses, the auditor and auditee are in a bilateral monopoly that is difficult to break.[65]

The audited firm will prefer to retain the current auditor because of transaction costs (such as running a search) resulting from a switch, and because the incumbent auditor can offer a lower price than competitors.[66] To be hired for the first time, auditors charge a "lowball" price in the first year, but their competitive advantage allows them to keep potential competitors at bay while charging a price above the annual cost in future years.[67] Because of competition, auditors do not extract economic rents from the audited client, but only "quasi-rents" that compensate them for the lowball in the first year.[68] This pricing structure is not necessarily an abuse by the auditing industry, but rather a consequence of the declining marginal cost of follow-up audits.

2. Dangers to Auditor Independence and the Selection of the Auditor

Regulators have sometimes seen "low-balling" as a danger to auditor independence,[69] and quasi-rent theory seems to suggest that independence is impossible to achieve. The auditor's monopolistic ability to extract quasi-rents should create incentives to hang on to a

62. DeAngelo, *Auditor Independence*, *supra* note 24, at 119–121.

63. *Id.* at 118.

64. Benito Arruñada & Cándido Paz-Ares, *Mandatory Rotation of Company Auditors: A Critical Examination*, 17 INT'L REV. L. & ECON. 31, 32–33 (1997).

65. DeAngelo, *Auditor Size*, *supra* note 61, at 188.

66. DeAngelo, *Auditor Independence*, *supra* note 24, at 119–21; DeAngelo, *Auditor Size*, *supra* note 61, at 188.

67. DeAngelo, *Auditor Independence*, *supra* note 24, at 119. Competitors seeking to displace an incumbent auditor would again have to make a lowball bid, which would then put them into a similar situation.

68. *See, e.g.*, Benito Arruñada, *The Provision of Non-Audit Services by Auditors: Let the Market Evolve and Decide*, 19 INT'L REV. L. & ECON. 513, 516 (1999); DeAngelo, *Auditor Independence*, *supra* note 24, at 120. For a quantitative discussion of the issue of competing bids, *see* Robert P. Magee & Mei-Chiun Tseng, *Audit Pricing and Independence*, 65 ACCT. REV. 315, 318–20 (1990).

69. DeAngelo, *Auditor Independence*, *supra* note 24, at 113. Most recently, low-balling has been criticized by the SEC in the release amending auditor independence rules. *See* Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 33-7919 § 3(C)(2)(a)(i) (Feb. 5, 2001); Coffee, *Acquiescent Gatekeeper*, *supra* note 42, at 28–29; DeAngelo, *Auditor Independence*, *supra* note 24, at 114–15; *see also* Fischel, *supra* note 17, at 1053.

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client to extend this economic advantage.[70] Being seen as insufficiently cooperative from the client's perspective could put an auditor at risk for not being reappointed in the following year.[71] Upon closer inspection, whether this concern holds water depends largely on the appointment process.

First, many jurisdictions provide for mandatory disclosure in the event of the removal of an auditor. In the United States, issuers must disclose when an auditor resigns, declines to stand for reelection, or is dismissed.[72] The firm must disclose *whether* the accountant resigned, declined to stand for reelection, or was dismissed, and whether the accountant had issued an adverse opinion or qualified audit opinion.[73] The disclosures also must describe disagreements with the auditor.[74] Firing a recalcitrant auditor thus becomes a "high visibility sanction," which should deter managers from using it as a threat to bring the auditor in line with their opinion.[75]

The EU Audit Directive is similar in this respect but seems to rely on regulation rather than disclosure. Member states must "ensure that statutory auditors or audit firms may be dismissed only where there are proper grounds" (which do not include mere disagreements about accounting treatments or audit procedures).[76] Moreover, the audited firm must inform the regulator responsible for supervising auditors of a resignation or dismissal and must provide an explanation.[77] However, given that EU law does not generally require disclosure, such a removal may go under the radar of the market. Moreover, it does not address the question of non-reappointment (i.e., what happens when an audit firm is not invited back after the completion of an audit).

Second, a key question is who decides about the appointment and removal of the auditor. For example, in the United States the audit committee—which is itself subject to independence requirements—is also responsible for the auditor's selection, which could suggest that the committee is likewise in charge of replacing the auditor.[78] Similarly, the EU Audit Directive requires a proposal by the audit committee for the selection of the auditor.[79] However, reliance on the

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70. Fischel, *supra* note 17, at 1053.

71. DeAngelo, *Auditor Size*, *supra* note 61, at 190.

72. Regulation S-K, 17 C.F.R. § 229.304(a)(1) (1998).

73. § 229.304(a)(1)(i)–(ii).

74. § 229.304(a)(1)(iv).

75. Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV 1233, 1237 (2002).

76. EU Audit Directive, *supra* notes 7 and 9, art. 38(1).

77. *Id.* at art. 38(2).

78. *See* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 141 (2002).

79. EU Audit Directive, *supra* notes 7 and 9, art. 41(3) (applying only to "public interest entities," i.e. publicly traded firm and some others).

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audit committee raises a number of other questions, such as whether the committee itself is sufficiently independent.

The involvement of shareholders in the selection process might provide an additional check. Unlike US law,[80] the EU Audit Directive requires a shareholder vote[81] and envisions an enhancement of independence through selection by shareholders.[82] The same ideas echo in the theoretical literature. Some models integrate the quasi-rent approach into the agency environment, with a principal appointing an auditor to monitor an agent-manager.[83] With the auditor having an incentive to retain the client because of the quasi-rent, the principal can then discipline the auditor by threatening him with removal.[84] Low-balling thus creates a bond set aside by the auditor when he defers part of the first period's audit fee to future periods.[85] In the case of collusion, the auditor is not only subject to liability but also loses the bond.[86] The larger the bond, the stronger the auditor's incentives will be to maintain a high degree of audit quality and independence.[87]

In practice, it is rarely shareholders who actively select the auditor. Even under the EU Directive, shareholders at best ratify a selection made in practice by management or an audit committee that may not be truly capable of independent judgment itself.[88] The requirement of a shareholder vote may in fact do more harm than good: in most European countries (like in most countries around the world), publicly traded companies are usually dominated by controlling shareholders or coalitions of large key shareholders on whose support

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80. *See, e.g.*, Lauren M. Cunningham, *Auditor Ratification: Can't Get No (Dis)Satisfaction*, 31 ACCT. HORIZONS 159 (2017) ("More than 90 percent of Russell 3000 companies voluntarily ask shareholders to ratify the company's choice of auditor . . . as a matter of 'good corporate governance.'").

81. EU Audit Directive, *supra* notes 7 and 9, at art. 37(1).

82. *See id.* at pmbl. recital 22 (discussing the selection of the auditor by shareholders in the context of independence); *id.* at art. 37(2) (permitting alternative auditor selection systems instead of appointment by shareholders only if they are designed to ensure the auditor's independence); *see also* Anand & Moloney, *supra* note 29, at 287–91 (suggesting that the presence of blockholders in Europe militates in favor of a shareholder-centric strategy in audit oversight).

83. *See generally* Chi-Wen Jevons Lee & Zhaoyang Gu, *Low Balling, Legal Liability and Auditor Independence*, 73 ACCT. REV. 533 (1998).

84. *Id.* at 535.

85. *Id.* at 545.

86. *Id.* at 535, 545.

87. *Id. at* 539–40, 545.

88. In particular, in the context of interested party transactions, the Delaware courts are typically suspicious of supposedly disinterested directors' ability to provide an independent business judgment in the presence of controlling shareholders. *See, e.g.*, *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 436 (Del. Ch. 2002) (analogizing the controlling shareholder to an "800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla"); *see generally* Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1286–90 (2017).

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management depends.[89] Europe's most widely publicized accounting scandal involving audit failure, Parmalat, involved the diversion of assets to its controlling shareholders, mainly at the expense of creditors.[90] A truly independent auditor would also need to be independent from dominant shareholder groups.[91] It is therefore inconceivable that the shareholder vote would have beneficial effect for auditor independence.

D. *Gatekeeper Reputation and the Market Impact of Quasi-Rents*

At first glance, the gatekeeper and quasi-rent models seem to have little in common. The former emphasizes the auditor's reputational incentive to remain independent, whereas the latter shows how the cost structure of an auditor–client relationship puts independence at risk. It is, however, quite easily possible to reconcile the two models by analyzing an audit firm across multiple clients. If it draws quasi-rents from each engagement, then an accounting scandal puts quasi-rents from multiple auditor client relationships at risk.[92] If, for example an auditor has n clients, then her total quasi-rent would sum up to $Q = \sum_{i=1}^{n} q_i$, where q_i is the quasi-rent at firm i. If management at firm x puts pressure on the auditor to approve a problematic accounting choice, she would risk losing the quasi-rent amounting to q_x. However, if a fully fledged accounting scandal erupts with probability p, she risks

89. Except for the United States, the United Kingdom and, to a lesser extent, Japan and Australia, most countries around the world often have companies with controlling shareholders. *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Gur Aminadav & Elias Papaioannou, *Corporate Control Around the World*, 75 J. FINANCE (forthcoming June 2020) (manuscript at 1) (on file with authors). Moreover, it should be noted that the number of companies going public with dual-class shares has increased in the past years. *See* Robert J. Jackson Jr., Comm'r, U.S. Sec. & Exch. Comm'n, Address at University of California Berkeley Law, Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018). Therefore, the rise of dual-class firms has generated more companies with controlling shareholders in the United States. For an analysis of the corporate ownership structure prevailing in Australian and Japanese companies, *see* STILPOR NESTOR & JOHN K. THOMPSON, CORPORATE GOVERNANCE PATTERNS IN OECD ECONOMIES: IS CONVERGENCE UNDERWAY? (2006); Jungwook Shim & Toru Yoshikawa, *The Evolution of Ownership Structure in Japanese Firms (1962–2012*), *in* JAPANESE MANAGEMENT IN EVOLUTION: NEW DIRECTIONS, BREAKS, AND EMERGING PRACTICES 21, 21–46 (Tsutomu Nakano ed., 2017); Alan J. Dignam & Michael Galanis, *Australia Inside-Out: The Corporate Governance System of the Australian Listed Market*, 28 MELBOURNE U. L. REV. 1 (2004); Julian R. Franks et al., *The Ownership of Japanese Corporations in the 20th Century* (ECGI Fin., Working Paper No. 410, 2014), https://ssrn.com/abstract=2397142 [https://perma.cc/EDH7-34NQ] (Feb. 20, 2020).

90. Coffee, *Gatekeeper Failure*, *supra* note 34, at 332–33; Coffee, *Corporate Scandals*, *supra* note 6, at 207–08 (contrasting the role of auditors in dispersed and concentrated ownership regimes).

91. *See* Coffee, *Corporate Scandals*, *supra* note 6, at 208.

92. *See, e.g.*, Arruñada & Paz-Ares, *supra* note 64, at 49; Arruñada, *supra* note 68, at 520.

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losing all the other quasi-rents. In other words, a rational auditor would accede to the client's demands if $q_x > p \cdot \sum_{i=1, i \neq x}^{n} q_i$ (i.e., when the benefit from client x exceeds the (probabilistic) loss of the benefit of all of the other clients in the event of a scandal).

Consequently, an auditor's quasi-rents with other clients (i.e., his position in the market overall) constitutes the reputational bond that should secure her independence.[93] This has a number of consequences. First, whether an auditor has incentives to remain independent depends on how important the client in question is to her. An auditor with a one-client practice that provides all of her income is unlikely to be in the economic position to act independently.[94] Empirical findings show that larger offices of audit firms tend to provide higher audit quality.[95] By contrast, an auditor with a large market share and diversified client base should in theory have a strong incentive to act independently with respect to *each individual* client.[96] Moreover, if gatekeepers are under strong pressure to keep their price close to cost, they may have incentives to shirk on quality.[97] This is not to say that an oligopolistic market structure is necessarily optimal. On the one hand, market concentration may be in part a function of the complexity of accounting standards. Larger accounting firms may be better able to train staff and spread the cost of keeping up with the requirements set by the applicable GAAP across many clients.[98] On the other hand, market concentration may enable auditors to increase fees.[99] It may also have the impact of reducing competition on audit quality.[100] Consequently, market structure likely entails a tradeoff: If audit firms are too small, there is no deterrent reputational sanction, and they may not be able to use economics of scale. If audit firms are too big, audit quality may suffer from lack of competition.[101]

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93. Arruñada & Paz-Ares, *supra* note 64, at 49.

94. *See, e.g.*, Coffee, *Gatekeeper Failure*, *supra* note 34, at 322.

95. *See* Jong-Hag Choi et al., *Audit Office Size, Audit Quality, and Audit Pricing*, 29 AUDITING: J. PRAC. & THEORY 73 (2010); Jere R. Francis et al., *Office Size of Big 4 Auditors and Client Restatements*, 30 CONT. ACCT. RES. 1626 (2013).

96. Arruñada, *supra* note 68, at 520; Gadinis & Mangels, *supra* note 27, at 815; Kim, *supra* note 34, at 431; *see also* Choi, *supra* note 20, at 942–43, 959–60; Fischel, *supra* note 17, at 1053.

97. Choi, *supra* note 20, at 941–42.

98. Louis-Philippe Sirois et al., *Auditor Size and Audit Quality Revisited: The Importance of Audit Technology*, 22 COMPTABILITÉ – CONTRÔLE – AUDIT 111, 125 (2016) (creating a model where fixed costs are more easily sustainable in a larger audit market because of economies of scale).

99. Choi, *supra* note 20, at 943–45. Choi's model (which applies to gatekeepers in general) suggests that this will lead some producers not to attempt to produce high-quality products. However, this assumes that they can avoid certification cost to a gatekeeper and selling an uncertified low-quality product, which is not possible in the audit market. For a more detailed discussion of the effects of audit market concentration, *see infra* Section IV.A.

100. Coffee, *Understanding Enron*, *supra* note 41, at 1414–15.

101. COFFEE, GATEKEEPERS, *supra* note 6, at 318.

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Second, if regulatory intervention can increase the probability of detection (p), auditors will have stronger incentives to uncover misrepresentations. Professor John Coffee has suggested that a decreased likelihood of securities litigation against auditors and other gatekeepers during the 1990s was one of the factors that led to a deterioration of audit quality and an increased number of restatements of earnings; changes in the case law and the Private Securities Litigation Reform Act of 1995 are likely reasons according to Coffee.[102] While liability as such may not add much to reputation in terms of the deterrent effect on auditors, a lawsuit and the ensuing negative publicity could trigger a reputational sanction. However, if the probability of detection of gatekeeper failure is quite low, as some have argued,[103] theory would dictate that additional sanctions are necessary for deterrence. With the collapse of the audit firm as the potential sanction, it is virtually impossible to implement additional sanctions.[104]

Third, an auditor's independence could be compromised if she draws additional benefits from an auditor–client relationship. A client's management might be able to add to the amount of the quasi-rent q_x by sweetening the deal with contracts for additional nonaudit services (NAS). This could compromise the auditor's independence.[105] However, if all of the other clients do the same in the same proportion, then in theory the relative weights in the equation showing the auditor's incentives will be unchanged, and the auditor will be just as independent as before.[106] If one client consumes a disproportionate amount of NAS, this may compromise the auditor's independence.[107] A key question is how strongly dependent the auditor is on a specific client.

Fourth, and most importantly, this analysis highlights the necessity to determine *who the functional gatekeeper is*. Coffee, in his analysis of the Enron scandal, suggests that Arthur Anderson's Houston office was strongly dependent on its biggest client, Enron, to an extent that it could be described as a one-client practice.[108] Sure, Arthur Anderson had considerable reputational capital at stake worldwide and, therefore, should have had strong reputational incentives. However, Anderson's staff in Houston most likely did not

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102. Coffee, *Gatekeeper Failure*, *supra* note 34, at 311–15, 318–21; Coffee, *Understanding Enron*, *supra* note 41, at 1409; *see also* Gadinis & Mangels, *supra* note 27, at 814 (noting the low probability of detection).

103. Gadinis & Mangels, *supra* note 27, at 817.

104. *Id.* at 818.

105. *See, e.g.*, Coffee, *Understanding Enron*, *supra* note 41, at 1411.

106. Arruñada, *supra* note 68, at 520.

107. *See id.* at 520–22 (suggesting that the objective of regulating NAS should be client diversification).

108. Coffee, *Gatekeeper Failure*, *supra* note 34, at 322; *see also* Coffee, *Understanding Enron*, *supra* note 41, at 1415–16; Kim, *supra* note 34, at 431.

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internalize this full incentive before the scandal. The advantage of "cooperating" with Enron's management may have outweighed the risk of reputational loss from an *ex ante* perspective. Hence, the key problem was an *internal agency problem* within the accounting firm. Individual auditors making key decisions do not have incentives that would be optimal from the perspective of the audit firm as a whole. While individual partners enjoy the benefits associated with any increase in the value and reputation of the audit firm, they do not internalize all the costs of the audit firm's failure. While Arthur Andersen's audit partners suffered financially from the firm's demise, they typically were able to transition to other positions and continue their careers.[109] Moreover, long-term relationships between audit firm staff and managers and accountants in the audited company may develop into collegial relations or even friendships, which makes them less likely to resist problematic accounting treatments or even outright illegal conduct.[110] If individual professionals are under pressure to grow specific client accounts, the advantages of acquiescing to client wishes are thus borne in part by the individual professionals.[111] By contrast, the firm may continue to bear the reputational disadvantages, the reputational intermediary strategy is bound to fail.[112]

III. TRADITIONAL RESPONSES TO THE AUDITORS' INDEPENDENCE PUZZLE (AND WHY THEY ALL FAIL)

A. *Introduction*

Auditor independence has been promoted through a variety of mechanisms. There are certain strategies commonly used across jurisdictions. These strategies include supervision, disclosure obligations, disqualification of auditors, fines, civil liability, and, in cases involving fraud, even criminal sanctions. This Part provides a comparative perspective on strategies that have been tried across

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109. *See* Chris Gaetano, *15 Years After Enron, Arthur Andersen Brand Resurges*, NYS SOCIETY CPAS (May 2, 2017), https://www.nysscpa.org/news/publications/the-trusted-professional/article/15-years-after-enron-arthur-andersen-brand-resurges [https://perma.cc/RMJ2-UT8U] (archived Feb. 20, 2020).

110. Gadinis & Mangels, *supra* note 27, at 816.

111. *See, e.g.*, Tad Miller, *Do We Need to Consider the Individual Auditor when Discussing Auditor Independence?*, 5 ACCT., AUD. & ACCOUNTABILITY J. 74, 77 (1992) (discussing how individual auditors may see growing service fees from particular clients as advantageous to their career).

112. *See id.* at 79–80 (modelling audit firm's and partner's different interest in a client relationship); *see also* Colleen Honigsberg, *The Case for Individual Audit Partner Accountability*, 72 VAND. L. REV. 1871 (2019) (analyzing the misalignment of incentives between audit partner and audit firms and suggesting a system of "audit scorecards" to address this issue).

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countries over the years. The following sections will discuss the imposition of auditor rotation and bans of certain services.

B. *Rotation Models*

One of the most common tools to enhance auditor independence has been auditor rotation, which is sometimes mandated by law or regulation.[113] *Internal rotation* takes place when the audit partner leading the audit process changes after a number of years but the audit firm remains the same.[114] This type of rotation is justified on two primary grounds. First, rotation seeks to address the internal governance problem in audit firms.[115] Second, they are also justified due to the loss of trust potentially faced by public investors if they observe that the same audit team who works on a daily basis with the audited firm has not changed over time.[116] After all, long-term relationships may create familiarity, which may make the auditors lose their objectivity.[117] Therefore, this factor, along with the inherent conflict of interests faced by auditors as a result of the fact of being paid by the client, may make public investors more skeptical about the impartiality of the auditor.

Thus, it should be in the interest of both companies and audit firms to change the audit partner and part (if not all) of its team, even if the replacement of the audit team generates new costs in terms of knowledge and familiarity with the audited firm. However, the fact that audit firms have not introduced it voluntarily suggests that either they do not have incentives to do so, or that their internal governance

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113. *See, e.g.*, EU Audit Directive, *supra* notes 7 and 9, at art. 17 (requiring rotation of audit firms after 10 years, and rotation of audit partners after 7 years in the context of public-interest entities). While *internal rotation* has been imposed in most countries around the world, including the United States, the European Union, China and Singapore, external rotation has been implemented just in a few jurisdictions, including the European Union and Brazil. Usually, the period of internal rotation is between five to seven years, depending on the jurisdiction, while the period of external rotation goes from five years (Brazil, United States) to ten years (European Union). *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 775, § 203 (codified at 15 U.S.C. § 7232) (amending § 10A of the Securities Act of 1934 to require audit partner rotation after 5 years); Mara Cameran et al., *The Audit Mandatory Rotation Rule: The State of Art*, 3 J. FIN. PERSP. (2015); Armour et al., *Transactions with Creditors*, *supra* note 4, at 123.

114. *See* Cameran et al., *supra* note 113, at 2.

115. Some empirical studies actually suggest that changing audit partners may create positive effects. *See* Henry Laurion et al., *U.S. Audit Partner Rotations*, 92 ACCT. REV. 209 (2017) (identifying an increase in the number of restatement discoveries). For an analysis of the internal governance problem existing within audit firms and how to fix it, *see infra* Parts IV.2–3.

116. Cameran et al., *supra* note 113, at 26.

117. This "familiarity threat" is mentioned in section 100.10(d) of the IFAC Code of Ethics. Code of Ethics for Professional Accountants, INT'L FED'N ACCOUNTANTS (2006), https://www.ifac.org/system/files/publications/files/ifac-code-of-ethics-for.pdf [https://perma.cc/AD2A-CUHV] (archived Feb. 20, 2020).

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is not geared toward maximizing the joint interest of the firm.[118] While audit firms may want to preserve quasi-rents across all audit clients, individual partners might not fully internalize the possible risk for the firm.[119] After all, if the firm fails, or it loses part of its reputation, this might not fully reflect on audit partners who may even transition to a different firm. Arguably, internal rotation can bring the interests of individual audit partners better in line because their potential advantages from being captured by the audit client will be reduced to a few years at most.[120] Consequently, many countries have decided to intervene by imposing internal rotation.[121]

External rotation occurs when the entire audit firm changes.[122] This type of rotation seeks to address the inherent conflict of interests between the audit firm and its client by limiting the period by which the audit firm can interact with and get fees from the audited company.[123] From a policy perspective, if the imposition of internal rotation can be challenged based on the private incentives held by audited companies and audit firms, there are still more arguments against the imposition of external rotation.[124]

First, changing the entire audit firm is more costly than internal rotation.[125] It will force the new auditor to spend even more hours to become familiar with the client.[126] In addition, it may require more coordination efforts between the new and the previous auditor.[127] Therefore, since these costs will be charged to the client, the audited company will likely respond with an increase in the price of its goods and services. As a result, this measure may make firms and investors

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118. *See supra* Part II.4; *infra* IV.2–3.

119. *See supra* Part II.4; *infra* IV.2–3.

120. *See, e.g.*, Henry Laurion et al., *supra* note 115, at 210.

121. Internal rotation has been implemented in most jurisdictions around the world, including the United States, the European Union, China, and Singapore. Countries not imposing internal rotation include, for example, Brazil and South Korea. *See* Cameran et al., *supra* note 113, at 5–8.

122. *Id.* at 2.

123. *Id.* at 9–11.

124. *Id.* at 113.

125. *See, e.g.*, Arruñada & Paz-Ares, *supra* note 64, at 36 (estimating cost increases between fifteen percent and twenty-five percent). For a review of the empirical literature on mandatory rotation, *see* Soo Young Kwon et al., *The Effect of Mandatory Audit Firm Rotation on Audit Quality and Audit Fees: Empirical Evidence from the Korean Audit Market*, 33 AUDITING: J. PRAC. & THEORY 167 (2014); Yi Liang, *Evaluating Market-Based Corporate Governance Reform: Evidence from a Structural Analysis of Mandatory Auditor Rotation* (Temple Univ. Sch. Bus., Working Paper, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2686354 [https://perma.cc/VMT5-8FXZ] (archived Feb. 20, 2020); Cameran et al., *supra* note 113.

126. Cameran et al., *supra* note 113, at 11–12.

127. To alleviate this concern, art. 23(3) of the EU Audit Directive provides that an auditor or audit firm that has been replaced must provide the income auditor "with access to all relevant information concerning the audited entity." EU Audit Directive, *supra* notes 7 and 9.

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worse off.[128] Second, the imposition of external rotation may make it easier for the management to seek the most accommodating auditor more frequently.[129] Third, from a theoretical perspective, it is not clear that a rotation requirement will reduce the auditor's dependence on specific clients.[130] In the model outlined in subpart IIC, a reduction of the auditor's quasi-rents in a specific client because of external rotation is paralleled by the reduction of quasi-rents with all other clients subject to the same requirement.[131] Thus, if an auditor has a diversified client base, rotation will not have an effect on the auditor's economic incentives set by quasi-rents *ceteris paribus*.[132] Fourth, if the nonrenewal of an auditor is a valuable signal to the market,[133] then imposing mandatory rotation will dilute this signal potentially provided by a renewal or dismissal of auditors. Finally, if having an auditor for a long period of time makes investors lose their trust, firms should have incentives to change auditors even if it is not required.[134] For these reasons, it is not clear whether the imposition of external rotation is a desirable measure.[135] That might explain why this rule has not been adopted by many jurisdictions, although the EU now requires it for publicly traded firms (and some others).[136]

C. *Prohibition of Nonaudit Services*

Audit firms usually provide a full range of professional nonaudit services (NAS), including tax and consultancy work. The ability to provide these services can generate several types of benefits. On the level of the individual client, there are considerable economies of scope between audit services and related NAS that create cost savings

128. *See* Josep Garcia-Blandon et al., *On the Relationship between Audit Tenure and Fees Paid to the Audit Firm and Audit Quality*, 17 ACCT. IN EUR. 78 (2020) (finding that audit firm tenure is positively associated with audit quality, while individual auditor tenure is associated with a reduction in audit quality).

129. John C. Coffee, Jr., *Auditing is too important to be left to the auditors!*, COLUM. LAW SCH. BLUE SKY BLOG (Jan. 28, 2019), http://clsbluesky.law.columbia.edu/2019/01/28/auditing-is-too-important-to-be-left-to-the-auditors/ [https://perma.cc/79U7-W46P] (archived Feb. 9, 2020) [hereinafter Coffee, *Auditing*]. For a more detailed explanation of the criticism of the external mandatory rotation based on this argument, *see* John C. Coffee, Jr., *Why Do Auditors Fail? What Might Work? What Won't?*, (Eur. Corp. Governance Inst. Working Paper No. 436/2019, 2019), https://ssrn.com/abstract=3314338 [https://perma.cc/526G-RBSL] (archived Feb. 9, 2020) [hereinafter Coffee, *Why*].

130. *See* Arruñada & Paz-Ares, *supra* note 64.

131. *Id.*

132. *See, e.g.*, *id.* at 49.

133. *See supra* notes 72–75 and accompanying text.

134. *See supra* Part II.C.

135. *See* Cameran et al., *supra* note 113.

136. *See* EU Audit Regulation, *supra* note 11, at art. 17(1). In the US, § 207 of the Sarbanes-Oxley Act of 2002 stipulated that the US General Accounting Office should study the merits of external rotation, but ultimately rejected it. Pub. L. No. 107-24, 116 Stat. 745 (codified at 15 U.S.C. § 7232).

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(relative to the separate provision of such services by a different firm), which can also be passed on to clients.[137] In addition, NAS may increase the knowledge and expertise of auditors in many areas potentially useful to conduct an audit.[138] On the market level, it can increase the profitability and competitiveness of audit firms. Thus, they will be in a better position to spend more resources on technology and human capital that can ultimately increase the quality of the auditor's work.

However, while the possibility of providing a full range of professional services can create several benefits, it may also create problems. First, services provided to the auditor's client may create more economic dependency if the auditor's client portfolio is not diversified.[139] To address this problem, regulators have often responded by limiting the fees potentially charged to a single client.[140] For example, under EU law, fees received by an audit firm from a single client for nonaudit services must not exceed 70 percent of audit fees over a three-year period.[141] If a firm receives more than 15 percent of its total fees from a single client, this must be disclosed to the audit committee in order to discuss measures to mitigate dangers to independence.[142]

Second, providing certain services may create a problem of "self-review."[143] In other words, sometimes auditors may provide professional services (e.g., tax, valuations) that may affect the company's financial statements. Since the auditor's primary role is verifying a company's financial statements and making sure that they fairly present the audited firm's financial position according to generally accepted accounting principles, there will be a clear conflict if the auditor has to review something their firm previously prepared for the client.[144] Obviously, preparing the client's financial statement would be the most obvious conflict.[145] However, there are more subtle ones that may affect the company's financial statements, including valuations, tax services, and the implementation of a system of

137. Arruñada, *supra* note 68, at 513–14.

138. *See, e.g.,* Mohinder Parkash & Carol F. Venable, *Auditee Incentives for Auditor Independence: The Case of Nonaudit Services,* 66 ACCT. REV. 113 (1993) (discussing knowledge spillovers); Dan A. Simunic, *Auditing, Consulting, and Auditor Independence*, 22 J. ACCT. RES. 679, 681 (1984) (discussing knowledge spillovers).

139. *See* Arruñada & Paz-Ares, *supra* note 64.

140. *See* EU Audit Regulation, *supra* note 11, at art. 4(1).

141. *See id.* at art. 4(2).

142. *See id.* at art. 4(3).

143. *See* INDEP. STANDARDS BD., STAFF REPORT: A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE 4 (2001).

144. *See id.*

145. For this reason, it is one of the most relevant types of NAS traditionally prohibited. *See* EU Audit Regulation, *supra* note 11, at art. 5; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 775 (codified at 15 U.S.C. § 7232).

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internal control.[146] In jurisdictions with close book-tax conformity,[147] tax services may create similar problems.[148] Therefore, NAS services may not only threaten independence by tightening the economic ties to the client but also by the fact that the auditor has to review its own work. Consequently, some legislatures have responded by restricting the types of NAS potentially provided to audit clients.[149]

While the need to prohibit NAS from creating a self-review threat should be self-evident, attempts to limit economic dependence on clients often appear to miss the mark.[150] Just as with quasi-rents from the provision of audit services (above subpart IIC), a large firm with hundreds of clients will not normally be dependent on nonaudit services provided to a specific client.[151] Firms that provide audit services to all clients will increase their quasi-rents overall and not be more or less dependent on any one of them.[152] More importantly, individual audit partners or teams may be dependent even if the entire firm is not. Requiring the approval of nonaudit services by the audit committee[153] may be a step in the right direction if the committee looks not only at the independence of the audit firm, but the specific partner. Ultimately, the issue is one of the audit firm's internal governance (see below subpart V.C.).

Even more controversial is the complete prohibition of NAS by licensed audited firms.[154] This is a more extreme response that has not been implemented in any major jurisdiction, likely because services provided to other clients do not create a threat to independence of audit

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146. *See* Simunic, *supra* note 138.

147. *See, e.g.*, Martin Gelter & Zehra G. Kavame Eroglu, *Whose Trojan Horse? The Dynamics of Resistance against IFRS*, 36 U. PA. J. INT'L L. 89, 145 (2014) (contrasting strong book-tax conformity in France and Germany with the US); Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 115–122 (2005) (comparing the relatively close book-tax conformity with greater differences between financial and tax accounting in the US and the UK).

148. *See* Christian Nowotny, *Taxation, Accounting, and Transparency: The Missing Trinity of Corporate Life*, *in* TAX AND CORPORATE GOVERNANCE 101, 107–08 (Wolfgang Schön ed. 2008).

149. Note that unlike Sarbanes-Oxley Act § 201(g), EU Audit Regulation, art. 5(1)(a) prohibits most tax services. *See* EU Audit Regulation, *supra* note 11, at art. 5; Sarbanes-Oxley Act of 2002, § 201(g).

150. *See* DeFond & Zhang, *supra* note 47, at 309 (describing the empirical results on the impact of NAS on audit quality as inconclusive); Jere R. Francis, *Are Auditors Compromised by Nonaudit Services? Assessing the Evidence*, 23 CONT. ACCT. RES. 747 (2006) (describing the empirical results on the impact of NAS on audit quality as inconclusive).

151. *See* Arruñada, *supra* note 68.

152. *See id.* at 520.

153. Sarbanes-Oxley Act of 2002, § 201(h); Regulation S-X, 17 C.F.R § 210.2.01(c)(7)(i)(A) (2020); *see also* EU Audit Directive, *supra* notes 7 and 9, at art. 39(6)(e).

154. *See* Walter Doralt et al., *Auditor Independence at the Crossroads – Regulation and Incentives*, 13 EUR. BUS. ORG. L. REV. 89, 94 (2012) (discussing this proposal).

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clients.[155] However, hiring an auditor for nonaudit services can be a route for being hired for future audit work and the other way around.[156] Prohibiting auditors from conducting nonaudit services in general would force firms to separate their audit business from their consultancy business.[157] As the provision of NAS can be beneficial for the quality and competitiveness of the audit profession,[158] this solution would come at a heavy price.

The provision of NAS *before* an audit raises primarily a self-review threat, given that NAS tend to be more profitable.[159] Consequently, rules prohibiting specific types of NAS seem most appropriate. These should apply in the abstract to previous years as long as the NAS still have an effect on the audited financial statements. At present, US law, which prohibits NAS only contemporaneously to the audit,[160] is underinclusive, while the EU Audit Regulation, which reaches back to the prior fiscal year,[161] is better tailored to this threat. To be on the safer side, regulators could consider longer cooling-off periods.

NAS *after* the end of an audit engagement can affect economic independence when the audit firm provides audit services with the expectation of being hired in the future for consultancy work.[162] Temporal limitations to provide NAS to previous audit clients should be long enough to undermine the value of any promise made by the company or the auditor. This would reduce the value of any promise for future hiring (considering that other circumstances may intervene, such as the replacement of the client's management or new controlling shareholders). Prohibitions of several years after an audit would likely eliminate problems.

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155. *See* Doralt et al., *supra* note 154.

156. This argument has been made by the Labor Party in the United Kingdom to advocate for breaking up the Big Four. *See MPs urge break-up of Big Four accountancy firms*, FIN. TIMES (Apr. 2, 2019), https://www.ft.com/content/b7c0d144-5487-11e9-91f9-b6515a54c5b1 [https://perma.cc/T7Z2-5UKQ] (archived Feb. 9, 2020).

157. This proposal has actually been proposed by the Labor Party in the United Kingdom. *See id*.

158. *See supra* notes 137–138 and accompanying text.

159. *See generally* STATUTORY AUDIT SERVICES MARKET STUDY, COMPETITION & MKTS. AUTH. (Apr. 18, 2019), https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf?_ga=2.264723404.2118062599.1566879225-1197864597.1566879225 [https://perma.cc/S2ME-XTND] (archived Feb. 9, 2020).

160. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(g), 116 Stat. 745 (codified at EU Audit Regulation, *supra* note 11, at art. 5; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 775 (codified at 15 U.S.C. § 7232); Regulation S-X, 17 C.F.R. § 210.2-01(c)(4) (2020).

161. *See* EU Audit Regulation, *supra* note 11, at art. 5(1)(b) (extending prohibitions of certain NAS provided to public interest entities to the year preceding the audit).

162. *See* Monika Causholli, Dennis J. Chambers & Jeff L. Payne, *Future Non-Audit Services Fee and Audit Quality*, 31 CONT. ACCT. RES. 681 (2014) (finding that subsequent opportunities to provide NAS are associated with lower audit quality).

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IV. RECENT PROPOSALS TO DEAL WITH THE AUDITORS' INDEPENDENCE PUZZLE

The regulatory responses implemented to address the auditors' independence puzzle do not seem to successfully solve the conflict of interest faced by auditors. For this reason, new proposals have been suggested in the past years, including the possibility of breaking up big audit firms, as well as increasing the power of public investors in the nomination of auditors.[163] As will be mentioned in subpart IVA, these proposals can solve part of the problem. However, they still present some flaws. As a result, Part V proposes a new model to deal with the auditors' independence puzzle in a more efficient manner.

A. *Break-Up of Audit Firms*

The United Kingdom, following a proposal submitted by the Labour Party, has been recently discussing whether audit firms (particularly the Big 4) should be broken up.[164] Namely, it has been argued that audit is often the route to have access to consultancy services, and that the conflicts of interest between auditors and clients undermine the quality of the work and ultimately the value of audit to investors.[165] Moreover, critics claim that since the audit industry is mainly controlled by the Big 4, these firms, in their situation of factual oligopoly, do not have incentives to provide top quality services.[166] Breaking up audit firms aims at several goals. First, by reducing the size of the Big 4, the reform seeks to increase the quality of services because of competition.[167] Second, it intends to force auditors to specialize on audit services.[168] Finally, and perhaps more importantly, by prohibiting audit firms from providing nonaudit services to existing or nonexisting clients, this proposal would also reduce conflicts of interest.[169]

This proposal faces a number of considerable objections. First, auditing financial statements is a difficult task that requires a broad

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163. *See* Coffee, *Why*, *supra* note 129.

164. Following a number of corporate collapses including the demise of Carillion and BHS, the UK regulator has been seeking to address auditor independence. Cognizant of a high level of concentration in the audit industry (the Big Four audit ninety-seven percent of the FTSE 350), the regulator considered breaking up the Big Four. While the Competition and Market Authority ultimately decided against this measure, the Labour Party official endorses a break-up. *See* STATUTORY AUDIT SERVICES MARKET STUDY, *supra* note 159; *see also MPs urge break-up of Big Four accountancy firms*, *supra* note 156.

165. *See* STATUTORY AUDIT SERVICES MARKET STUDY, *supra* note 159, at 82–83, 86.

166. *See id.* at 102–04.

167. *See id.* at 76–77.

168. *See id.* at 123–25.

169. *See id*.

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set of skills, including expertise in accounting, statistics, business management, and tax, among other areas. As discussed in subpart IIIC, knowledge spillovers from NAS can increase their level of expertise for their work as auditors.[170] Second, since audit firms would not be allowed to provide NAS, they will become less profitable. As a result, they might reduce their investments in technology and human capital, which could negatively affect audit quality over time. Third, the diminished accounting firms might find it more difficult to draw a talented workforce into the audit profession, given that NAS often provide the most interesting opportunities for talented professionals. Fourth, auditing large, often multinational, clients requires international coordination, and typically clients prefer the same "Big 4" group as its auditor in all jurisdictions.[171]

Fifth, as discussed above, concentration in the audit market may be a consequence of economics of scale and scope in the market for audit services that is hard to avoid.[172] The complexity and ever-changing nature of accounting standards likely makes it costly and time-consuming to keep up. Large firms likely have an advantage over smaller firms because they can spread investment in knowledge and skills across many clients. Finally, if reputation and client diversification set important incentives for audit firms to preserve their independent position, as suggested by gatekeeper theory, then a breakup of the industry into smaller firms could undercut the status of audit firms as "reputational intermediaries."[173] While in a large audit firm the tug-a-war between the overall interest of the firm and the individual interest of partners might put some breaks on the possible capture of specific partners by clients, this will no longer be true in small firms.[174] Smaller firms might ultimately become quite dependent on specific clients, especially when these are multinational corporations with considerable bargaining power.[175] Therefore, breaking up the audit industry could make economic independence problems worse and distract from the key problem, namely an audit firm's internal agency cost.

B. *Empowerment of Shareholders*

In a recent article, Professor John Coffee advocated for a new approach to auditor independence.[176] First, he argued that the regulator should grade auditors.[177] Second, public investors

170. *See supra* Part III.C.
171. *See* STATUTORY AUDIT SERVICES MARKET STUDY, *supra* note 159, at 152.
172. *See id.* at 92–93.
173. *See supra* Part II.D.
174. *See, e.g.*, Arruñada, *supra* note 68, at 42–43.
175. *See id.*
176. *See* Coffee, *Auditing*, *supra* note 129.
177. *See id.*

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representing a certain percentage of the company's equity (e.g., 10 percent) should be entitled to nominate a different auditor and place its nominee before the shareholders for a vote at the annual meeting.[178] While institutional investors are usually described as passive investors,[179] they often vote on generic issues of corporate governance that recur across their portfolios (e.g., board diversity, climate change, etc.), in part because they can follow a common policy.[180] Therefore, since, according to Coffee, the appointment of an auditor represents such a generic issue, they would engage in the election of auditors.[181] In conjunction with institutional investors, Coffee also argues that activist investors (such as hedge funds) and proxy advisors should also have incentives to engage in the process of appointing auditors.[182] In the case of activist investors, getting involved in this process may be part of a larger strategy of presenting themselves as the shareholders' champion and then seeking board representation.[183] Therefore, they will be happy to play the role of instigators and bear the costs.[184] In the case of proxy advisors, if the regulator grades the quality of an auditor's work, it will be easier (and safer) for them to recommend a vote against these auditors.[185] Therefore, they should also have incentives to engage in the appointment of auditors.

Even though this proposal would increase the accountability of auditors to public investors, it is unlikely to solve the auditors' independence puzzle. First, unless this system is implemented in conjunction with a long temporal prohibition to provide NAS to the audit client, audit firms will still have incentives to favor the interest of corporate insiders as a means to increase the likelihood of being hired for consultancy services. Second, even if public investors have the ability to nominate an auditor, controlling shareholders (in controlled firms) and managers (in firms with dispersed ownership structure) still have a great influence in the shareholders' meeting. Auditors will continue to have incentives to please insiders in order to secure its appointment. Third, while large public investors, such as BlackRock, Vanguard, and State Street, have incentives to police auditors in those companies they invest in, they may not want to antagonize audit firms they work with in another role. After all, they also need to be audited,

178. *See id*.

179. *See generally* Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy* (Eur. Corp. Governance Inst. Working Paper No. 433/2018, 2019), https://ssrn.com/abstract=3282794 [https://perma.cc/94LX-4DB3] (archived Feb. 10, 2020).

180. *See* Coffee, *Auditing*, *supra* note 129.

181. At present, there is not even legal requirement for shareholders to vote on the appointment of the auditors. However, most firms allow shareholders to ratify the engagement. *See supra* notes 80-82 and accompanying text.

182. *See* Coffee, *Auditing*, supra note 129.

183. *See id.*

184. *See id*.

185. *See id.*

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typically by one of the Big 4. Fourth, Coffee argues that selecting the auditor represents a generic corporate governance issue because, across their portfolios, institutional investors want objective information and could follow a common policy of voting against a poorly graded auditor.[186] However, even though having accurate information is indeed a general matter, the desirability of an auditor may differ across firms. Even among the Big 4, some audit firms may have more expertise in certain sectors. This argument would be even more compelling if the audit industry were more competitive. Therefore, selecting the most appropriate auditor may require some investigation costs that a passive investor may not want to bear. Finally, and perhaps more importantly, in companies with controlling shareholders, which are most companies around the world,[187] facilitating the nomination of auditors for minority investors would not make a significant difference. As the controller will still dominate the appointment of auditors through the shareholder meeting, the auditor will have incentives to treat corporate insiders (and particularly the controller) favorably—or at least public investors can reasonably think so.[188]

V. GOING FORWARD: NEW PROPOSALS FOR AUDITOR INDEPENDENCE

Regulators seeking to solve the auditor independence puzzle face two primary challenges. On the one hand, they need to provide a solution to the inherent conflict of interest existing between audit firms and their clients.[189] On the other hand, this solution should not undermine the quality of the audit services.[190] The following subparts develop a proposal to solve the auditors' independence puzzle. These reforms will focus on three primary areas: (i) a reform of the system for the appointment of auditors in the context of controlled firms; (ii) a reform of the composition and operation of the audit committee; and (iii) a final reform increasing transparency in the internal governance of audit firms and audit partners' compensation.

186. *See id.*

187. *See supra* note 89 and accompanying text.

188. In fact, some of the most significant accounting scandals involved controlled firms. In some cases (*e.g.*, Parmalat, Madoff), these companies were controlled by a family or founder. In others (*e.g.*, Enron), the firm was controlled by the managers.

189. This challenge has guided many audit reforms, including those implemented after Enron, or those recently suggested in the United Kingdom consisting of break-up audit firms. For an analysis of audit reforms, *see* Coffee, *Why*, *supra* note 129.

190. *See* Arruñada & Paz-Ares, *supra* note 64, at 56–58; Coffee, *Why*, *supra* note 129.

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A. *Majority-of-the-Minority Approval in Controlled Firms*

The empowerment of shareholders makes sense in companies with a dispersed ownership structure where there is a high risk of managerial agency problems. Therefore, it fails in companies with controlling shareholders. In these companies, the insiders to be watched not only include managers but also the controlling shareholder, or coalitions of large shareholders that jointly control the company. In such companies, there is no possibility that a shareholder vote on the auditor will improve his independence. This is true both under US law, where shareholders ratify the appointment as a matter of practice, and under the EU Audit Directive, which requires an appointment of the auditor by shareholders.[191] In practice, the auditor will be elected *in practice* by the controller.

This problem is very familiar in the context of independent directors.[192] Indeed, independent directors are often not truly independent in controlled firms due to the influence of the controlling shareholder in their appointment and removal.[193] For this reason, scholars and policymakers have brought forward several proposals, some of which have been implemented internationally.[194]

Other than boards, which combine a number of functions, namely both monitoring and the implementation of the interests of shareholders (but also groups of shareholders) within corporate decision-making, auditors exclusively have a monitoring function. It is therefore not self-evident that the appointment of auditors should be left to the majority of shareholders. As a matter of fact, controlling shareholders will not need an auditor to monitor management, but will have more direct channels available if they need additional information about the firm. Frequently, they are strongly represented on boards, or their representatives take leading management functions (e.g., in family firms). Accounting scandals in firms with controlling shareholders typically involve self-dealing transactions with them that a more independent auditor might have uncovered.[195]

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191. *See supra* notes 80–81 and accompanying text.

192. *See, e.g.*, Maria Gutierrez & Maribel Saez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63 (2013); Wolf-Georg Ringe, *Independent Directors: After the Crisis,* 14 EUR. BUS. ORG. L. REV. 401 (2013); Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L.J. 281 (2010); John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis* 40 (Eur. Corp. Governance Inst., Working Paper No. 108, 2008); Bebchuk & Hamdani, *supra* note 88.

193. *See* Bebchuk & Hamdani, *supra* note 88.

194. For a summary of these proposals, *see* Aurelio Gurrea-Martínez, *Towards a credible system of independent directors in controlled firms* (Ibero-American Inst. for L. & Fin., Working Paper Series 1/2019, 2019), https://ssrn.com/abstract=3380868 [https://perma.cc/5UBZ-LRQL] (archived Feb. 10, 2020); Bebchuk & Hamdani, *supra* note 88.

195. *See* Coffee, *supra* note 6, at 207–08.

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In such firms, policymakers need to see auditors as agents of public investors, other stakeholders, and users of financial statements. While it is hardly practicable to include all of these groups in the election or ratification process for the auditor, it seems straightforward to replicate some of the proposals brought forward in the context of independent directors.

This does not mean that rules for the appointment of auditors need to vary across firms. Controlling shareholders (if there are any) should merely be required to abstain from voting. Admittedly, this proposal does not change the appointment process in dispersed ownership firms, where institutional investor activism would have to play a major role in making sure that the auditors are not too close to the management. The proposal suggested in this Article merely seeks to create a similar situation in controlled firms by excluding the key group to be monitored from the election. Effectively, auditors should thus be elected by a majority of the minority investors. The audit committee and/or board should then be required to negotiate the audit engagement agreement in good faith.

Some questions might be raised regarding when exactly a shareholder should be prohibiting from voting. First, how to delineate controlling shareholders for the purpose of majority-of-the-minority (MOM) approval? Relying exclusively on *de facto* control and an assessment by a court would create an increased risk of an *ex post* invalidity of the appointment. Laws therefore often use more formal control definitions for various purposes.[196] To prevent an easy circumvention of the definition, it seems advisable to use a relatively low threshold and to define as controlling shareholders those with the ability to exercise or control the exercise of 30 percent or more of the votes to be cast, and those able to appoint or remove directors holding a majority of voting rights at board meetings.[197]

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196. For example, in the context of takeovers (especially in countries with a mandatory bid rule), the concept of control is usually defined. In some countries, a situation of control exists, unless it is shown otherwise, whenever a shareholder has a certain percentage of the company´s voting rights. Other countries follow a more functional definition of control, based on the idea of the facto control. For an analysis of this discussion, *see* Umakanth Varottil, *Comparative Takeover Regulation and the Concept of 'Control'*, 2015 SING. J. LEGAL STUD. 208, 208–31. Likewise, in the context of groups of companies, particularly when it comes to the imposition of consolidating financial statements, the concept of control is often defined by the legislation too. For example, in the EU Member States, a parent company is required to prepare consolidated financial statements (unless an exemption applies) whenever it has control over other companies. For that purpose, Audit Directive art. 22(1) establishes certain presumptions of control, including when the company holds the majority of another company's voting rights, or when it has the ability to appoint the majority of the board in another company. *See* EU Audit Directive , *supra* notes 7 and 9.

197. *See*, *e.g.*, FINANCIAL CONDUCT AUTHORITY, FEEDBACK ON CP12/25: ENHANCING THE EFFECTIVENESS OF THE LISTING REGIME AND FURTHER CONSULTATION Annex A 2–4 (2013), https://www.fca.org.uk/publication/consultation/cp13-15.pdf [https://perma.cc/7448-UQT5] (archived Feb. 10, 2020).

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Second, what if there is not a single controller, but multiple large shareholders that dominate the firm in combination? In this case, and similarly to what happens in the context of takeover regulation,[198] the law should clarify that acting in concert to satisfy the criteria for control also excludes shareholders from voting.

Finally, it should be kept in mind that minority shareholders, under some circumstances, may be reluctant to oppose the appointment of auditors selected by the majority. After all, they might also need to be audited, and the existence of a factual oligopoly in the audit industry may force them to choose the same auditors that they are supposed to police. Ideally, minority investors should be required to disclose conflicts of interest and, if it is severe enough, be prohibited from voting as well (for example, when a minimum percentage of the audit firm's revenues come from the minority investors).

While the imposition of a MOM approval for the appointment of auditor is not a perfect solution, it significantly improves the current regime since it minimizes the risk associated with letting the auditors be selected by the group of people that they are supposed to monitor. In light of market failures in the audit industry and the insiders' ability to opportunistically select a compliant auditor, this solution should be adopted as a mandatory rule.

B. *Enhancing the Role and Composition of the Audit Committee*

Most countries around the world require public companies to have an audit committee to oversee the company's financial reporting and audit policies.[199] This committee plays a significant role in the appointment, removal, and monitoring of the company's auditor.[200] For this reason, most of its members must be independent directors.[201] Likewise, as this committee should have the technical knowledge required to oversee auditors and financial reporting, some jurisdictions

198. In the EU, for example, *see* Council Directive 2004/25, art. 5, 2004 O.J. (L 142) 17 (EC) (regarding Takeover Bids). In other jurisdictions, *see* Varottil, *supra* note 196.

199. *See* OECD CORPORATE GOVERNANCE FACTBOOK, ORG. FOR ECON. CO-OPERATION & DEV. 121–22 (2019), www.oecd.org/corporate/corporate-governance-factbook.htm [https://perma.cc/7EM8-HQP3] (archived Feb. 10, 2020) [hereinafter OECD] (reporting that ninety-two percent of jurisdictions now require listed companies to establish an independent audit committee, while the remaining jurisdictions recommend it in corporate governance codes).

200. For a general overview of the role of the audit committee, *see* IOSCO REPORT ON GOOD PRACTICES FOR AUDIT COMMITTEE AND SUPPORTING AUDIT QUALITY, INT'L ORG. OF SEC. COMM'NS (Jan. 2019), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD618.pdf [https://perma.cc/66BL-R24P] (archived Feb. 10, 2020). In the US, *see* Regulation S-X, 17 C.F.R. § 210.2-01(c)(7) (2020) (requiring the approval of the auditor's engagement as well as the approval of the amount of NAS by the audit committee).

201. *See* OECD, *supra* note 199.

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require the members of the audit committee (or some of them) to have expertise in accounting, audit, and/or financial matters.[202]

Unfortunately, audit committees often do not seem to be doing their job in an effective manner, since the empirical evidence suggests that the audit market penalizes auditors for providing investors with value-relevant information that is critical of management.[203] Therefore, companies—with the approval of the audit committee—may prefer to hire less strict auditors.[204] As a result, any future reform seeking to solve the auditors' independence puzzle should put more emphasis on the audit committee.

First, the audit committee should be formed by a majority of members with expertise in accounting, auditing, and finance.[205] Otherwise, they might not be able to identify weaknesses in the company's internal control as well as the accounting and audit practices. Second, this committee should be formed by people willing and able to decide what is best for public investors, regardless of the interest of the corporate insiders. Unfortunately, this is a more severe problem. Many individuals with expertise in accounting may lack independence because of close connections with the audit industry. Moreover, the appointment of independent directors (including those included in the audit committee) is usually influenced by corporate

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202. For example, in the United States, issuers must disclose whether at least one "financial expert" serves on the audit committee. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745 (codified at 15 U.S.C. § 7265). In addition, the NYSE requires that at least one member must have "accounting or related financial management expertise." *See* NYSE LISTED COMPANY MANUAL § 303A.07(a), https://nyseguide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-75 (last visited Feb. 10, 2020) [https://perma.cc/P6Q2-J4QV] (archived Feb. 10, 2020). Likewise, NASDAQ listing standards require at least one audit committee member to be "financially sophisticated," and require all audit committee members to be able to read and understand financial statements. *See* NASDAQ EQUITY RULES, IM-5605-3, IM-5605-4. Under EU law "at least one member of the audit committee shall have competence in accounting and/or auditing." EU Audit Directive, *supra* notes 7 and 9, at art. 39(1).

203. *See* Elizabeth N. Cowle & Stephen P. Rowe, *Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job* 17 (Working Paper, 2019), https://ssrn.com/abstract=3228321 [https://perma.cc/XNN9-D4LK] (archived Feb. 10, 2020) (tracking the issuance of internal control material weaknesses (ICMWs) and finding that the issuance of a single ICMW is associated with a 2.5 percent lower growth in the number of clients and an eight percent decline in year-over-year revenue for that office).

204. *See id.* at 26–27 (blaming the audit committee for the punishment, in terms of fewer appointments and lower fees, of those auditors detecting more internal weaknesses); *see also* STATUTORY AUDIT SERVICES MARKET STUDY, *supra* note 159 (audit industry report recommending increased accountability of audit committees).

205. In most countries, members with financial expertise represent only a minority on the committee. Moreover, expertise on corporate governance is not required. For example, Sarbanes-Oxley Act § 407 requires issuers to disclose whether one committee member qualifies as a "financial expert" or not. *See also* Regulation S-K, Item 407, 17 C.F.R. § 229.407(d)(5) (2020).

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insiders.[206] Therefore, for the audit committee to work effectively, and for the auditors to create confidence in public investors, regulators need to first enhance the system of approval and removal of independent directors.[207] In the context of firms with dispersed ownership structures, where the CEO plays an important role in the appointment and removal of independent directors, the system can be improved by increasing the voice and power of shareholders, for example, by enhancing the system of proxy voting and the role of proxy advisors.[208] By contrast, in companies with controlling shareholders, the appointment and removal of independent directors is mainly decided by the controller.[209] In these companies, a credible system of independent directors should require the vote by both the shareholders' meeting and a majority of the minority for the appointment and removal of independent directors, as well as the mandatory existence of at least one independent director appointed by minority investors.[210] Finally, members of the audit committee should have enough time in the monitoring of the company's auditors and financial matters. Indeed, while "busy directors" can be beneficial for certain functions and companies,[211] members of the audit committee need to spend time interacting with the auditor and the company's accounting team, as well as assessing the company's financial policies. Therefore, this work can be time consuming. Thus, along with independence and expertise, availability and commitment are additional pillars of an effective audit committee.

C. *Enhancing the Internal Governance of Audit Firms*

As discussed above in subpart IID, scandals such as Enron show that the functional gatekeeper is often not the audit firm as a whole, but the key engagement partner or a small group that audits a firm

206. *See* Bebchuk & Hamdani, *supra* note 88; Gurrea-Martínez, *supra* note 194.

207. *See* Bebchuk & Hamdani, *supra* note 88; Gurrea-Martinez, *supra* note 194.

208. On the increasing role of institutional investors, *see*, *e.g.*, John C. Coates, IV *Thirty Years of Evolution in the Roles of Institutional Investors in Corporate Governance*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 79–98 (Jennifer Hill et al. eds. 2015); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

209. *See* Armour et al., *supra* note 192, at 40; Bebchuk & Hamdani, *supra* note 88; Gutierrez & Saez, *supra* note 192, at 63; Ringe, *supra* note 192, at 401; Varottil, *supra* note 192, at 281.

210. *See* Bebchuk & Hamdani, *supra* note 88; Gurrea-Martínez, *supra* note 194.

211. *See* Alexander Ljungqvist & Konrad Raff, *Busy Directors: Strategic Interaction and Monitoring Synergies* 38–40 (Nat'l Bureau of Econ. Research, Working Paper No. 23889, 2017) (finding that the cumulating of directorships need not necessarily harm firms if there are positive monitoring synergies); *see also* Stephen P. Ferris, Narayanan Jayaraman & Min-Yu (Stella) Liao, *Better Directors or Distracted Directors? An International Analysis of Busy Boards* (Georgia Inst. of Tech. Scheller Coll. of Bus., Research Paper No. 17–30, 2017), https://ssrn.com/abstract=3012820 [https://perma.cc/T2QW-8V2Q] (archived Feb. 10, 2020).

Electronic copy available at: https://ssrn.com/abstract=3476683

and develops the relationship with that client. The hypothetical interests of the accounting firm as a whole are not entirely absorbed by these individuals, even if they are partners, thus leading to an *internal agency problem*.[212] While the audit firm as a whole may have stronger incentives to maintain high standards of independence and audit quality, this may not necessarily be true for individuals within the firm.[213] Reforms relating to rotation and nonaudit services therefore fail if they do not tackle this issue.

There are a number of factors at play that influence the incentives of individual auditors. On the one hand, individual partners may be more easily captured by an individual client because he obtains only a small percentage of the firm's profit and loss. On the other hand, in a large firm, partners may be well-positioned to monitor each other (for which they might have incentives because of personal liability), and they may be in a good position to put internal control in place.[214] Arguably, with the establishment of consulting in audit firms, audit partners and the firm's consulting divisions became natural allies that often were more powerful than the accounting firm's internal audit division.[215]

In addition, while accounting firms today form international groups, they are not global partnerships. Each of the four networks is organized around either a UK Company limited by guarantee or a Swiss cooperative, of which its national units (sometimes several in a country) are members.[216] The coordinating entities provide some common standards across countries, but their partners in the country in question own the national affiliates.[217] Obviously, separate national structures are necessary because of differing national regulatory requirements. The national units are separate in terms of liability and regulatory sanctions, but it is less clear what effects reputational incidents have. While the Anderson network unraveled worldwide after Enron, a localized scandal in one of the networks would likely not have any impact beyond the country in question. One lesson is that it is difficult to generalize about the effectiveness of sanctions or agency conflicts within these firms. The interests of firms within one network

212. *See supra* notes 108–112 and accompanying text.

213. *See* Kraakman, *Gatekeepers*, *supra* note 35, at 71–72 ("larger firms obviously make more reliable gatekeepers"); Miller, *supra* note 111, at 78 (suggesting that an engagement partner may not report errors because of the utility received from the client). For empirical results, *see* Choi et al., *supra* note 95; Francis et al., *supra* note 95; *see also* Honigsberg, *supra* note 112.

214. *See* Kraakman, *Gatekeepers*, *supra* note 35, at 72.

215. *See* Coffee, *Understanding Enron*, *supra* note 41, at 1415.

216. *See* Hannah L. Buxbaum, *The Viability of Enterprise Jurisdiction: A Case Study of the Big Four Accounting Firms*, 48 U.C. DAVIS L. REV. 1769, 1796–97 (2015).

217. *See id.* at 1803–07.

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may sometimes diverge, but likely not enough to alleviate concerns that the connection can sometimes create a conflict of interest.[218]

What can legislatures and regulators do to improve incentives for individual auditors? One option is to prosecute them in cases of wrongdoing rather than the firm as a whole, which has already happened in a number of cases.[219] Starting from the premise that firms will not fully resolve internal agency problems themselves, they may also be content with a settlement with prosecutors or regulators that might actually expose a partner to criminal liability.[220] However, generally it appears that individual partners should have more "skin in the game."

Reform in this area could rest on multiple strategies. First, one possibility would be to strengthen incentives for partners to monitor each other. Large accounting firms are rarely unlimited liability entities such as general partnerships today, but rather LLPs in the United States or corporations in some other countries.[221] Arguably, this could undercut incentives for partners to monitor each other. Going back to unlimited liability is likely unfeasible politically, especially after the trend toward limited liability during past decades. In fact, the main reason for the spread of the LLP in professional services firms in the United States was the concern about being held liable for the negligence one has possibly never even met.[222] Moreover, partners typically need to make a considerable equity investment to join a firm; the risk of losing this share should in theory create a monitoring incentive already.[223]

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218. Art. 1(2) of the EU Audit Directive provides an expansive definition of "network", to which both the Directive and the Audit Regulation attach consequences in the context of independence requirements. *See* EU Audit Regulation, *supra* note 11; EU Audit Directive, *supra* notes 7 and 9, at art. 1(2).

219. *See, e.g.*, Cunningham, *supra* note 54, at 1700–01 (discussing criminal investigations against KPMG in 2005).

220. *See* Asaf Eckstein & Gideon Parchomovsky, *The Reverse Agency Problem in the Age of Compliance* 26–43 (Univ. of Penn. Inst. for L. & Econ. Research, Paper No. 19–38, 2019), https://ssrn.com/abstract=3460064 [https://perma.cc/F559-ZFKK] (archived Feb. 10, 2020).

221. For example, in Germany, § 27 Wirtschaftsprüferordnung (WPO) permits any type of registered business association. Wirtschaftsprüferordnung [WPO] [Auditor Order] June 17, 2016, § 27 (Ger.), https://www.wpk.de/uploads/tx_templavoila/WPO_02.pdf [https://perma.cc/4YSN-4J7B] (archived Feb. 11, 2020).

222. *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 127 (2010); Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1066 (1995).

223. *See* Clive Lennox & Bing Li, *The consequences of protecting audit partners' personal assets from the threat of liability*, 54 J. ACCT. & ECON. 154 (2012) (finding that switching to LLP status had no effect on audit quality in the UK, and that switches were likely introduced by the cost of the exposure of partners' personal assets to risk). Arguably, "enterprise liability" that treats different units of a Big Four network as jointly and severally liable could set further incentives for mutual monitoring. However, it does not eliminate each firms' partners limited liability. *See generally* Buxbaum, *supra* note

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Second, one could think about tweaking incompatibilities and prohibitions. Auditor independence rules already often apply to individual partners working in audit teams or in the chain of command above them.[224] However, the effectiveness of incompatibilities is sometimes limited. For example, both US law and EU law establish a "cooling-off period" for the employment of former employees of the accounting firm in an audit client.[225] The difficulty here is that this prohibition is only effective if the audit firm remains the same; it does not prevent the audit client from rewarding one of the auditor's employees with a lucrative job offer if the audit firm is a different one in the next year.

Third, regulators could strengthen individual sanctions, such as personal financial penalties, the possibility of losing the license as a CPA, or a prohibition against working in the financial industry after a regulatory finding of wrongdoing. However, relatively remote sanctions might not exert a sufficient deterrent effect compared to the more immediate benefits resulting from the relationship with the client.

Fourth, and most importantly, regulators should consider how remuneration is structured within audit firms. In the United States, under the Securities and Exchange Commission's independence requirements, an audit firm is not considered independent if "any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review or attest services."[226] The EU Audit Directive requires

> adequate remuneration policies, including profit-sharing policies, providing sufficient performance incentives to secure audit quality. In particular, the amount of revenue that the statutory auditor or the audit firm derives from providing non-audit services to the audited entity shall not form part of the

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216, at 1819–28 (discussing the viability of enterprise liability in multinational accounting firms).

224. *See, e.g.*, Regulation S-X, 17 C.F.R. § 210.2-01(f)(8), (11) (2020) (defining "chain of command" and "covered person" in the context of audit independence requirements).

225. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 206, 116 Stat. 745 (codified at 15 U.S.C. § 7232) (prohibiting public accounting firms from auditing issuers if individuals in certain leading financial positions with the audit client were previously employed in the audit firm and participated in an audit of the issuer during a one-year period before the initiation of the audit); Regulation S-X, 17 C.F.R. § 210.2-01(c)(2)(iii) (2020) (prohibiting employment of former employees, shareholders and partners of the accounting firm at the audit client under certain circumstances); EU Audit Directive , *supra* notes 7 and 9, at art. 42(3) (prohibiting the key audit partner from taking a key management position in the audited firm for two years).

226. Regulation S-X, 17 C.F.R. § 210.2-01(c)(8) (2020); *see also* Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 33-8183 (May 6, 2003) (introducing this provision into Regulation S-X in 2003).

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> performance evaluation and remuneration of any person involved in, or able to influence the carrying out of, the audit.[227]

In addition, the EU Audit Regulation, in the audit of public interest entities, prohibits contingent fees.[228]

While these rules go a long way, they do not change the expectation inside accounting firms to develop a particular client relationship over the years, success at which will likely result in professional advancement within the firm and long-term growth of compensation.[229] In large law firms in the United States, seniority-based, lock-step compensation systems have, since the 1980s, given way to systems where partner remuneration is based on individual contributions to the firm's profits, and partners can be de-equitized if they fail to generate revenue.[230]

Accounting firms around the world use a variety of compensation systems for partners, making comparisons difficult. Generally, compensation systems involve two choices. First, how many partners should be included in a profit pool (e.g., should a pool include all auditors in a particular local office, or all in the country)? Second, to what extent should the profit pool be divided equally? Within each pool, should some of the compensation vary by individual performance?[231] Firms have their own reasons for setting up a particular system. Less variability and larger pools mean that risks (e.g., liability) are shared among a larger set of partners.[232] This is utility increasing *ex post* if partners are risk averse, but it reduces their incentive to avoid liability because it will be socialized.[233] More variability and smaller pools set greater incentives to increase profits, but may make individual partners more susceptible to client demands.[234] It may also reward partners for taking risky clients because the risk will be borne by the entire firm.[235]

Data about compensation systems are hard to come by, but research from several European countries suggests that partners' compensation is positively associated with the size of the client

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227. EU Audit Directive, *supra* notes 7 and 9, at art. 24a(1)(j).

228. EU Audit Regulation, *supra* note 11, at art. 4(1).

229. *See* Gadinis & Mangels, *supra* note 27, at 815.

230. *See* Francis, *supra* note 23, at 362; Kim, *supra* note 34, at 432–33.

231. *See* Jürgen Ernstberger et al., *Are Audit Firms' Compensation Policies Associated With Audit Quality?*, CONT. ACCT. RES. (forthcoming 2020).

232. *See* Simunic, *supra* note 138, at 678–79.

233. *See id.*

234. *See, e.g.*, Geoff Burrows & Christopher Black, *Profit Sharing in Australian Big 6 Accounting Firms: An Exploratory Study*, 23 ACCT. ORG. & SOC. 517, 519–21 (1998); Greg Trompeter, *The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Audit Partner Judgement*, 13 AUDITING: J. PRAC. & THEORY 56, 57 (1994).

235. *See* Francis, *supra* note 23, at 362–63.

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portfolio and the acquisition of new clients.[236] Larger accounting firms tend to have more variable compensation practices (presumably because they are less in need of risk-sharing), but *ceteris paribus* more variable compensation is associated with lower audit quality (especially in medium-size firms).[237]

Any regulatory intervention in compensation systems intended to improve audit independence and quality would have to struggle with balancing the goals of risk-sharing and incentivizing partners to perform with the possible risk of creating a pressure-cooker atmosphere to maximize revenue by pleasing clients. Moreover, regulation of fee systems needs to grapple with the difficulty of taking into account that firms at least implicitly reward partners for acquiring new clients. Even if regulation mandated a firm-wide pool using a lockstep or sharing system, presumably the prospective ability to acquire new clients would be taken into account when firms invite a prospective new partner to join. The same is true for reforms requiring the inclusion of variable compensations *not* based on profit making (but instead based on, for example, internal audit quality reviews, which recent European research suggests that may mitigate negative incentive effects[238]).

Consequently, reforms should preferably *not* require accounting firms to implement a sharing system that excludes performance-oriented components more consistently than at present.[239] Sensible reform should emphasize increased transparency of compensation systems and their incentive effects. In many countries, audit firms already have to publish "transparency reports" (e.g., under Art. 40 of the EU Audit Directive). Under Art. 40, audit firms already must, among other things, annually disclose their legal structure and ownership, as well as what internal measures they undertake to ensure independence.[240] They must disclose "information concerning the basis for the partners' remuneration."[241] However, the actual

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236. *See* W. Robert Knechtel, Lasse Niemi & Mikko Zerni, *Empirical Evidence on the Implicit Determinants of Compensation in Big 4 Audit Partnerships*, 51 J ACCT. RES. 34 (2013) (researching Sweden).

237. *See* Marie-Laure Vandenhaute et al., *Professional and Commercial Incentives in Audit Firms: Evidence on Partner Compensation*, EUR. ACCT. REV. (forthcoming 2020) (researching Belgium); Ernstberger et al., *supra* note 231 (researching Germany).

238. *See* Vandenhaute et al., *supra* note 237.

239. We are skeptical about the idea of going further into the direction of explicit performance-based compensation. *See* Hannes, *supra* note 39, at 420–34 (proposing the issuance of restricted stock to auditors combined with mandatory rotation). First, the proposal requires the implementation of mandatory rotation, which entails a number of problems discussed above in section III.B. Second, the restriction period would have to be long enough to ensure that the auditor accounting fraud would be uncovered during the time. This would make a considerable part of the auditor's compensation depend on business risk that (unlike for managers) is completely outside the auditor's control.

240. EU Audit Directive, *supra* notes 7 and 9, at art. 40(1)(a), (g).

241. *Id.* at art. 40(1)(j).

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transparency reports are often rather general on this particular point and may include a few paragraphs that explain that there are fixed and variable components of partner compensation.[242] While audit firms have to list public interest clients, they are not required to list engagement partners for each of them.[243]

These transparency reports are in principle a valuable regulatory instrument that has the potential to strengthen auditor independence. While the disclosure of individual partner compensation might conflict with privacy law principles in many countries, reforms should aim at precisely specifying how firms use performance-based metrics to calculate partner compensation, and at requiring firms to explain what profit pools they use for nonvariable components. Transparency reports should also include lists of engagement partners for each publicly traded audit client in their report.[244] In addition, if the audit firm provides any nonaudit services to such audit client, the responsible partners for these services and the amount of fees received for such services should be disclosed as well as audit fees. The ability to gauge responsibilities for each client would enable investors to better judge the value of an audit report.

VI. CONCLUSION

Auditors play a major role in corporate governance and capital markets. *Ex ante*, auditors facilitate firms' access to finance by creating trust among public investors. *Ex post*, auditors can prevent misbehavior and prevent financial fraud by corporate insiders. In order to fulfill these goals, however, in addition to having the adequate knowledge and expertise, auditors should perform their functions in an independent manner. Unfortunately, for a variety of reasons, including the possibility of providing nonaudit services or the fact of being hired and paid by the audited company, auditors face a clear conflict of interest. Therefore, even if they eventually act independently,

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242. *See* Rogier Deumes et al., *Audit Firm Governance: Do Transparency Reports Reveal Audit Quality?*, 31 AUDITING: J. PRAC. & THEORY 193 (2011) (finding no association between more detailed transparency reports and audit quality).

243. *See* EU Audit Directive, *supra* notes 7 and 9, at art. 40(1)(f).

244. In the US, accounting firms have been required to disclose the names of engagement partners, but not their compensation. *See* Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards, PCAOB Release No. 2015-008 (Dec. 15, 2015), https://pcaobus.org/Rulemaking/Docket029/Release-2015-008.pdf [https://perma.cc/SBQ6-M9Y6] (archived Feb. 10, 2020); Order Granting Approval of Proposed Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards, SEC Release No. 34-77787 (May 9, 2016), https://www.sec.gov/rules/pcaob/2016/34-77787.pdf [https://perma.cc/3YRQ-YVGV] (archived Feb. 10, 2020) (approving the PCAOB rule).

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investors have incentives to think otherwise. And if so, this lack of trust must be translated in an overall increase of a firm's cost of capital.

It has been argued that the existence of various market failures, including asymmetries of information and negative externalities potentially created by audit failure, justify a regulatory intervention, especially in the context of the auditor independence. The existing literature has attempted to solve the auditor's independence puzzle through a variety of mechanisms, including prohibitions, rotation, or more recently breaking up of audit firms or empowerment of public investors. This Article has highlighted flaws and limitations of all of these regulatory responses. For this reason, this Article has proposed a new model to solve the auditors' independence puzzle, which includes a system of majority-of-the-minority approval for the appointment of auditors in controlled firms, combined with a stronger role for public investors in the audit committee and increased transparency and disclosure obligations about the internal governance and compensation system of audit firms. Given the tradeoffs inherent in the regulatory choices at hand, the proposal is therefore intended to strengthen decision-making by investors and thus the possibility of a certain level of firm-specific choices.

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