

REPORT
POGO

Accounting's Big Lie – and How to Fix It

October 6, 2022

Acknowledgements

AUTHOR

David Hilzenrath

ADVISORS

Scott Amey
Brandon Brockmyer

EDITING AND FACT-CHECKING

Julia Delacroix
Neil Gordon
Mia Steinle

DESIGN

Leslie Garvey
Renzo Velez

Supported by a grant from Luminate

POGO is grateful to J. Edward Ketz for reviewing a draft of this report.



1100 G Street NW, Suite 500
Washington, DC 20005
WWW.POGO.ORG

THE PROJECT ON GOVERNMENT OVERSIGHT (POGO)

is a nonpartisan independent watchdog that investigates and exposes waste, corruption, abuse of power, and when the government fails to serve the public or silences those who report wrongdoing.

We champion reforms to achieve a more effective, ethical, and accountable federal government that safeguards constitutional principles.

Table of Contents

Executive Summary	4
Part 1: The Problem	6
The Lie	6
Incentives Matter	10
Feeling Confident?	14
Misplaced Trust.....	16
Defining Independence	20
Independence Violations	22
No Time for Complacency.....	25
Part 2: Possible Solutions	32
Government Does The Audits	33
Government Hires Auditors	35
Stock Exchanges Hire Auditors	37
The Insurance Model	38
Eliminate the Audit Requirement.....	40
Mix and Match Options	40
Red Team	42
Restrict Audit Firms to Auditing	43
Term Limits for Auditors.....	46
<i>Term Limits — The Theory.....</i>	<i>46</i>
<i>Term Limits — The Early History.....</i>	<i>47</i>
<i>Term Limits—The Shootdown of a Trial Balloon</i>	<i>49</i>
<i>Term Limits and Their Limits — Looking Forward</i>	<i>55</i>
Tell the Truth	57

A colossal conflict of interest compromises the auditing of public companies and the financial security of everyone who depends on them.
The Project On Government Oversight is planning a conference on what to do about it. The following is meant to serve as a starting point for discussion.
It provides background on the issue and options for potential reform.

Executive Summary

Corporations, big accounting firms, and the federal government have been selling the public a lie.

They claim that the financial statements of public companies — including those traded on the stock market — are audited by independent accounting firms.

But the audit firms are not independent.

They are dependent.

The audit firms are chosen and paid by the companies they audit. Just as the company hires its auditor, the company has the power to fire its auditor.

As professor Don Moore of California's Haas School of Business has put it, "The very notion that the current system allows for truly independent audits is laughably implausible."¹

The system incentivizes auditors to please their clients instead of protecting the public.

In this report, the Project On Government Oversight (POGO) explores ways to realign the incentives and make the system more rational.² We examine a range of alternatives, from having the government perform audits to eliminating the audit requirement altogether.

¹ Don Moore, "Prepared comments for PCAOB hearing March 21, 2012 on auditor rotation," Comment on PCAOB Rulemaking Docket 037 (March 21, 2012), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/ps_moore.pdf.

² This report was funded in part by Luminate. In 2020, Luminate awarded the Project On Government Oversight a grant of \$75,000 to build on POGO's past investigative reporting about corporate auditing by diagnosing and explaining problems with the system, analyzing potential solutions, and promoting reform. This report is part of that ongoing work.

The potential reforms include having a third party — such as a regulatory agency, stock exchange, or insurance company — assign auditors.

Some ideas, like imposing term limits on auditors, have been debated extensively. Others, like enlisting a “Red Team” to search for problems and paying it a bounty if it finds them, may be new.

We review how the accounting industry has long opposed term limits, historically the leading proposal, and we explain why the present is no time for complacency.

We also explain how arcane rules meant to determine whether audit firms qualify as independent miss the forest for the trees — or maybe for the leaves.

We show how auditing’s perverse incentives have shaped a history of unethical and illegal behavior, how trust in auditors has been misplaced, and why an effective system of checks and balances should harness the power of auditors’ self-interest instead of relying on their consciences.

Part 1 of our report lays out the problem. Part 2 analyzes potential solutions.

We believe the best time to fix the system is now, before it contributes to the next crisis. However, we also take a long view. We recognize that it can take scandals or disasters to stir policymakers to action. The last major U.S. audit reforms were enacted in 2002, after the energy-trading company Enron collapsed in an accounting fraud of historic proportions.

That legislation created a special regulator for auditors of public companies — the Public Company Accounting Oversight Board (PCAOB) — but it left auditing’s fundamental problem intact.

It failed to protect us from subsequent disasters like the crisis of 2008, which brought the global financial system to the brink of collapse.

If policymakers don’t address the auditing problem before the next crisis, we believe they should at least be equipped to act when the next crisis strikes.

And, if the road to audit reform is otherwise blocked, there’s one simple step the government could take.

Stop lying.

Abandon the illusion or self-delusion and stop calling dependent auditors independent.

Part 1: The Problem

The Lie

Every public company's annual financial report perpetuates a lie.

Financial disclosures are supposed to give the public a true picture of a company's health and profitability. To make them more trustworthy, the government requires that the numbers be audited by independent accountants. The annual financial report includes what it describes as a report by an independent accounting firm, and, in that document, the accounting firm responsible for the audit describes itself as "independent."

But the audit firm is not independent.

It is dependent.

The audit firm is chosen and paid by the company it is auditing. Just as the company hires its auditor, the company has the power to fire its auditor.

Big companies can pay their audit firms tens of millions of dollars a year, and, for an audit firm, losing a client means cutting off a revenue stream that could otherwise stretch into an open-ended future.³

The auditor's assessment is formally titled, "Report of Independent Registered Public Accounting Firm." But only in the Orwellian sense is that accurate, like "War is Peace" and "Freedom is Slavery." It's a delusion, an exercise in doublethink.

We'd say this is an open secret, but it's no secret at all. It's blindingly obvious.

Auditors are caught in a fundamental conflict of interest.

They are supposed to serve the public. They're expected to act as watchdogs. "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client," the U.S. Supreme Court has stated. "This 'public watchdog' function demands that the accountant maintain total independence from

³ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, PCAOB Rulemaking Docket Matter No. 37, Public Meeting," Transcript, March 21, 2012, 49, https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/2012-03-21_transcript-notice.pdf.

the client at all times, and requires complete fidelity to the public trust,” the court has said.⁴

But the corporations are the auditors’ clients, and auditors have powerful motivation to keep their clients happy.

It’s an absurd system. The incentives are fundamentally misaligned.

In a 2020 article in *The CPA Journal* titled “The Myth of Auditor Independence,” J. Edward Ketz described it as “a patronage system that rewards cozy relationships between auditors and clients and discourages strict adherence” to accounting rules.⁵

“This patronage system needs to go away — the sooner, the better,” Ketz wrote.⁶

Similarly, Max H. Bazerman, a professor at Harvard Business School, cut to the heart of the matter in a statement to regulators a decade ago. “If we do want independent audits, it is time to recognize that, without a massive overhaul of the existing system, this goal will ... elude us,” Bazerman wrote. “Society is currently paying enormous costs without getting the very service that the industry claims to provide: independent audits.”⁷

Don Moore of the Haas School of Business at the University of California at Berkeley put it more succinctly: “The very notion that the current system allows for truly independent audits is laughably implausible.”⁸

All three of those scholars have noted a body of research showing that, even at a subconscious level, people’s self-interest tends to bias them.

⁴ United States v. Arthur Young & Co., 465 U.S. 805 (1984), <https://supreme.justia.com/cases/federal/us/465/805/>.

⁵ J. Edward Ketz, “The Myth of Auditor Independence: Waking Up to Unconscious Bias,” *The CPA Journal*, February 2020, <https://www.cpajournal.com/2020/03/06/the-myth-of-auditor-independence/>; In a rebuttal to Ketz, a former lawyer to and partner at big accounting firms argued that, “justified as his views may be ... the independence concept no longer serves the interests of the public, and should be scrapped altogether.” Jim Petersen, “Revisiting ‘The Myth of Independence,’” *The CPA Journal*, June/July 2021, <https://www.cpajournal.com/2021/08/27/revisiting-the-myth-of-independence/>.

⁶ Ketz, “The Myth of Auditor Independence” [see note 5].

⁷ Max H. Bazerman, “Creating Auditor Independence,” Comment on PCAOB Rulemaking Docket 037 (March 21, 2012), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/ps_bazerman.pdf.

⁸ Don Moore, “Prepared comments for PCAOB hearing March 21, 2012 on auditor rotation” [see note 1].

“Due to the often-subjective nature of accounting and the close relationships that exist between accounting firms and their clients, even the most honest auditors can be unintentionally biased in ways that mask a client company’s true financial status, thereby misleading investors, regulators, and even the company’s management,” Bazerman wrote.⁹

Even the big accounting firm KPMG has acknowledged that, in interactions with corporate managers, auditors can face conflicting pressures.

“Applying professional skepticism is about making tough choices,” the then-chief executive officer of KPMG said in 2012. “At that critical point when the auditor is faced with a decision about whether to keep pushing, either pushing back on management’s representation or pushing forward for more audit evidence, what forces are motivating the auditor to keep at it? And what forces are there that may be pushing in the opposite direction? And the question we’re faced with today is how do we increase those forces that contribute to that skeptical mindset?”¹⁰

In some cases, the lie that the auditor is independent is a prelude to others. In some cases, though blessed by the auditor, the financial statements turn out to be erroneous or even fraudulent, and the company’s internal controls — another focus of the audit — turn out to be defective. In the worst cases, lots of people lose. Companies implode, employees lose jobs and benefits, individual investors and pension funds lose money saved for retirement, communities suffer, and chain reactions affect the economy and financial system.¹¹

⁹ Bazerman, “Creating Auditor Independence” [see note 7].

¹⁰ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 37 [see note 3].

¹¹ “When the system fails, workers can lose jobs. Investors can lose money, including savings invested in 401(k) accounts and other individual retirement plans. Pension funds for teachers, firefighters, and other large groups can take a hit. And all manner of other people whose lives and livelihoods are connected to the affected company — in ways they may not even realize — can suffer.” David Hilzenrath, “What the U.K. Can Learn from the U.S. Experience with Audit Reform: Don’t Do What We Did,” Project On Government Oversight, July 7, 2021, <https://www.pogo.org/analysis/2021/07/what-the-u-k-can-learn-from-the-u-s-experience-with-audit-reform-dont-do-what-we-did/>; “When audits fail and, through fraud or error, a company inflates its stock price, a lot of people and institutions can get hurt. Employees can lose jobs, benefits, and retirement savings. The company’s vendors and lenders can be left holding the bag. Individual shareholders can lose money invested through IRAs and 401(k) plans. Pension funds can lose money invested for large groups of workers such as teachers and firefighters. The ripple effects can spread through the community where the company is based and through the broader economy.” David Hilzenrath, “Remember Enron? It Could Happen Again on Biden’s Watch,” Project On Government Oversight, December 3, 2020, <https://www.pogo.org/analysis/2020/12/remember-enron-it-could-happen-again-on-bidens-watch/>.

A recent government proposal would raise the stakes by expanding the scope of audits. It would require companies to make new audited disclosures about how they are affected by severe weather and climate-related risks such as flooding, drought, wildfires, and rising sea levels.¹²

The climate proposal by the Securities and Exchange Commission could deliver a windfall for audit firms — and a new expense for corporate shareholders.

If society is looking for reliable climate disclosures, it has a vested interest in making sure any audits of those disclosures are reliable.

In this report, the Project On Government Oversight (POGO) explores ways to realign auditing's incentives and make the audit system more rational. We examine a range of alternatives, from having the government perform audits to eliminating the audit requirement altogether.

We asked five major audit firms and a trade group for the accounting industry what can be done to eliminate auditing's fundamental conflict of interest. We also invited them to explain in what sense, if any, companies' outside auditors are independent, and whether it's dishonest to call them independent. None responded to our questions.¹³

We believe the best time to fix the system is before it contributes to the next crisis.

However, we also take a long view. We recognize that it can take scandals or disasters to stir policymakers to action. Audits were originally mandated in reaction to the stock market crash of 1929. The last major U.S. audit reforms were enacted in 2002, after the energy-trading company Enron collapsed in an accounting fraud of historic proportions.¹⁴ Even after Enron's meltdown, it was unclear that Congress would do

¹² Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors," Press Release 2022-46, March 21, 2022, <https://www.sec.gov/news/press-release/2022-46>; See also: Securities and Exchange Commission, "Enhancement and Standardization of Climate-Related Disclosures," Fact Sheet, accessed June 15, 2022, <https://www.sec.gov/files/33-11042-fact-sheet.pdf>; The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334, 21,365 (proposed April 11, 2022), <https://www.govinfo.gov/content/pkg/FR-2022-04-11/pdf/2022-06342.pdf>.

¹³ POGO sent those inquiries to Deloitte, Ernst & Young (EY), Grant Thornton, KPMG, PricewaterhouseCoopers (PwC), and the Association of International Certified Professional Accountants (AICPA).

¹⁴ Since then, the PCAOB has adopted more limited reforms, such as requiring auditors to identify "critical audit matters" in their reports and requiring public identification of the accounting firm partners in charge of individual audits. We discuss those in this report. For background on critical audit matters, see: Public Company Accounting Oversight Board, "Implementation of Critical Audit Matters:

anything. It took another accounting scandal, the implosion of telecommunications giant WorldCom, to drive legislation through Congress and across then-President George W. Bush's desk.¹⁵

That legislation created a new regulator for auditors of public companies — the Public Company Accounting Oversight Board (PCAOB) — but it left auditing's fundamental problem intact.

If today's policymakers don't address the problem in the absence of a crisis, we believe they should be equipped to act when the next crisis strikes.

We also recognize that, when the moment comes, time will be of the essence. Political momentum can fade quickly. A common strategy for industries facing calls for reform is to drag out the deliberative process until any sense of urgency recedes.

We hope this analysis will serve as a basis for discussion. We hope the discussion can help generate a blueprint for reform that policymakers could implement when the political stars align, if not sooner.

Incentives Matter

The framers of the U.S. system of government believed incentives matter.

They didn't trust in the goodness of people. "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal

The Basics," Staff Guidance, March 18, 2019,

<https://pcaobus.org/Standards/Documents/Implementation-of-Critical-Audit-Matters-The-Basics.pdf>;

The later Dodd-Frank Act also affected audits. It "expands the PCAOB's authority to oversee auditors of broker-dealers," the PCAOB explained at the time. See: Public Company Accounting Oversight Board,

"PCAOB Statement upon Signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act,"

Press Release, July 20, 2010, https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-statement-upon-signing-of-the-dodd-frank-wall-street-reform-and-consumer-protection-act_297;

Also, so-called auditor independence rules have been changed in recent years. See: Public

Company Accounting Oversight Board, "PCAOB Adopts Amendments to Align Independence

Requirements with SEC Rules," Press Release, November 19, 2020, <https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-adopts-amendments-to-align-independence-requirements-with-sec-rules>;

Securities and Exchange Commission, "SEC Updates Auditor

Independence Rules," Press Release 2020-261, October 16, 2020, <https://www.sec.gov/news/press-release/2020-261>.

¹⁵ David S. Hilzenrath, Jonathan Weisman, and Jim VandeHei, "How Congress Rode a 'Storm' to Corporate Reform," *Washington Post*, July 28, 2002,

<https://www.washingtonpost.com/archive/politics/2002/07/28/how-congress-rode-a-storm-to-corporate-reform/8b86dffc-430a-4434-8bda-1858d63d7d0f/>.

controls on government would be necessary,” James Madison famously wrote in *The Federalist Papers*.¹⁶

The framers of the Constitution sought to harness incentives toward the desired end. They created a system of checks and balances in which ambition was meant to counteract ambition — one where the interests of each branch of government would drive it to restrain the others.¹⁷

The roots of many financial crises can be traced in part to misaligned incentives.

For example, the savings and loan crisis of the 1980s and 1990s, in which much of the lending industry received a taxpayer bailout, resulted in part from savings and loan associations making reckless investments with federally insured deposits. In the absence of effective regulation, the federal backstop enabled the gambling.¹⁸

Early in the internet age, before a bubble in dot-com stocks burst, Wall Street investment banks fueled the runup with cheerleading “research” reports on companies.¹⁹

“The equities analysts of Merrill Lynch and other Wall Street firms were charged with objectively advising retail investors whether to buy or sell publicly traded stock. The analysts had rated some stock a strong buy, while at the same time disparaging it in Internet emails as ‘a piece of junk’ or a ‘powder keg,’” a Harvard Business School case study recounts.²⁰

As a summary of the case study notes, the analysts issuing the “buy” ratings had a conflict of interest: the Wall Street firms they worked for were competing for the dot-

¹⁶ James Madison, Federalist No. 51, 1788, <https://billofrightsinstitute.org/primary-sources/federalist-no-51>.

¹⁷ James Madison, Federalist No. 51 [see note 16].

¹⁸ Will Kenton, “Savings and Loan (S&L) Crisis,” Investopedia, updated July 30, 2021, <https://www.investopedia.com/terms/s/sl-crisis.asp>.

¹⁹ John Cassidy, “The Investigation: How Eliot Spitzer Humbled Wall Street,” *New Yorker*, April 7, 2003, <https://www.newyorker.com/magazine/2003/04/07/the-investigation>; Patrick McGeehan, “Merrill Lynch Under Attack as Giving Out Tainted Advice,” *New York Times*, April 9, 2002, <https://www.nytimes.com/2002/04/09/business/merrill-lynch-under-attack-as-giving-out-tainted-advice.html>; Securities and Exchange Commission, “SEC Fact Sheet on Global Analyst Research Settlements,” April 28, 2003, <https://www.sec.gov/news/speech/factsheet.htm>; National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report* (January 2011), 59, <https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

²⁰ Rawi Abdelal, Rafael Di Tella, and Jonathan Schlefer, “Eliot Spitzer: Pushing Wall Street to Reform,” Harvard Business School Case 708-019 (revised April 2009), abstract, <https://www.hbs.edu/faculty/Pages/item.aspx?num=35663>.

coms' business. The investment banks made money by advising the companies and underwriting the companies' stock offerings.

Without admitting or denying wrongdoing, 10 major Wall Street firms settled enforcement actions by agreeing to pay a total of almost \$1.4 billion and implement reforms.²¹

The financial crisis of 2008, largely the result of a bubble in subprime mortgages, had many authors. Mortgage brokers and lenders made money up front, incentivizing them to issue loans that borrowers couldn't afford. Instead of holding onto the loans and relying on borrowers to make a steady stream of monthly payments, lenders offloaded the loans to others. The right to receive the payments was packaged into securities and sold to investors. Bond rating agencies greased the sales by assigning top grades to securities that turned out to be garbage. The bond rating agencies were hired and paid by the businesses issuing the bonds.²² Home appraisers made mortgages possible by vouching that the real estate provided adequate collateral. But appraisers owed their income to lenders, and lenders pressured them to inflate values.²³

Like auditors, appraisers lacked independence.

"The integrity of our mortgage system depends on independent appraisals. Again and again our industry-wide investigation found that banks were putting pressure on appraisers to drive up the value of loans just to make a quick buck," Andrew Cuomo said in 2008, as attorney general of the state of New York.²⁴

²¹ Securities and Exchange Commission, "Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking," Press Release 2003-54, April 28, 2003, <https://www.sec.gov/news/press/2003-54.htm>.

²² National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, 57, 147, 148, 158 [see note 19]; Better Markets, "Fact Sheet: Credit Rating Agency Conflicts of Interest Again Fueling A Financial Crisis," updated May 19, 2020, https://bettermarkets.org/sites/default/files/CRA_Fact_Sheet_updated_5-19-20.pdf.

²³ New York State Office of the Attorney General, "New York Attorney General Cuomo Announces Agreement With Fannie Mae, Freddie Mac, And Ofheo," Press Release, March 3, 2008, <https://ag.ny.gov/press-release/2008/new-york-attorney-general-cuomo-announces-agreement-fannie-mae-freddie-mac-and>; National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, 39, 47, 120 [see note 19]; "WaMu pushed for higher home appraisals-witness," Reuters, June 20, 2012, <https://www.reuters.com/article/wamu-appraisals/wamu-pushed-for-higher-home-appraisals-witness-idUSL1E8HJ89720120620>; Kara Johnson, "New Rules to Control Inflated Home Appraisals," *Mortgageloan.com*, accessed May 5, 2022, <https://www.mortgageloan.com/new-rules-to-control-inflated-home-appraisals-2886>.

²⁴ New York State Office of the Attorney General, "New York Attorney General Cuomo Announces Agreement With Fannie Mae, Freddie Mac, And Ofheo" [See note 23].

No wonder so many mortgages and mortgage-backed securities proved unsustainable. Incentives tend to predict outcomes.

Through those chapters in history and more, auditors failed to protect the public. In many instances, their reports gave no hint that numbers were unreliable, that internal controls were wanting, or that companies they audited were in danger of collapse.

A *Washington Post* story from 2001 by the author of this report illustrated the problem:

Years before Enron Corp. collapsed, wiping out thousands of jobs and billions of dollars of shareholder wealth, outside auditors from the big accounting firm Arthur Andersen found \$51 million of problems in the company's books — and decided to let them go uncorrected.

While auditing Enron's 1997 financial results, Andersen proposed that the energy company make "adjustments" that would have cut its annual income by almost 50 percent, to \$54 million from \$105 million, according to testimony Andersen has presented to Congress.

Enron chose not to make those adjustments and Andersen put its stamp of approval on the company's financial report anyway.²⁵

Robert Prentice, a professor at the McCombs School of Business at the University of Texas at Austin, has explained why the now-defunct accounting firm might have been predisposed to go along with Enron's accounting:

Or think of Arthur Andersen's David Duncan, the auditor in charge of the Enron account. Enron was one of Andersen's largest clients and Duncan's career essentially hung on the success of Enron. Andersen was making a healthy \$25 million a year auditing Enron and another \$27 million by providing nonaudit services. Andersen expected that its Enron related revenue would soon double to \$100 million a year. In other words, Andersen, Duncan, and Duncan's subordinates all had a strong self-interest in concluding that Enron was in good financial shape and that its various financial machinations were consistent with good accounting practices. In the shadow of such a strong self-interest, it

²⁵ David Hilzenrath, "Early Warnings of Trouble at Enron," *Washington Post*, December 30, 2001, <https://www.washingtonpost.com/archive/politics/2001/12/30/early-warnings-of-trouble-at-enron/4094d347-e9c3-4972-bb64-4c12708d6145/>.

would have been very difficult for even an auditor with the best of intentions to make judgments in an objective manner.²⁶

While Arthur Andersen defended its work, the firm acknowledged the central issue.

“For our system to work, you and the investing public must have confidence that the fees we are paid, regardless of the nature of that work, will not weaken our resolve to do what is right and in the best interests of investors,” C.E. Andrews, who was at the time global head of auditing and business advisory for Andersen, said in testimony to Congress in 2001.²⁷

Feeling Confident?

In a 2004 article in *The Journal of Corporation Law* titled “The Mother of All Conflicts,” law professor Richard Kaplan of the University of Illinois described his experience long ago as a junior auditor at a big accounting firm.

“The accounting firm culture held that making trouble for a client was the road to professional oblivion,” Kaplan wrote. He continued:

After all, the audit personnel who were the subjects of praise and admiration were the ones who earned the highest epithet: “He ... knows how to keep clients happy.” Experts in the intricacies of financial accounting standards were regarded with much less awe. Indeed, their principal utility seemed to lie in formulating hypertechnical rationalizations that would provide nominal compliance with “generally accepted accounting” precepts while enabling the client to do what it intended. That, apparently, was how you kept a client “happy.”²⁸

POGO’s reporting has shown what the big accounting firm PricewaterhouseCoopers (PwC) expected of an auditor in Silicon Valley more recently. In written feedback on his performance, PwC partners explained what it would take for the auditor to advance at the firm. “Build the relationships where the client would never want to leave PwC,”

²⁶ Robert Prentice, Written Testimony for the PCAOB Public Hearing in Houston, Texas (October 18, 2012), 5, https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/ps_prentice.pdf.

²⁷ “An Overview of the Enron Collapse”: Hearing Before the Senate Committee on Commerce, Science, and Transportation, 107th Cong. (December 18, 2001) (testimony of C.E. Andrews), 32, <https://www.govinfo.gov/content/pkg/CHRG-107shrg82282/pdf/CHRG-107shrg82282.pdf>.

²⁸ Richard L. Kaplan, “The Mother of All Conflicts: Auditors and Their Clients,” *Illinois Public Law and Legal Theory Research Papers Series*, Research Paper No. 04-13 (June 14, 2004): 365, <https://dx.doi.org/10.2139/ssrn.556623>.

the feedback said. “As a partner you have to have the position that you want these guys to like you,” the document from 2014 added.²⁹

At big audit firms, a partner’s “primary source of job security is the partner’s ‘book of business’ or client list,” Robert A. Conway, a former audit partner at a major firm, wrote in his 2020 book, *The Truth About Public Accounting: Understanding and Managing the Risks the Auditors Bring to the Audit*.³⁰

“This means there is a lot of pressure on each partner to keep their existing base of clients. This pressure can create tension between ‘keeping the client happy’ and good audit quality,” Conway wrote.³¹

The accounting firm Grant Thornton made a similar point in a 2011 statement to regulators.

“No partner wants to be the one to lose a significant or long-standing relationship,” Grant Thornton wrote.³²

The fundamental conflict of interest is bad enough, but there are also exacerbating factors.

Audit firms do more than audit; they sell other services to corporations. That puts them in the position of soliciting business from companies they must be willing to antagonize. It also puts them in the position of having to objectively assess business results they helped shape. Though it’s subject to restrictions, it complicates an already fraught relationship.

In addition, some individual auditors are, in a manner of speaking, selling themselves. Many accountants have used auditing as a stepping stone to employment at companies they’ve audited, and many companies have hired from the ranks of their auditors.

“Another aspect of the patronage system that characterizes the auditing institution is the alumni effect where [companies] hire partners or managers of the auditing firm.

²⁹ David Hilzenrath, “PwC Whistleblower Alleges Fraud in Audits of Silicon Valley Companies,” Project On Government Oversight, May 10, 2018, <https://www.pogo.org/investigation/2018/05/pwc-whistleblower-alleges-fraud-in-audits-of-silicon-valley-companies/>.

³⁰ Robert A. Conway, *The Truth About Public Accounting: Understanding and Managing the Risks the Auditors Bring to the Audit* (2020), 32.

³¹ Conway, *The Truth About Public Accounting*, 32 [see note 30].

³² Grant Thornton to the Office of the Secretary of the Public Company Accounting Oversight Board, Comment on PCAOB Rulemaking Docket 037 (December 14, 2011), 2, https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/522_gt.pdf.

The problem is that they will hire only the ones they consider ‘played ball’ with them,” Ketz said.³³ There’s a one-year cooling-off period for auditors going to work for companies they audited, but that’s too short, Ketz added.³⁴

Then there’s the incentive for audit firms to cut corners — to boost their profits by skimping on the time, effort, and labor spent performing an audit — for example, by relying heavily on junior auditors and stretching them too thin.³⁵

In sum, the auditing system does the opposite of what Madison advocated in his treatise on checks and balances. When it comes to the relationship between auditor and client, ambition can further ambition.³⁶

Misplaced Trust

Trust in audits has long been a leap of faith.

At a 1933 hearing, before Congress drafted the audit requirement, an accountant named Arthur Carter urged Congress to entrust the work to public accountants.³⁷

“Who audits you?” a senator asked.

“Our conscience,” the accountant replied.

³³ Email from J. Edward Ketz to David Hilzenrath, March 28, 2022. Ketz pointed to this article: Michael Favere-Marchesi and Craig Emby, “The alumni effect and professional skepticism: An experimental investigation,” *Accounting Horizons*, Volume 32, Issue 1, 2018, 53-63, <https://doi.org/10.2308/acch-51920>.

³⁴ More specifically, federal rules “prohibit an accounting firm from auditing an issuer’s financial statements if certain members of management of that issuer had been members of the accounting firm’s audit engagement team within the one-year period preceding the commencement of audit procedures,” as the SEC said in 2003. Securities and Exchange Commission, “Strengthening the Commission’s Requirements Regarding Auditor Independence,” Release No. 33-8183, January 28, 2003, <https://www.sec.gov/rules/final/33-8183.htm>.

³⁵ Olaf Storbeck, “EY Germany to cut staff workloads in post-Wirecard overhaul; Big Four firm promises to address ‘permanent occupational stress and overburdening’ of its auditors,” *Financial Times*, April 28, 2022, <https://www.ft.com/content/b4c603a9-d4f7-4f24-b27c-ad5f7f16a880>.

³⁶ The U.S. constitutional system can also defy Madison’s theory. The ambitions of members of Congress can enable a president’s ambitions, not just counteract them.

³⁷ S. 875, *A bill to provide for the furnishing of information and the supervision of traffic in investment securities in interstate commerce: Hearings before the Senate Committee on Banking and Currency*, 73rd Cong. (March 31 to April 8, 1933) (statement of A.H. Carter, president of the New York State Society of Certified Public Accountants), 58, https://www.google.com/books/edition/Securities_Act_hearings_Before_73_1_on_S/yqLCYJU-w1gC?hl=en&gbpv=1&pg=PA58.

The senator asked how an auditor differed from a corporate controller.

The controller “is in the employ of the company,” Carter responded.

It was a subtle distinction, and the auditor’s conscience has at times proven a weak match for other motivations.

For example, in 2019, the SEC charged the accounting firm KPMG with engaging in rampant self-serving dishonesty. KPMG agreed to pay a \$50 million penalty and admitted to the facts laid out in an SEC enforcement order.³⁸

In a related news release, the SEC said “numerous KPMG audit professionals cheated on internal training exams by improperly sharing answers and manipulating test results” and that the cheating “included lead audit engagement partners who not only sent exam answers to other partners, but also solicited answers from and sent answers to their subordinates.”³⁹

The SEC also said senior members of the firm improperly obtained and used confidential information about which of KPMG’s audits regulators planned to inspect. The SEC had earlier compared that to “stealing the exam.”⁴⁰

“The breadth and seriousness of the misconduct at issue here is, frankly, astonishing,” Steven Peikin, co-director of the SEC’s Enforcement Division, said in an SEC news release.⁴¹

In related cases, several accountants were convicted of or pleaded guilty to criminal charges.⁴²

³⁸ Securities and Exchange Commission, “KPMG Paying \$50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams,” Press Release 2019-95, June 17, 2019, <https://www.sec.gov/news/press-release/2019-95>.

³⁹ Securities and Exchange Commission, “KPMG Paying \$50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams” [see note 38].

⁴⁰ Securities and Exchange Commission, “Six Accountants Charged with Using Leaked Confidential PCAOB Data in Quest to Improve Inspection Results for KPMG,” Press Release 2018-6, January 22, 2018, <https://www.sec.gov/news/press-release/2018-6>.

⁴¹ Securities and Exchange Commission, “KPMG Paying \$50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams” [see note 36].

⁴² David S. Hilzenrath, “How Accountants Took Washington’s Revolving Door to a Criminal Extreme and How Hundreds of Others Have Taken It for a Spin,” Project On Government Oversight, January 14, 2020, <https://www.pogo.org/investigation/2020/01/how-accountants-took-washingtons-revolving-door-to-a-criminal-extreme/>; Kyle Brasseur, “Ex-KPMG Exec Avoids Prison in Final Cheating Scandal Sentencing,” *Compliance Week*, December 3, 2020, <https://www.complianceweek.com/accounting-and-auditing/ex-kpmg-exec-avoids-prison-in-final-cheating-scandal-sentencing/29787.article>.

If enforcement actions are any guide, there's been an outbreak of cheating at big accounting firms.

In September 2021, the U.S. audit oversight board charged that, at KPMG's Australia affiliate, more than 1,100 employees, including more than 250 auditors, "were involved in improper answer sharing — either by providing or receiving answers — in connection with tests for mandatory training courses" on topics such as professional independence, auditing, and accounting.⁴³

In February 2022, the same regulator charged that, at the PricewaterhouseCoopers (PwC) affiliate in Canada, more than 1,200 professionals engaged in similar misconduct.⁴⁴

The KPMG and PwC affiliates settled those cases without admitting or denying the charges. That has been typical in SEC and PCAOB enforcement actions.⁴⁵ Unless otherwise noted, SEC and PCAOB charges against auditors cited in this report followed that pattern.

Last year, the SEC charged another big accounting firm, Ernst & Young, with improperly using an inside track to win appointment as auditor of a Fortune 500 company. EY sought and received confidential information from an insider at the

⁴³ Public Company Accounting Oversight Board, *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions In the Matter of KPMG, Respondent*, PCAOB Release No. 105-2021-008 (September 13, 2021), 2, <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/enforcement/decisions/documents/105-2021-008-kpmg-australia.pdf>.

⁴⁴ Public Company Accounting Oversight Board, *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions In the Matter of PricewaterhouseCoopers LLP, Respondent*, PCAOB Release No. 105-2022-002 (February 24, 2022), 2, https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/enforcement/decisions/documents/105-2022-002_pwc-canada.pdf.

⁴⁵ See: Securities and Exchange Commission, "Administrative Proceedings," accessed June 29, 2022, <https://www.sec.gov/litigation/admin.htm>; In 2021, SEC enforcement director Gurbir S. Grewal announced a policy shift, saying, "We will, in appropriate circumstances, be requiring admissions in cases where heightened accountability and acceptance of responsibility are in the public interest." Gurbir S. Grewal, "Remarks at SEC Speaks 2021," (speech, Washington, DC, October 13, 2021), <https://www.sec.gov/news/speech/grewal-sec-speaks-101321>; Dave Michaels, "Wall Street, Companies May Have to Give Up More to Settle With SEC; New Policy Would Break From 'No Admit, No Deny' Pattern of Settlements," *Wall Street Journal*, October 13, 2021, <https://www.wsj.com/articles/sec-to-see-admissions-of-wrongdoing-in-some-enforcement-actions-11634139229>; Public Company Accounting Oversight Board, "Enforcement Actions," accessed July 13, 2022, <https://pcaobus.org/oversight/enforcement/enforcement-actions>.

company — the company’s chief accounting officer — about competing bids and the company’s selection process, the SEC said.⁴⁶

EY also helped draft the company’s request for proposals from audit firms, the SEC said.⁴⁷

Internally, EY explained how some of the conduct at issue gave it an advantage, according to an SEC disciplinary order.

“An internal EY victory ‘case study’ prepared shortly after EY was awarded the ... audit described this access as a ‘head start none of the other firms were given,’” the SEC said in a disciplinary order.⁴⁸

In June 2022, the SEC charged EY with new violations, saying hundreds of EY auditors cheated on tests required to obtain and maintain accounting licenses — including ethics exams. The SEC also charged EY with withholding evidence from the agency during its investigation.

“EY audit professionals’ repeated cheating on exams and the firm’s misrepresentations to the SEC violated ethics and integrity standards and discredited the accounting profession,” the SEC said in an enforcement order.⁴⁹

In that case, EY admitted the SEC’s allegations and agreed to pay a penalty of \$100 million.⁵⁰

None of this suggests the public should count on accountants’ integrity to protect them.

⁴⁶ Securities and Exchange Commission, “SEC Charges Ernst & Young, Three Audit Partners, and Former Public Company CAO with Audit Independence Misconduct,” Press Release 2021-144, August 2, 2021, <https://www.sec.gov/news/press-release/2021-144>; Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP, James G. Herring, Jr., CPA, James A. Young, CPA, and Curt W. Fochtman, CPA, Respondents*, Securities Exchange Act of 1934 Release No. 92540 (August 2, 2021), <https://www.sec.gov/litigation/admin/2021/34-92540.pdf>.

⁴⁷ Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP, James G. Herring, Jr., CPA, James A. Young, CPA, and Curt W. Fochtman, CPA, Respondents* [see note 46].

⁴⁸ Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP, James G. Herring, Jr., CPA, James A. Young, CPA, and Curt W. Fochtman, CPA, Respondents* [see note 46].

⁴⁹ Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP, Respondent*, Securities Exchange Act of 1934 Release No. 95167 (June 28, 2022), 2-3, 15, <https://www.sec.gov/litigation/admin/2022/34-95167.pdf>.

⁵⁰ Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP, Respondent* [see note 49].

Better to leverage auditors' self-interest.

Defining Independence

Congress and the Securities and Exchange Commission (SEC) mandated independent audits for public companies in the 1930s, after the stock market crash of 1929.⁵¹

The government created a massive cash cow for the accounting industry, and it compelled corporations to buy the milk. It forced shareholders to pay for it. But what are shareholders getting for their money?

Federal rules spell out with specific illustrations what the government means by “independent.”⁵²

For example, accounting firms and individual accountants within those firms may be disqualified if they hold stock in a client company, borrow money from a client company, or have any direct business relationship with a client company.⁵³

There are exceptions. For instance, it's okay for an auditor of a bank to have a car loan from the bank, provided the loan was obtained on normal terms and is collateralized by the car. It's okay for an auditor of an insurance company to have an insurance policy from the insurer, provided the auditor wasn't associated with the audit firm when the policy was issued and the “likelihood of the insurer becoming insolvent is remote.”⁵⁴

But what happens if the likelihood changes over time? And why is the likelihood of insolvency an appropriate standard at all, given that the auditor could be called upon to opine on that very point — the likelihood of the client becoming insolvent?

With respect to the car loan, why focus on the stated criteria when in the event of default, the loan company remains in a position to repossess the car — or not?

And, of course, the prohibition on business relationships doesn't prohibit the accounting firm from providing various professional services to the audit client.

⁵¹ Securities and Exchange Commission, “Policy Statement: The Establishment and Improvement of Standards Related to Auditor Independence,” Release No. 33-7507, 34-39676, IC-23029, FR-50, February 18, 1998, <https://www.sec.gov/rules/policy/33-7507.htm>.

⁵² 17 C.F.R. § 210.2-01, <https://www.law.cornell.edu/cfr/text/17/210.2-01>.

⁵³ 17 C.F.R. § 210.2-01 [see note 52].

⁵⁴ 17 C.F.R. § 210.2-01 [see note 52].

In other words, the so-called auditor independence rules require mental gymnastics.⁵⁵

Audit firms have couched audit reports on individual companies accordingly. For example, a report by one firm says it is “required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.”⁵⁶

The SEC rules include this overarching provision:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client.⁵⁷

All, it seems, but the most obvious: the accounting firm works for its client. As others have noted, under the current system, any reasonable person taking the SEC standard quoted above at face value could reasonably conclude that no auditor qualifies as independent.

⁵⁵ Here are some questions potentially worthy of investigation but beyond the scope of this paper: Is the role of the auditor blurred at another level, further compromising the auditor’s independence? Instead of just auditing the financial statements the company has generated and opining on them, does the auditor help the client revise its financial statements to bring them into compliance? If so, does that obscure from public view problems the auditor helped its client correct and any lack of competence or integrity on the part of the client? Does it leave the auditor auditing its own work? In 2018, POGO described related allegations by former PwC auditor Mauro Botta. Hilzenrath, “PwC Whistleblower Alleges Fraud in Audits of Silicon Valley Companies” [see note 29]; Accounting professor Joshua Ronen alluded to correcting financial statements before the audit report is issued: “If the auditor’s attempt to correct the accounting misstatements is unsuccessful, then the auditor issues a qualified opinion that refers to either limitations on the scope of the audit (such as inability to access information) or departures from GAAP” — a reference to Generally Accepted Accounting Principles. Joshua Ronen, “Corporate Audits and How to Fix Them,” *Journal of Economic Perspectives* 24, no. 2 (Spring 2010): 191, <https://doi.org/10.1257/jep.24.2.189>.

⁵⁶ Amazon.com, Inc., *Form 10-K for the Fiscal Year Ended in December 31, 2020* (February 2, 2021), 35, <https://www.sec.gov/Archives/edgar/data/1018724/000101872421000004/amzn-20201231.htm#i75de98b9097f40f3b5884e541f532421> 55.

⁵⁷ 17 C.F.R. § 210.2-01 [see note 52].

Independence Violations

As it turns out, as lax as the independence rules may be, audit firms have still had trouble complying with them — as Ketz noted in “The Myth of Auditor Independence.”⁵⁸

The alleged violations make a mockery of the rules.⁵⁹ But that’s not all. They give further proof of why the public shouldn’t simply put its trust in auditors to do the right thing. They show where the incentives can lead.

For instance, in 2019, the Public Company Accounting Oversight Board took enforcement action against accounting firm Marcum LLP, saying it violated independence rules with respect to 62 companies.⁶⁰ Marcum hosted an annual conference for investors at which it “expressly touted” companies it audited as high-quality investments, the regulator said.⁶¹ That “created a mutual interest” between Marcum and its clients in seeing that the companies “lived up to Marcum’s billing,” the PCAOB said.⁶²

⁵⁸ Ketz, “The Myth of Auditor Independence” [see note 5]. Currently, regulators are “carrying out a sweeping investigation of conflicts of interest at the nation’s largest accounting firms, asking whether consulting and other non-audit services they sell undermine their ability to conduct independent reviews of public companies’ financials,” the *Wall Street Journal* reported in March 2022. Dave Michaels, “Big Four Accounting Firms Come Under Regulator’s Scrutiny,” *Wall Street Journal*, March 15, 2022, <https://www.wsj.com/articles/big-four-accounting-firms-come-under-regulators-scrutiny-11647364574>.

⁵⁹ We say “alleged violations” because the SEC has typically settled enforcement cases without an admission of wrongdoing.

⁶⁰ Public Company Accounting Oversight Board, “PCAOB Sanctions Two Firms and One Individual for Auditor Independence Violations,” Press Release, September 10, 2019, https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-sanctions-two-firms-and-one-individual-for-auditor-independence-violations_712; Public Company Accounting Oversight Board, *Order Making Findings and Imposing Sanctions in the Matter of Marcum LLP and Alfonse Gregory Giugliano, CPA, Respondents*, PCAOB Release No. 105-2019-022 (September 10, 2019), 1, <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/enforcement/decisions/documents/105-2019-022---marcum.pdf>.

⁶¹ Public Company Accounting Oversight Board, *Order Making Findings and Imposing Sanctions in the Matter of Marcum LLP and Alfonse Gregory Giugliano, CPA, Respondents*, 3 [see note 60].

⁶² Public Company Accounting Oversight Board, *Order Making Findings and Imposing Sanctions in the Matter of Marcum LLP and Alfonse Gregory Giugliano, CPA, Respondents*, 4 [see note 60].

PwC has been cited as a repeat offender. In 2002, the SEC accused PwC of violating the rules with 16 audit clients over a five-year period, rendering their financial statements invalid.⁶³ In 2019, the SEC accused PwC of violating the rules again.⁶⁴

Also in 2019, the SEC accused accounting firm RSM US of violating independence rules in connection with more than 100 audits.⁶⁵

In 2014, the SEC charged KPMG with violating the rules with respect to three companies it audited.⁶⁶ Among the alleged violations: KPMG employees owned stock in one of the companies.⁶⁷

In 2014, the SEC charged Ernst & Young with violations for claiming it was independent of two companies at a time when it had been lobbying congressional staff on their behalf.⁶⁸ In December 2021, the SEC charged three Ernst & Young personnel with independence violations in relation to Cintas, another company Ernst & Young was auditing.⁶⁹ The SEC said Ernst & Young did tax work for Cintas on a

⁶³ Securities and Exchange Commission, “PricewaterhouseCoopers Settles SEC Auditor Independence Case; PwC and Its Broker-Dealer Affiliate to Pay a Total of \$5 Million Avon Settles SEC Enforcement Action, Agrees to Restate,” Press Release 2002-105, July 17, 2002, <https://www.sec.gov/news/press/2002-105.htm>; Related SEC enforcement orders include: Securities and Exchange Commission Order ... *In the Matter of Avon Products, Inc., Respondents*, Securities Exchange Act of 1934 Release No. 46215 (July 17, 2002), <https://www.sec.gov/litigation/admin/34-46215.htm>; Securities and Exchange Commission Order ... *In the Matter of PricewaterhouseCoopers LLP, and PricewaterhouseCoopers Securities LLC, Respondents*, Securities Exchange Act of 1934 Release No. 46216 (July 17, 2002), <https://www.sec.gov/litigation/admin/34-46216.htm>.

⁶⁴ Securities and Exchange Commission, “SEC Charges PwC LLP With Violating Auditor Independence Rules and Engaging in Improper Professional Conduct,” Press Release 2019-184, September 23, 2019, <https://www.sec.gov/news/press-release/2019-184>.

⁶⁵ Securities and Exchange Commission, Order ... *In the Matter of RSM US LLP (f/k/a McGladrey LLP), Respondent*, Securities Exchange Act of 1934 Release No. 86770 (August 27, 2019), 2, <https://www.sec.gov/litigation/admin/2019/34-86770.pdf>.

⁶⁶ Securities and Exchange Commission, “SEC Charges KPMG With Violating Auditor Independence Rules,” Press Release 2014-12, January 24, 2014, <https://www.sec.gov/news/press-release/2014-12>.

⁶⁷ Securities and Exchange Commission, Order ... *In the Matter of KPMG LLP, Respondent*, Securities Exchange Act of 1934 Release No. 71389 (January 24, 2014), 2, <https://www.sec.gov/litigation/admin/2014/34-71389.pdf>.

⁶⁸ Securities and Exchange Commission, “SEC Charges Ernst & Young With Violating Auditor Independence Rules in Lobbying Activities,” Press Release 2014-136, July 14, 2014, <https://www.sec.gov/news/press-release/2014-136>.

⁶⁹ Securities and Exchange Commission, “SEC Charges Three Ernst & Young Professionals with Violating Auditor Independence Rules,” Press Release, December 10, 2021, <https://www.sec.gov/enforce/34-93749-s>.

contingency fee basis — charging a percentage of tax benefits the accounting firm helped Cintas secure — which is against the rules.⁷⁰

Then there was the 2016 case against Ernst & Young, which took the auditor-client relationship to a different level. One EY partner became “romantically involved” with a client company’s chief accounting officer, and another “maintained an improperly close friendship” with the company’s chief financial officer, the SEC said.⁷¹

When the company was considering dropping EY as its auditor, the second of those partners, Gregory S. Bednar, was assigned to head the audit team and “was specifically tasked” by EY “to improve its relationship” with the company.⁷²

Soon, Bednar and the company’s CFO were staying overnight at each other’s homes and taking family trips together. They traveled out of town to attend events together — including a football playoff game, a hockey game, and the Masters golf tournament. The expenses for Bednar’s entertainment exceeded \$100,000, the SEC said.⁷³

When a senior partner at the audit firm informed Bednar that the firm would be unable to pay for certain expenses, the partner nonetheless thanked Bednar for his “continued focus on building long lasting client relationships,” the SEC said.⁷⁴

A 2018 SEC enforcement action against audit firm Crowe LLP further showed why an independent mindset — or the lack thereof — matters.⁷⁵

⁷⁰ Securities and Exchange Commission, *Order ... In the Matter of Philip S. Hurak, Esq., Respondent*, Securities Exchange Act of 1934 Release No. 93751 (December 10, 2021), 4, <https://www.sec.gov/litigation/admin/2021/34-93751.pdf>.

⁷¹ Securities and Exchange Commission, “Ernst & Young, Former Partners Charged With Violating Auditor Independence Rules,” Press Release 2016-187, September 19, 2016, <https://www.sec.gov/news/pressrelease/2016-187.html>.

⁷² Securities and Exchange Commission, “Ernst & Young, Former Partners Charged With Violating Auditor Independence Rules” [see note 71].

⁷³ Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP and Gregory S. Bednar, CPA, Respondents*, Securities Exchange Act of 1934 Release No. 78872 (September 19, 2016), 4-6, <https://www.sec.gov/litigation/admin/2016/34-78872.pdf>.

⁷⁴ Securities and Exchange Commission, *Order ... In the Matter of Ernst & Young LLP and Gregory S. Bednar, CPA, Respondents* [see note 73].

⁷⁵ Securities and Exchange Commission, “SEC Charges Audit Firm and Suspends Accountants for Deficient Audits,” Press Release 2018-302, December 21, 2018, <https://www.sec.gov/news/press-release/2018-302>; Securities and Exchange Commission, *Order ... In the Matter of Crowe Horwath LLP, Joseph C. Macina, CPA, and Kevin V. Wydra, CPA, Respondents*, Securities Exchange Act of 1934 Release No. 84920 (December 21, 2018), <https://www.sec.gov/litigation/admin/2018/34-84920.pdf>.

Crowe audited a temporary staffing company called Corporate Resource Services (CRS).

For the 2013 fiscal year, Crowe asserted that it met the independence requirements and gave CRS a clean audit opinion.⁷⁶

However, Crowe did not qualify as independent, the SEC said. Crowe was in business with CRS. While it was auditing CRS, Crowe was subcontracting employees from CRS and farming them out as consultants to Crowe clients, the SEC said.⁷⁷

Crowe performed a deficient audit, the SEC said. For example, though Crowe identified a risk of fraud at CRS involving a related company that handled CRS's payroll taxes, Crowe did not obtain any supporting documentation for amounts that company billed CRS, the SEC said.⁷⁸

Oops.

CRS "went bankrupt in 2015 after the discovery of approximately \$100 million in unpaid federal payroll tax liabilities," the SEC said.⁷⁹

No Time for Complacency

Some might argue that there's nothing to worry about because, while there have been Enron-like accounting debacles in other countries, there haven't been any new Enrons in the United States recently.

They might argue that the situation has improved in the 20 years since Congress — in response to Enron, WorldCom, and a series of other corporate accounting scandals — created a regulator just for auditors, the PCAOB, and made other regulatory changes.

⁷⁶ Securities and Exchange Commission, *Order ... In the Matter of Crowe Horwath LLP, Joseph C. Macina, CPA, and Kevin V. Wydra, CPA, Respondents* [see note 75].

⁷⁷ Securities and Exchange Commission, *Order ... In the Matter of Crowe Horwath LLP, Joseph C. Macina, CPA, and Kevin V. Wydra, CPA, Respondents* [see note 75].

⁷⁸ Securities and Exchange Commission, *Order ... In the Matter of Crowe Horwath LLP, Joseph C. Macina, CPA, and Kevin V. Wydra, CPA, Respondents* [see note 75].

⁷⁹ Securities and Exchange Commission, "SEC Charges Audit Firm and Suspends Accountants for Deficient Audits" [see note 75].

They might point to a long but recently reversed downward trend in “restatements,” a euphemistic term for corrections companies publish when their financial statements turn out to have been wrong.⁸⁰

Despite the enduring lack of auditor independence, it’s possible that auditing has improved. But getting complacent would be a mistake. It would ignore a variety of troubles.

For example, the financial crisis of 2008, the related meltdown of major financial firms, and systemic problems in the mortgage industry unfolded after the post-Enron reforms were implemented.

So did Bernie Madoff’s epic Ponzi scheme, which devastated many victims. Madoff’s firm wasn’t audited by a major accounting firm, but entities that invested in it — so-called “feeder funds” — were.⁸¹

Wells Fargo, the big bank, was exposed as abusing customers on a large scale and suffered major consequences, yet its internal controls had received clean audit opinions.⁸² The company’s auditor, KPMG, acknowledged in 2016 that it “became aware of instances of unethical and illegal conduct by Wells Fargo employees, including incidents involving these improper sales practices,” but asserted that its audits had been performed appropriately.⁸³

Within the past two years, the SEC has charged such well-known companies as General Electric and Under Armour with misleading investors.⁸⁴ Without admitting or

⁸⁰ Nicole Hallas, “2020 Financial Restatements Review,” Audit Analytics, December 7, 2021, <https://blog.auditanalytics.com/2020-financial-restatements-review/>. See also: Derryck Coleman, Madeleine Conley, and Nicole Hallas, “2021 Financial Restatements; A Twenty-One-Year Review,” Audit Analytics, May 2022, https://www.auditanalytics.com/doc/2021_Financial_Restatements_A_Twenty-One-Year_Review.pdf.

⁸¹ James Mackintosh, “Accounting firms drawn into Madoff scandal,” *Financial Times*, December 18, 2008, <https://www.ft.com/content/e8294d3c-ccef-11dd-9905-000077b07658>; Michael J. de la Merced, “In Madoff’s Wake, Scrutiny of Accounting Firms,” *New York Times*, December 21, 2008, <https://www.nytimes.com/2008/12/22/business/22accounting.html>.

⁸² Hilzenrath, “What the U.K. Can Learn from the U.S. Experience with Audit Reform” [see note 11].

⁸³ Lynne M. Doughtie, chairman and CEO of KPMG LLP, to Senators Elizabeth Warren, Bernard Sanders, Mazie Hirono, and Edward J. Markey, about KPMG’s role as auditor of Wells Fargo, November 28, 2016, 2, 4, https://www.warren.senate.gov/files/documents/2016_11_28_KPMG_Response.pdf.

⁸⁴ Securities and Exchange Commission, “General Electric Agrees to Pay \$200 Million Penalty for Disclosure Violations,” Press Release 2020-312, December 9, 2020, <https://www.sec.gov/news/press-release/2020-312>.

denying the charges, GE agreed to pay a \$200 million penalty, and Under Armour agreed to pay a \$9 million penalty.⁸⁵

Over the years, the PCAOB's annual inspections of major audit firms have found that many audits failed to meet regulatory standards.⁸⁶

As recently as August 2022, the oversight board cited problems in audits of brokers, dealers, and broker-dealers — categories of financial firms that make up much of Wall Street. While inspections over the past 11 years show improvement, “the overall deficiency rates remain unacceptably high,” the board reported.⁸⁷

“Some of these deficiencies have been observed during inspections on a recurring basis for many years,” the board added.⁸⁸

The downward trend in corporate accounting restatements, which spanned 2006 through 2020, came to an abrupt end last year when corrections spiked, according to data compiled by Audit Analytics, a research firm.⁸⁹ In 2021, the number of restatements nearly quadrupled, rising to its highest level since 2006. The increase was driven by a proliferation of companies using a relatively new business model and

⁸⁵ “SEC Charges Under Armour Inc. With Disclosure Failures,” SEC Press Release 2021-78, May 3, 2021, <https://www.sec.gov/news/press-release/2021-78>; Securities and Exchange Commission, *Order ... In the Matter of Under Armour, Inc., Respondent*, Securities Exchange Act of 1934 Release No. 91741 (May 3, 2021), <https://www.sec.gov/litigation/admin/2021/33-10940.pdf>.

⁸⁶ David S. Hilzenrath, “Botched Audits: Big Four Accounting Firms Fail Many Inspections,” Project On Government Oversight, September 5, 2019, <https://www.pogo.org/investigation/2019/09/botched-audits-big-four-accounting-firms-fail-many-inspections>; The PCAOB inspection results improved sharply in 2020, but it's hard to know what to make of that development. Did audits improve? Did the PCAOB under a deregulatory regime become less rigorous? Did the pandemic and remote work have anything to do with it? See: Jason Bramwell, “It's True: PwC Had a Nearly Flawless 2020 PCAOB Inspection Report,” Going Concern, November 1, 2021, <https://www.goingconcern.com/pwc-2020-pcaob-inspection-report>; “PCAOB 2020 Inspection Reports,” big4stats.com, November 6, 2021, <https://big4stats.com/pcaob-2020-inspection-reports>; Public Company Accounting Oversight Board, “Firm Inspection Reports,” accessed June 21, 2022, <https://pcaobus.org/oversight/inspections/firm-inspection-reports>.

⁸⁷ Public Company Accounting Oversight Board, “Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers,” PCAOB Release 2022-004, August 19, 2022, 4, <https://pcaobus.org/inspections/documents/2021-broker-dealer-annual-report.pdf>.

⁸⁸ Public Company Accounting Oversight Board, “Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers,” 5 [see note 87].

⁸⁹ Coleman, Conley, and Hallas, “2021 Financial Restatements; A Twenty-One-Year Review” [see note 80]; Email from Nicole Hallas to David Hilzenrath, September 23, 2022.

guidance from regulators about how those companies should have been keeping their books, Audit Analytics said.⁹⁰

The accounting problems that lead to restatements don't appear to be entirely random. Look closely at the Audit Analytics data, and you can see a chronic pattern: restatements tend to reduce corporate profits more than they increase reported profits. In other words, the bad accounting tended to make the companies look better.⁹¹

Though the number of restatements is sometimes cited as a barometer of auditing quality or of the overall quality of corporate financial disclosures, it's a crude one.

One of the main reasons the number of restatements declined over the past decade is that the number of companies registered with the SEC declined, Audit Analytics said.⁹²

If you dismiss the latest spike as an anomaly, the earlier decline in restatements might indicate that auditors are doing a better job and having a prophylactic effect. However, there could be other explanations. There could be fewer errors to catch — or auditors could be catching fewer errors. Or, when they spot problems, auditors could be going easier on their clients.

“Companies are increasingly likely to correct accounting problems by quietly updating past numbers, rather than alerting investors and reissuing financial statements,” *The Wall Street Journal* reported in 2019.⁹³

Francine McKenna — author of *The Dig* newsletter, veteran of big accounting firms, and longtime audit analyst — says something similar has been happening in the realm of enforcement. The SEC and the Justice Department have been letting companies and executives get away with more, McKenna said.

⁹⁰ Coleman, Conley, and Hallas, “2021 Financial Restatements; A Twenty-One-Year Review,” 4-5 [see note 80].

⁹¹ Coleman, Conley, and Hallas, “2021 Financial Restatements; A Twenty-One-Year Review,” 9-10 [see note 80].

⁹² Coleman, Conley, and Hallas, “2021 Financial Restatements; A Twenty-One-Year Review,” 6 [see note 80].

⁹³ Jean Eaglesham, “Shh! Companies Are Fixing Accounting Errors Quietly,” *Wall Street Journal*, December 5, 2019, <https://www.wsj.com/articles/shh-companies-are-fixing-accounting-errors-quietly-11575541981>; Preeti Choudhary, Kenneth J. Merkley, and Katherine Schipper, “Immaterial Error Corrections and Financial Reporting Reliability,” (June 15, 2021), 12, 17, 43, <http://dx.doi.org/10.2139/ssrn.2830676>.

“There’s been sort of this gradual slide down the hill that says, ‘We are not going to call people out any more. We are not going to admit that people are cheating,’” McKenna said on the *Crypto Critics’ Corner* podcast.⁹⁴

A lot of accounting problems may not come to light until there’s another recession, some observers say.

“That’s because economic expansions supply firms with many avenues to contort and invent revenues,” Ketz, author of “The Myth of Auditor Independence,” told POGO. “When we do go into the next recession, let’s see what happens. My bet is that when that happens, the scandals will occupy a large space of the business news media,” Ketz, a scholar at Penn State, said by email.⁹⁵

Howard Schilit specializes in scrutinizing corporate financial reports for investment firms and wrote the book, *Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports*. He has no shortage of work.

“I think the auditors have probably gotten no better and probably worse,” Schilit told POGO.⁹⁶

“They have so narrowed the scope of what they believe they are responsible for that it renders their opinion, in my judgment, almost meaningless,” Schilit said.⁹⁷

Schilit faults auditors for not calling out companies that mislead investors by using creative financial metrics that do not conform to accounting rules.

Meanwhile, audits may be more important today than they were 20 years ago, when the post-Enron reforms were enacted, said Lawrence A. Cunningham, a professor at George Washington University Law School and director of the school’s research program on corporate governance.⁹⁸

That’s because the “shareholder demographic” has changed, Cunningham said in an interview with POGO. In the past, “a very large critical mass” of institutional investors had analysts evaluating individual companies. However, there has been a shift toward index funds, which invest in broad market indices like the S&P 500 instead of picking

⁹⁴ Cas Piancey and Bennett Tomlin, “The Foul Financials of Cryptocurrency (Feat. Francine McKenna),” *Crypto Critics’ Corner*, podcast, March 17, 2022, 35:17, <https://cryptocriticscorner.com/2022/03/18/episode-60-the-foul-financials-of-cryptocurrency-feat-francine-mckenna/>.

⁹⁵ Email from J. Edward Ketz to David Hilzenrath, March 28, 2022.

⁹⁶ Howard Schilit interview with David Hilzenrath, April 1, 2022.

⁹⁷ Howard Schilit interview with David Hilzenrath, April 1, 2022.

⁹⁸ Lawrence A. Cunningham interview with David Hilzenrath, March 28, 2022.

stocks, Cunningham said. Those funds have neither the need nor the staff to scrutinize the accounting of individual companies.⁹⁹

“It’s a disaster from a systemic perspective, because you have no one watching the store,” Cunningham said.¹⁰⁰

Also, in recent years, increasing numbers of individuals have been playing the market, Cunningham said.¹⁰¹

While Enron may be a fading memory, overseas, accounting scandals have led to the collapse of major corporations and cast a spotlight on auditors in recent years. The fact that they’ve occurred abroad and not here is cold comfort.

One such scandal involved Wirecard, based in Germany.¹⁰² It is a case study.

In 2020, Wirecard issued an extraordinary statement, revealing that about \$2 billion it supposedly had on hand was apparently an illusion.

“The Management Board of Wirecard assesses on the basis of further examination that there is a prevailing likelihood that the bank trust account balances in the amount of 1.9 billion EUR do not exist,” the company said.¹⁰³

As a chronology compiled by the *Financial Times* put it, the announcement showed “the potential scale of a multiyear accounting fraud.”¹⁰⁴

⁹⁹ Lawrence A. Cunningham interview with David Hilzenrath, March 28, 2022.

¹⁰⁰ Lawrence A. Cunningham interview with David Hilzenrath, March 28, 2022.

¹⁰¹ Lawrence A. Cunningham interview with David Hilzenrath, March 28, 2022.

¹⁰² Olaf Storbeck, “EY and Wirecard: anatomy of a flawed audit,” *Financial Times*, October 25, 2021, <https://www.ft.com/content/bcadbdcb-5cd7-487e-afdd-1e926831e9b7?shareType=nongift>.

¹⁰³ Wirecard AG, “Statement of the Management Board about the current situation of the Company,” Press Release, June 22, 2020, <https://www.wirecard.com/2020/06/22/wirecard-ag-statement-of-the-management-board-about-the-current-situation-of-the-company/>.

¹⁰⁴ Dan McCrum, “Wirecard: the timeline; How the payments group became one of the hottest stocks in Europe while battling persistent allegations of fraud,” *Financial Times*, June 25, 2020, <https://www.ft.com/content/284fb1ad-ddc0-45df-a075-0709b36868db>; See also: Ryan Browne, “German payments firm Wirecard files for insolvency after revealing \$2 billion accounting black hole,” CNBC, June 25, 2020, <https://www.cnbc.com/2020/06/25/german-payments-company-wirecard-files-for-insolvency.html>.

Wirecard filed for the German equivalent of bankruptcy, the *Wall Street Journal* reported. The missing \$2 billion was “equivalent to the company’s entire profit over more than a decade,” the *Journal* reported.¹⁰⁵

Ernst & Young audited Wirecard “for more than a decade and provided unqualified audits until 2018,” the *Financial Times* reported.¹⁰⁶ A whistleblower warned EY of fraud at Wirecard four years before the company collapsed, the *Financial Times* reported.¹⁰⁷

“Many people believe that the fraud at Wirecard should have been detected earlier and we fully understand that. Even though we were successful in uncovering the fraud, we regret that it was not uncovered sooner,” EY’s Global Chairman and Chief Executive Carmine Di Sibio said in September 2020, according to a Reuters report.¹⁰⁸

Whatever the root causes of the Wirecard debacle may be, the regulatory system the United States put in place for auditors 20 years ago failed to avert it.

In 2019, the PCAOB issued an inspection report on Ernst & Young’s German affiliate, Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft, saying the regulator reviewed the firm’s work on three audits and identified no defective audits.¹⁰⁹

In a 2019 letter to the PCAOB, leaders of the accounting firm wrote, “We are pleased that no audit performance issues are identified within the report.”¹¹⁰

¹⁰⁵ Paul J. Davies, “How Wirecard Went From Tech Star to Bankrupt,” *Wall Street Journal*, July 2, 2020, [https://www.wsj.com/articles/wirecard-bankruptcy-scandal-missing-\\$2billion-11593703379](https://www.wsj.com/articles/wirecard-bankruptcy-scandal-missing-$2billion-11593703379).

¹⁰⁶ Olaf Storbeck, “Whistleblower warned EY of Wirecard fraud four years before collapse,” *Financial Times*, September 30, 2020, <https://www.ft.com/content/3b9afceb-eaeb-4dc6-8a5e-b9bc0b16959d>.

¹⁰⁷ Storbeck, “Whistleblower warned EY of Wirecard fraud four years before collapse” [see note 106].

¹⁰⁸ Huw Jones, “EY to ‘raise bar’ in spotting fraud after Wirecard accounts scandal,” Reuters, September 15, 2020, <https://www.reuters.com/article/us-ey-wirecard-idUKKBN26625V>.

¹⁰⁹ Public Company Accounting Oversight Board, *Report on 2018 Inspection of Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft*, Release No. 104-2019-100 (May 23, 2019), 4, <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/inspections/reports/documents/104-2019-100-ernst-young-gmbh-wirtschaftspruefungsgesellschaft-germany.pdf>.

¹¹⁰ Public Company Accounting Oversight Board, *Report on 2018 Inspection of Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft*, 11 [see note 109]; See also: Karin Matussek, “Wirecard ‘criminals’ duped us, says EY auditor,” *Accounting Today*, March 23, 2021, <https://www.accountingtoday.com/articles/wirecard-criminals-had-us-duped-ey-auditor-tells-lawmakers>.

Part 2: Possible Solutions

What are the alternatives?

What can be done to remove or mitigate auditing's fundamental conflict of interest?

The system now in place relies on a patchwork of counter-measures. The PCAOB inspects audit firms, but the inspections are largely lacking in transparency.¹¹¹ The PCAOB has the power to enforce audit rules, but, as a POGO investigation has shown, its disciplinary record is feeble.¹¹² At times, the PCAOB appears to have been captured by the audit industry.¹¹³

The KPMG “stealing the exam” scandal showed that, worse still, the oversight board had been corrupted. PCAOB personnel leaked confidential information to KPMG or brought inside information to KPMG when seeking or assuming more lucrative jobs at the accounting firm.¹¹⁴

The PCAOB answers to and shares authority with the SEC. The SEC office that oversees auditing and accounting — the Office of the Chief Accountant — has been staffed by a revolving door of personnel from big accounting firms.¹¹⁵

It's long past time to think outside the prison of the status quo.

The following are several approaches that could change the relationship between the auditors and the audited. They may not be mutually exclusive. Some could be used in combination with others. Some have been aired previously in academic and policy

¹¹¹ David S. Hilzenrath and Nicholas Trevino, “How an Agency You’ve Never Heard of Is Leaving the Economy at Risk,” Project On Government Oversight, September 15, 2019, <https://www.pogo.org/investigation/2019/09/how-an-agency-youve-never-heard-of-is-leaving-the-economy-at-risk/>.

¹¹² Hilzenrath and Trevino, “How an Agency You’ve Never Heard of Is Leaving the Economy at Risk” [see note 111]; David S. Hilzenrath and Adam Barclay, “Auditing Watchdog Hides Information from Investors,” Project On Government Oversight, October 17, 2019, <https://www.pogo.org/investigation/2019/10/auditing-watchdog-hides-information-from-investors/>.

¹¹³ David S. Hilzenrath, “How Accountants Took Washington’s Revolving Door to a Criminal Extreme” [see note 42]; David S. Hilzenrath, “Captured: Financial Regulator At Risk,” Project On Government Oversight, January 14, 2020, <https://www.pogo.org/investigation/2020/01/captured-financial-regulator-at-risk/>.

¹¹⁴ Hilzenrath, “How Accountants Took Washington’s Revolving Door to a Criminal Extreme” [see note 42].

¹¹⁵ Hilzenrath, “Captured: Financial Regulator At Risk” [see note 113].

circles, and others have not. Some would upend the current system, while others would change it more modestly.

Though we identify potential advantages and disadvantages of each, we present them without endorsement.

Government Does The Audits

Instead of delegating auditing to a private, for-profit industry, the government could do the auditing itself.

The watchdog role auditors are supposed to play is arguably a regulatory one.

There are parallels. To protect the food supply, the Department of Agriculture deploys meat inspectors. To safeguard the banking system and federally insured deposits, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp., and the Federal Reserve deploy bank examiners. To make sure nuclear power plants are operating safely, the Nuclear Regulatory Commission employs its own inspectors. To promote compliance with tax laws, the Internal Revenue Service audits individuals and companies.

To protect airline passengers and crew, the Federal Aviation Administration recently said it would perform final inspections on new Boeing 787 Dreamliner jets instead of allowing Boeing, the manufacturer of the planes, to certify their airworthiness, according to news reports by Reuters and others.¹¹⁶

How well those government efforts work is a reasonable question. They have weaknesses and vulnerabilities.

Federal regulators are hardly impervious to improper influence. Regulators can be captured, and vested interests can exert political influence on regulators through Congress and the executive branch. In the infamous Keating Five scandal, senators who received political contributions from Charles Keating intervened with regulators scrutinizing Keating's Lincoln Savings and Loan Association. Keating later pleaded

¹¹⁶ David Shepardson and Eric M. Johnson, "U.S. to inspect new 787 Dreamliners, says Boeing cannot self-certify," Reuters, February 15, 2022, <https://www.reuters.com/business/aerospace-defense/faa-will-conduct-final-inspections-new-boeing-787-dreamliners-2022-02-15/>; David Schaper, "FAA toughens oversight of Boeing's 787 Dreamliner," NPR, February 15, 2022, <https://www.npr.org/2022/02/15/1080930976/faa-toughens-oversight-of-boeings-787-dreamliner>.

guilty to crimes, and Lincoln collapsed during the S&L crisis at a cost of billions of dollars.¹¹⁷

Congress controls the purse strings of federal regulators, and one way that industries can undermine regulators is to target their budgets.

Any team of government auditors would have to be adequately funded, and it could take a lot of government auditors to audit all the corporations listed on U.S. stock markets.

Some might question the government's ability to attract enough auditors with the requisite training, but over time demand can create its own supply. If accountants wanted a career auditing public companies, the government would be the only place to go.

Cutting out the accounting firms could remove costs from the system. Society wouldn't have to pay for partner profits or marketing expenses, such as entertaining clients.

"Until the SEC has its own corps of financial investigators who routinely examine a corporation's financial statements, the basic conflict of interest you described will remain," Richard Kaplan of the University of Illinois told POGO.¹¹⁸

"The government has its own auditors for something it cares about – namely, its tax revenue. If the government cares enough about the integrity of financial statements, it should do likewise," Kaplan said.¹¹⁹

Still, politically, creating another government bureaucracy could be a tough sale.

Armed with the wealth and power that flows from its lucrative franchise, the auditing industry can be counted on to defend that franchise.

¹¹⁷ *Preliminary inquiry into allegations regarding Senators Cranston, DeConcini, Glenn, McCain and Riegle, and Lincoln Savings and Loan: Hearings before the Select Committee on Ethics, United States Senate*, 101st Cong., (November 15, 1990 to January 16, 1991), 4-5, <https://catalog.hathitrust.org/Record/011337543>. "Excerpts of Statement By Senate Ethics Panel," *New York Times*, February 28, 1991, <https://www.nytimes.com/1991/02/28/us/excerpts-of-statement-by-senate-ethics-panel.html>; Elizabeth R. Purdy, "Charles H. Keating, American Businessman," *Britannica*, accessed June 30, 2022, <https://www.britannica.com/biography/Charles-Keating>.

¹¹⁸ Email from Richard Kaplan to David Hilzenrath, March 23, 2022.

¹¹⁹ Email from Richard Kaplan to David Hilzenrath, March 23, 2022.

The auditing industry has guarded its claim to corporate auditing in part by arguing that Congress carefully studied and rejected the idea of government auditors in the 1930s.¹²⁰ But that's a myth, Michael E. Doron, an associate professor of accountancy at California State University, Northridge, has written.

"The United States has never witnessed a real debate over the role government should play in the audits of publicly traded companies' financial statements," Doron wrote. "The financial statement audit was hastily delegated to the accounting profession with little debate more than 80 years ago, when the Securities Acts were written."¹²¹

"The frequent mischaracterizations of these events through the past eight decades have handicapped discussion of this issue, allowing it to be dismissed as outside the mainstream of American practice," Doron wrote in a historical study. "It has also allowed the accounting profession to claim that its seat at the table of Wall Street regulation was earned, not hastily and reluctantly granted."¹²²

Government Hires Auditors

Another option would be for a regulatory agency to assign audit firms and pay them with money collected from corporations.

Cal State's Doron advocated that approach in a 2019 article in *The CPA Journal*.

Doron said an experiment in a state in India showed the potential benefits of using a "third-party payer." The experiment involved environmental protection. Industry practice "had been the same as for financial statement audits: an outside firm was hired to inspect and report on the level of pollution by regulated plants," Doron wrote. The system "failed to provide meaningful enforcement, because the inspectors had no incentive to issue negative reports on the plants that hired and paid them," Doron wrote.¹²³

However, when industrial plants were randomly assigned an auditor and auditors were paid from a central pool, the quality of inspections improved, researchers found.

¹²⁰ Michael E. Doron, "The Colonel Carter myth and the Securities Act: Using accounting history to establish institutional legitimacy," *Accounting History* 20, no. 1 (February 2015), <https://doi.org/10.1177/1032373214563692>.

¹²¹ Michael Doron, "ICYMI: The PCAOB as Third-party Payer; A Proposal to Address Concerns over Public Company Auditor Independence," *The CPA Journal*, February 2019, <https://www.cpajournal.com/2020/03/05/icymi-the-pcaob-as-third-party-payer/>.

¹²² Doron, "The Colonel Carter myth and the Securities Act" [see note 120].

¹²³ Doron, "ICYMI" [see note 121]

Among other improvements, “plants reduced their pollution emissions,” Doron wrote.¹²⁴

Doron proposed that the PCAOB assign and pay the audit firms. The oversight board already collects fees from publicly traded corporations to fund itself, he noted, and could piggyback on that system.

Doron laid out a variety of arguments for an official third party, such as the oversight board, to choose and pay the auditors.

The idea came up at a 1933 hearing, he said. A senator suggested letting the Federal Trade Commission pick the auditors. As recently as 2018, the accounting firm Grant Thornton endorsed the concept in the U.K., recommending that a public body select auditors for large companies.¹²⁵

As a second-tier audit firm, Grant Thornton could benefit from such an arrangement. It could help smaller accounting firms gain business from the so-called Big Four that dominate the auditing of major corporations. That could serve the useful purpose of increasing competition.

The PCAOB could use its discretion, leaving auditors in place if they are doing well or replacing them if they are doing poorly. Through its inspections — however flawed those might be — the oversight board has a window into auditor performance. In addition, or alternatively, the PCAOB could rotate auditors after a set number of years (more on that below).

The oversight board could also adjust the audit fees. That could counter the risk that audit firms would lowball their fees to win business and then cut corners on the audits.

In the U.S. corporate world, the vested interests — audit firms and their clients — could be counted on to oppose this model. They would no doubt argue that it undercuts the role of corporate boards of directors — and boards’ audit committees — as overseers of outside auditors.

But boards are part of the company. If they weren’t, we might not be having this discussion. The interests of board members are closely aligned with those of

¹²⁴ Esther Duflo, Michael Greenstone, Rohini Pande, and Nicholas Ryan, “Truth-telling by Third-Party Auditors and the Response of Polluting Firms: Experimental Evidence from India,” MIT Department of Economics Working Paper No. 13-17 (revised September 3, 2013), <https://dx.doi.org/10.2139/ssrn.2294736>, quoted in Michael Doron, “ICYMI” [see note 121].

¹²⁵ Madison Marriage, “Grant Thornton Calls for Independent Public Body to Appoint Auditors,” *Financial Times*, September 11, 2018, <https://www.ft.com/content/92050fc4-b5db-11e8-bbc3-ccd7de085ffe>, quoted in Doron, “ICYMI” [see note 121].

corporate management, especially if they get paid in stock or stock options and if they want to keep their board seats. There's no reason to think board members bring more expertise or independence to the task than a third party could muster.

"Most audit committees continue to seek a recommendation from management about auditor retention — and most auditors know that," Robert A. Conway, a former PCAOB official and Big Four audit partner, said in an email to POGO. The "so called" independent audit committee members "are often not as independent as they should be. These individuals frequently want to stay in good favor with the CEO (who in many instances, likely had something to do with each audit committee member's appointment to the Board of Directors)," Conway said.¹²⁶

The third-party plan poses less of a threat to the accounting industry than having government do the audits because it would leave the private accounting firms and their coveted franchise intact.

The proposal's biggest weakness may be that it depends on a third party, such as the PCAOB, to avoid being captured by the auditing industry or the corporations.

Doron envisioned that a corporation, including its board or audit committee, "would be free to voice concerns to the PCAOB."¹²⁷ However, for the third party administering the system, falling under the influence of the corporations could be just as damaging as falling under the influence of the auditors.

Stock Exchanges Hire Auditors

Could some other authority play the third-party role — assigning, reassigning, and disbursing payments to audit firms?

Stock exchanges might be candidates. They maintain standards for listed companies.

In 1933, even before the government mandated independent audits, the New York Stock Exchange adopted such a requirement for companies seeking to be listed.¹²⁸

¹²⁶ Email from Robert Conway to David Hilzenrath, November 15, 2021.

¹²⁷ Michael Doron, "ICYMI" [see note 121].

¹²⁸ Dale L. Flesher, Gary J. Previts, and Tonya K. Flesher, "The Life and Career of Colonel Arthur H. Carter;

A Leading Accountancy Professional of the 1930s," *The CPA Journal*, November 2020, <https://www.cpajournal.com/2020/11/23/the-life-and-career-of-colonel-arthur-h-carter/>.

In theory, a stock exchange could use the promise of good audits to attract investors. It could use the promise to inspire greater investor confidence in the financial disclosures of companies whose shares trade on the exchange.

But stock exchanges have conflicts of interest of their own. They make money, including listing fees, from listed companies.¹²⁹ They have an interest in attracting and keeping companies. That could translate into an incentive to make audits less costly, burdensome, or threatening to companies. It could also translate into an incentive to keep share prices up — instead of puncturing illusions.

Stock exchanges “may prefer pleasing their listed members to safeguarding the interests of long-horizon investors,” Joshua Ronen, a professor of accounting at New York University’s Stern School of Business, has written.¹³⁰

The Insurance Model

Ronen proposes a different solution, one centered on insurance.

With a variety of moving parts, it is far from a model of simplicity, and the summary below does not cover all of its complexities.

Under this plan, a company would have the option of seeking an insurance policy that would pay investors for losses in the event that the company’s financial statements turned out to be false.

“Companies would select an external auditor from a list of audit firms approved by their insurance carrier,” Ronen says. “The auditor would be hired and paid by the insurance carrier, but the audit fees would be reimbursed” by the company that’s being insured.¹³¹

The insurance coverage would take effect for a particular year’s financial statements only if the financial statements passed an audit. The size of a company’s insurance

¹²⁹ Shobhit Seth, “How The NYSE Makes Money,” Investopedia, updated March 31, 2020, <https://www.investopedia.com/articles/investing/050515/how-nyse-makes-money.asp>.

¹³⁰ Ronen includes this on the subject of stock exchanges hiring auditors: “Healy and Palepu ... argue that stock exchanges, wanting to signal their reputations in competition for listing fees, have incentives to ensure that listed companies provide high-quality information to investors. They therefore suggest that the exchanges hire the audit firms, negotiate their fees, and oversee the outcome of the audits themselves. The exchanges could cover the audit fees through an increase in stock-trading fees, through additional listing fees, or a combination of the two.” Ronen, “Corporate Audits and How to Fix Them,” 202–203 [see note 55].

¹³¹ Ronen, “Corporate Audits and How to Fix Them,” 205 [see note 55].

policy and the amount it pays for the coverage would be publicized, allowing the public to see how much confidence the insurer has in the company's financial statements.

Under Ronen's plan, the insurance companies could establish their own audit firms, increasing competition in the audit business.

Ronen's plan flows from a familiar indictment of the current system:

I am arguing that the intractable conflict of interest imposed on auditors cannot be rectified through legislation, regulation, enforcement, or litigation as long as auditors are engaged by the management of the firms they audit. Instead, what is needed is an agency relationship between the auditor and an appropriate principal whose economic interests are aligned with the goals of promoting better disclosures and greater economic efficiency.¹³²

As Ronen sees it, under the insurance model, the key players would have healthy incentives:

Once an insurer has underwritten a financial statement insurance policy, the insurer's objective would be to minimize the cost of claims against the policy — that is, the insurer's incentives would be aligned with those of investors. Towards meeting this objective, the insurer would provide incentives to its hired auditor to exert optimal effort, improving the financial statement's quality in the process. ... Auditors, having been hired by the insurers, would want to build reputations for high quality. Their independence, both real and perceived, would be enhanced.¹³³

This plan assumes that insurers would be willing and able on a large scale to take on the massive financial liabilities that could result from corporate accounting meltdowns like Enron.

It seems possible that the plan could create or preserve incentives contrary to those intended. Once auditors have given a company's financial statements their stamp of approval, and once insurers have insured them, each could have an incentive to avoid bringing to light any problems that would trigger expensive insurance claims.

The interests of insurers and the interests of the public are not necessarily aligned. One way insurers can increase profits is by trying to minimize payouts. That will come

¹³² Joshua Ronen, "Financial Statement Insurance," *Journal of Forensic Accounting* 4, no. 1 (January-June 2003): 5, https://pages.stern.nyu.edu/~jronen/articles/Forensic_Accounting.pdf.

¹³³ Ronen, "Corporate Audits and How to Fix Them," 206 [see note 55].

as no surprise to anyone who has fought to get an insurer to pay for medical bills, or car repairs, or a house lost to disaster.

In an email to POGO, Ronen dismissed those worries.

Under Ronen's plan, the auditor is hired by the insurer "and does the latter's bidding," Ronen said. The insurer would not have incentives to hide problems discovered by the auditor because that would "amount to aiding and abetting fraud, subjecting the insurer to potentially catastrophic liability," Ronen said.¹³⁴

Eliminate the Audit Requirement

Here's a radical alternative: Eliminate the audit requirement.

Lynn Turner, a former auditor, former chief accountant at the Securities and Exchange Commission, and longtime critic of the audit industry, thinks that would be an improvement.¹³⁵

At least as part of a larger plan.

Companies that procured optional audits might be sending a message to the investing public that they have nothing to hide — assuming the investing public values the audit and views it as more than window-dressing.

Instead of relying on audit fees as an entitlement, audit firms might have to earn them.

Mix and Match Options

With or without the audit requirement, there are a variety of reforms that could leave auditors less entrenched.

Turner would have shareholders vote every five years on whether their company should procure an audit and, if so, on whether to approve the company's choice of

¹³⁴ Email from Joshua Ronen to David Hilzenrath, March 23, 2022.

¹³⁵ Lynn E. Turner, "Reforms of the Auditing Profession: Improving Quality Transparency, Governance and Accountability," Harvard Law School Forum on Corporate Governance, December 28, 2020, <https://corpgov.law.harvard.edu/2020/12/28/reforms-of-the-auditing-profession-improving-quality-transparency-governance-and-accountability/>.

auditor. Turner advocates this approach in part “to establish accountability to investors as owners of the company.”¹³⁶

Under Turner’s plan, the PCAOB could require a company to put the audit up for bid if the PCAOB found that the auditor had committed malpractice. Audit firms would be limited to 20-year terms.

“Quite frankly, what’s been tried so far hasn’t worked. That’s the one thing we know,” Turner told POGO.¹³⁷

Turner emphasizes that, under his plan, the audit committee of the board of directors, not corporate managers, would nominate the auditor and negotiate the auditor’s fee.

If anything, Turner’s plan might not be enough of a departure from the status quo. Under the current system, audit committees of corporate boards are supposed to oversee audit matters,¹³⁸ but Turner himself has written that, too often, audit committees “delegate hiring and oversight of the auditor to management.”¹³⁹

In an interview, Turner said the rules requiring audit committees to oversee auditors themselves must be tightened and enforced.¹⁴⁰

Assuming shareholders would generally vote to procure audits, as Turner expects, it’s unclear what else would keep audit committees of corporate boards from relying on or taking their cues from corporate managers.

And if shareholders abandoned audits, where would we be? Flawed though audits may be, do they provide at least some check on corporate financial reporting?

Eliminating them could ratchet up the burden of “buyer beware.” Investors would be even more on their own to see through any false or phony accounting.

¹³⁶ Turner, “Reforms of the Auditing Profession” [see note 135]; However, as professor John C. Coffee Jr. of Columbia Law School notes toward the end of this report, shareholders are not necessarily objective observers. With some exceptions, once investors hold shares in a company, they do not want to be told that the company’s financial statements are unreliable, because they don’t want the value of their shares to decline. Email from John C. Coffee Jr. to David Hilzenrath, March 22, 2022.

¹³⁷ Lynn Turner interview with David Hilzenrath, April 13, 2022.

¹³⁸ Sarbanes-Oxley Act of 2002, Pub. Law No. 107-204, 115 Stat. 2390 et seq. § 301, <https://www.govinfo.gov/content/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf>.

¹³⁹ Turner, “Reforms of the Auditing Profession” [see note 135].

¹⁴⁰ Lynn Turner interview with David Hilzenrath, May 5, 2022.

The chief executive of a private technology company proposed another option that turns to shareholders: Give every shareholder that owns at least a 5% stake in a public company the right to audit the accounts at their own expense. The CEO, who didn't want to be quoted by name, offered the proposal in an email to POGO. "Isn't it their company and therefore their data after all?" the executive asked.

Another idea we've heard discussed is to make corporate executives face strict liability for false accounting. In other words, if the books turn out to be cooked, or if the accounting is materially wrong, their heads would be on the legal chopping block. Whether or not they were directly implicated in wrongdoing, they would be held responsible. To protect themselves, the theory goes, executives would demand that the auditors scrub everything thoroughly.

For that to work, executives couldn't hide behind the auditors. They couldn't claim as a legal defense that the auditors — the so-called experts — found that everything was okay.

Red Team

Another radical idea: Turn the incentives 180 degrees.

As an occasional backstop to current audits, allow a third party to come in and, on a contingency-fee basis, look for problems.

This new team would be rewarded for exposing fraud or error. We'll call it a red team.

Asked to suggest solutions to the conflict-of-interest problem, Michael Flaherman proposed the idea in interviews with POGO.¹⁴¹ Flaherman is an anti-corruption consultant, a former private equity executive, and a former board member of CalPERS, the California Public Employees' Retirement System. CalPERS, a big investor of pension money, has long taken an interest in corporate accountability.¹⁴²

As Flaherman envisions it, every three or five years a company would hire a red team the same way it hires auditors. Like an auditor, the red team would have full access to

¹⁴¹ Michael Flaherman interviews with David Hilzenrath, January 20 and March 16, 2022.

¹⁴² Leslie Wayne, "Calpers, a Loud Corporate Critic, To Adopt System to Judge Itself," *New York Times*, October 26, 1995, <https://www.nytimes.com/1995/10/26/business/calpers-a-loud-corporate-critic-to-adopt-system-to-judge-itself.html>; CalPERS, "Corporate Engagements," accessed June 30, 2022, <https://www.calpers.ca.gov/page/investments/corporate-governance/corporate-engagements>; Jenny Anderson, "It's Calpers-onal; Giant Pension Plan Flexing Its Financial Muscle," *New York Post*, April 18, 2004, <https://nypost.com/2004/04/18/its-calpers-onal-giant-pension-fund-flexing-its-financial-muscle/>.

the company's books and records. It would produce a report on its findings that would be filed with the SEC along with the company's annual financial report.

If the red team's findings required the company to restate financial results, the company would pay the red team a fee based on the size of the restatement. If the red team found a problem that was significant but unrelated to accounting, the company would pay a fixed-price bounty based on a schedule set out in advance.

Flaherman identified a pitfall: If the red team found a problem that was so serious it could kill the company — “a death-penalty problem” — the red team would be incentivized to sweep that under the rug, lest the company land in bankruptcy and the red team have trouble collecting its fee.

What incentive would a company have to hire a tough red team?

Flaherman called that the biggest weakness. It might be mitigated, he said, if red teams were required to publish their track records — for example, information about the restatements they've secured — and if the selection of the red team was put to a shareholder vote.

Alternatively, a third party, such as a regulatory agency, could assign red teams, as the author of this report's child Joey Hilzenrath suggested in conversation.¹⁴³

Restrict Audit Firms to Auditing

What if audit firms did nothing but audit?

In the United Kingdom, a long-running debate over how to reform auditing has focused largely on all the other things accounting firms do for corporations.

As some people see it, the crux of the independence problem is that audit firms don't just audit; they also sell an array of consulting services to corporations. Figuratively speaking, that can leave watchdogs at the front door begging for treats, a posture at odds with their mission.

In 2019, a study by an arm of the U.K. government called for an “operational split between the audit and non-audit practices of the Big Four.”¹⁴⁴ That was a reference to

¹⁴³ Joey Hilzenrath discussion with David Hilzenrath, March 26, 2022.

¹⁴⁴ Competition & Markets Authority (U.K.), *Statutory audit services market study: Final report* (April 18, 2019): 187, https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf.

the four dominant firms, Deloitte, Ernst & Young (EY), KPMG, and PricewaterhouseCoopers (PwC). The split would involve essentially compartmentalizing the two aspects of the firms' businesses.

"The aim of this is to ensure auditors' full focus is on conducting high quality audits, without their incentives being affected by the much greater revenue and profits from the non-audit side of the firm," the study said.¹⁴⁵

In March 2021, the U.K. government proposed a more modest step. It floated a plan to create "independent Audit Boards within firms" to govern the audit practices.¹⁴⁶

A group of advocacy organizations urged the U.K. government to go farther.

"To truly end conflicts of interest we urge the government to back full structural separation, so that audit and non-audit services are carried out by separate companies," the group¹⁴⁷ said in a joint statement.¹⁴⁸

Now, EY is preparing to do something along those lines. Subject to a vote by thousands of EY partners, the firm plans to split itself in two.¹⁴⁹ The result may not be a clean break between auditing and consulting; reportedly, the surviving audit firm might continue to provide some non-audit services.¹⁵⁰

Regardless, neither EY's split nor any variations on the theme would truly end conflicts of interest, because audit firms would still be paid by the companies they audit. If

¹⁴⁵ Competition & Markets Authority (U.K.), *Statutory audit services market study: Final report*, 187 [see note 145].

¹⁴⁶ Department for Business, Energy, & Industrial Strategy (U.K.), *Restoring trust in audit and corporate governance* (March 2021), 147, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970673/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf.

¹⁴⁷ Like the Project On Government Oversight, members of that group have received funding from Luminate to work on audit issues. The statement was coordinated under Luminate's auspices. POGO was invited to co-sign it but declined. POGO issued an open letter of its own: Hilzenrath, "What the U.K. Can Learn from the U.S. Experience with Audit Reform" [see note 11].

¹⁴⁸ Greenpeace, et al., "Audit needs a major overhaul: the government's plans are a good start," accessed June 22, 2022, <https://www.greenpeace.org.uk/wp-content/uploads/2021/07/Audit-Needs-a-Major-Overhaul.pdf>.

¹⁴⁹ EY, "Statement on the future of the EY Organization," Press Release, September 8, 2022, https://www.ey.com/en_us/news/2022/09/statement-on-the-future-of-the-ey-organization.

¹⁵⁰ Jean Eaglesham, "EY Faces Knotty Split of Its Lucrative Tax Business," *Wall Street Journal*, September 20, 2022, <https://www.wsj.com/articles/ey-faces-knotty-split-of-its-lucrative-tax-business-11663673562>.

audit firms were purged of non-audit work, they would be wholly dependent on their audit clients.

Nonetheless, requiring audit firms to focus exclusively on auditing — establishing pure audit firms — could advance the public interest for other reasons.

The first involves the shortsighted nature of U.S. auditor independence rules.

Though the rules limit the range of non-audit services accounting firms can provide for companies they audit, the limits leave plenty of room for trouble. For example, there is no prohibition on audit firms advising their clients on business strategy. In addition, though firms are under certain circumstances prohibited from selling their audit clients aggressive tax avoidance strategies, they are allowed to do so under other circumstances — for example, if those strategies are deemed more likely than not to survive legal scrutiny.¹⁵¹

More to the point, U.S. auditor independence rules myopically focus on the work that audit firms do for their audit clients. Though it may seem counterintuitive, the work they do for other companies can pose conflicts of interest, too.

If an audit firm is in the business of selling tax avoidance strategies — if it sells tax reduction schemes to companies B, C, and D, which are not audit clients — can it objectively judge the use of similar strategies by Company A, which is an audit client?¹⁵² Or does it have a vested interest in promoting such schemes and seeing that they succeed?¹⁵³

What's more, the fact that audit firms serve as consultants to companies poses other problems. In a world where four international firms dominate the auditing of large corporations, consulting relationships limit competition among auditors and companies' ability to switch auditors.

Say Company A is interested in replacing Deloitte as its auditor. If EY, KPMG, and PwC have consulting relationships with Company A, those relationships could disqualify the three firms from auditing Company A. They could discourage the three firms from even bidding to become Company A's auditor. The three firms might prefer consulting

¹⁵¹ Public Company Accounting Oversight Board, Rules of the Board, Section 3: Auditing and Related Professional Practice Standards, Rule 3522: Tax Transactions, https://pcaobus.org/about/rules-rulemaking/rules/section_3.

¹⁵² Jesse Drucker, "Officials Balked at a Drug Company's Tax Shelter. Auditors Approved It Anyway," *New York Times*, July 7, 2022, <https://www.nytimes.com/2022/07/07/business/perrigo-omeprazole-taxes-ey.html>.

¹⁵³ A person who did not want to be cited shared this point with POGO.

to auditing, they might find it more lucrative, and they might be loath to give up the consulting contracts. Even if only one or two of the firms have consulting relationships with Company A, those relationships could limit Company A's options.¹⁵⁴

Term Limits for Auditors

Term Limits — The Theory

That brings us to a proposal that has received more attention than any other: Term limits for auditors, also known as mandatory rotation of audit firms.

Some companies have relied on the same audit firm for decades. GE, a repeat offender on the financial reporting front, employed the same firm for more than a century.¹⁵⁵ For the audit firms, these audits can become an annuity. The already cozy relationship between the audit firm and its client can become even cozier.

As we've said before, once an audit firm has given a "clean" or "unqualified" opinion to financial statements that include fraud or error, the audit firm owns the problem. It has a perverse incentive not to expose the problem, because exposing the problem could expose the firm to liability.¹⁵⁶

The theory is that auditors would approach their work differently if they knew another firm was going to be taking over, reviewing the accounting, and making a clean sweep — lest it, too, own the problem. The theory is that an audit firm would have less incentive to bend to the client if it knew its term was limited. And the theory is that, every now and then, it would help to have fresh eyes on the accounting.

¹⁵⁴ EY's planned split seems to be mainly about maximizing consulting opportunities. According to the *Wall Street Journal*, EY's leaders hope breaking up the firm "will free the consultants to win billions of dollars of new business, unfettered by independence rules that restrict the [consulting] work accounting firms can do for audit clients." Jean Eaglesham, "Ernst & Young Leaders Expected to Approve Plan to Split Accounting Company," *Wall Street Journal*, September 5, 2022, <https://www.wsj.com/articles/ernst-young-leaders-expected-to-approve-plan-to-split-accounting-company-11662404933>.

¹⁵⁵ Securities and Exchange Commission, "SEC Charges General Electric With Accounting Fraud; GE Agrees to Pay \$50 Million to Settle SEC's Charges," Press Release 2009-178, August 4, 2009, <https://www.sec.gov/news/press/2009/2009-178.htm>; Securities and Exchange Commission, "General Electric Agrees to Pay \$200 Million Penalty for Disclosure Violations" [see note 84]. *Form 10-K for the Fiscal Year Ended December 31, 2020* (February 12, 2021), 55, <https://www.sec.gov/Archives/edgar/data/40545/000004054521000011/ge-20201231.htm>.

¹⁵⁶ Hilzenrath, "Remember Enron? It Could Happen Again on Biden's Watch" [see note 11]; Hilzenrath, "What the U.K. Can Learn from the U.S. Experience with Audit Reform" [see note 11].

Powerful arguments all.

The European Union, the U.K., and South Africa have in recent years adopted versions of this requirement.¹⁵⁷ It's too early to learn much, if anything, from their experience.¹⁵⁸ Indeed, there's precious little consensus on how to measure audit quality, let alone how to measure the impact of any policy change. In the European Union and the U.K., terms as long as 20 years are still permitted, so any benefit from mandatory rotation might be attenuated. South Africa's requirement begins to take effect next year.

Howard Schilit, the accounting sleuth, said he views five-year term limits as “the short-term best fix to the problems at hand.”¹⁵⁹

The “culture of the CPA firm has always been not to piss off clients,” Schilit told POGO. “It's much more difficult to change long-term behavior patterns than it is to change rules, but I think over time you could be hopeful that the behavior also changes.”¹⁶⁰

Term Limits — The Early History

In the United States, audit firms have fought the idea of mandatory rotation for decades, after each new crisis has focused attention on their performance. That history, which the PCAOB has recounted,¹⁶¹ may say more about the audit industry than it does about the merits of mandatory rotation.

In the 1970s, after a series of corporate scandals, a Senate panel published a report on what it called “The Accounting Establishment.” That searing critique — also known as the “Metcalf Report,” after a senator named Lee Metcalf — found that a long

¹⁵⁷ European Commission, “Reform of the EU Statutory Audit Market - Frequently Asked Questions (updated version),” June 17, 2016, https://ec.europa.eu/commission/presscorner/detail/en/MEMO_16_2244; The Statutory Auditors and Third Country Auditors Regulations (U.K.), 2017, https://www.legislation.gov.uk/ukxi/2017/516/pdfs/ukxi_20170516_en.pdf; Independent Regulatory Board for Auditors, “Rule on Mandatory Audit Firm Rotation,” 2017, <https://www.irba.co.za/upload/Government%20Gazette%20with%20Final%20Rule%20-%201%20June%202017.pdf>.

¹⁵⁸ Maripat Brown, “Mandatory Audit Firm Rotation in the FTSE 350,” Audit Analytics, May 26, 2020, <https://blog.auditanalytics.com/mandatory-audit-firm-rotation-in-the-ftse-350/>.

¹⁵⁹ Howard Schilit interview with David Hilzenrath, April 1, 2022.

¹⁶⁰ Howard Schilit interview with David Hilzenrath, April 1, 2022.

¹⁶¹ Public Company Accounting Oversight Board, “Concept Release on Auditor Independence and Audit Firm Rotation; Notice of Roundtable,” PCAOB Release No. 2011-006, PCAOB Rulemaking Docket Matter No. 37, August 16, 2011, 10, https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/release_2011-006.pdf.

association between a corporation and its auditor “may lead to such close identification of the accounting firm with the interests of its client’s management that truly independent action by the accounting firm becomes difficult.”¹⁶²

“One alternative is mandatory change of accountants after a given period of years, or after any finding by the SEC that the accounting firm failed to exercise independent action to protect investors and the public,” the Metcalf Report said.¹⁶³

The American Institute of Certified Public Accountants, a lobbying group and trade association for accounting firms, answered by commissioning a study of its own, by a panel it convened called the Cohen Commission. (Despite its official-sounding name, it had no governmental authority.)

The Cohen Commission argued against mandatory rotation.

“Since the cost of mandatory rotation of audit firms would be high and the benefits that financial statement users might gain would be offset by the loss of benefits that result from a continuing relationship, rotation of firms should not be required,” the Cohen Commission said.¹⁶⁴

After Enron, a series of observers called on Congress and the SEC to impose term limits on auditors.¹⁶⁵

Advocates included the AFL-CIO, speaking on behalf of unions that sponsored pension plans for millions of workers.

“In our opinion, the benefits to shareholders, lenders and the investing public from requiring rotation of auditors outweighs the additional cost that may be entailed in connection with a new auditor becoming familiar with the client,” Richard Trumka, then secretary-treasurer of the AFL-CIO, said in a 2001 letter to the SEC.¹⁶⁶

¹⁶² Staff of Senate Committee on Government Operations, Subcommittee on Reports, Accounting, and Management, 94th Cong., *Summary of The Accounting Establishment* (Committee Print, December 1976), 19, https://www.sechistorical.org/collection/papers/1970/1976_1201_MetcalfSummaryT.pdf.

¹⁶³ Staff of Senate Committee on Government Operations, Subcommittee on Reports, Accounting, and Management, 94th Cong., *Summary of The Accounting Establishment*, 19 [see note 162]

¹⁶⁴ Commission on Auditors’ Responsibilities and Manuel F. Cohen, *The Commission on Auditors’ Responsibilities: Report, Conclusions, and Recommendations* (1978), [PDF p. 33 of 232] https://egrove.olemiss.edu/aicpa_assoc/433.

¹⁶⁵ Public Company Accounting Oversight Board, “Concept Release on Auditor Independence and Audit Firm Rotation; Notice of Roundtable,” 11 [see note 161].

¹⁶⁶ Richard Trumka, secretary-treasurer of the AFL-CIO, to Jonathan G. Katz, secretary of the U.S. Securities and Exchange Commission, about “Request for Rulemaking Concerning Definition of

Again, the industry fought back.

Testifying before the Senate Banking Committee in 2002 on behalf of the American Institute of Certified Public Accountants, James E. Copeland, Jr., who was chief executive of Deloitte & Touche, called mandatory rotation “a prescription for audit failure”:¹⁶⁷

It would result in the destruction of vast stores of institutional knowledge and guarantee that auditors would be climbing a steep learning curve on a regular basis. It would expose the public to a greater and more frequent risk of audit failure. It would increase the likelihood of undetected fraud by management. It would make it easier for reckless management to mislead the auditor. And finally, it would allow companies to disguise opinion shopping by enabling them to portray a voluntary change in auditors as obligatory.¹⁶⁸

Term Limits—The Shootdown of a Trial Balloon

A decade ago, under Chairman James R. Doty, the PCAOB issued a “concept release” on auditor independence — a sort of regulatory trial balloon — and held a series of public meetings to explore the subject.¹⁶⁹ Doty identified auditing’s fundamental conflict of interest as an enduring problem.

“The inherent conflict presented by client pressures still weakens the commitment to investor protection,” Doty said in the text of a May 2012 speech to the American Institute of Certified Public Accountants, the industry’s main trade group.¹⁷⁰

“This is the unfinished business that occupies the PCAOB, and I might add audit regulators around the world who have also identified a gap between the purpose of

Independent Auditor and Limiting Services Accounting Firms May Provide to Audit Clients,” December 11, 2001, <https://www.sec.gov/rules/petitions/petn4-448.htm>.

¹⁶⁷ S. Hrg. 107-948, *Accounting Reform and Investor Protection, Hearings before the Senate Committee on Banking, Housing, and Urban Affairs*, Volume II, 107th Cong., (March 5, 6, 14, 19, 20, and 21, 2002), 821, <https://www.govinfo.gov/content/pkg/CHRG-107shrg87708/pdf/CHRG-107shrg87708-vol2.pdf>.

¹⁶⁸ S. Hrg. 107-948, *Accounting Reform and Investor Protection, Hearings before the Senate Committee on Banking, Housing, and Urban Affairs*, Volume II, 107th Cong., 821, [see note 167].

¹⁶⁹ Public Company Accounting Oversight Board, “Concept Release on Auditor Independence and Audit Firm Rotation; Notice of Roundtable,” [see note 161].

¹⁷⁰ James R. Doty, “The Future of Financial and Business Reporting from a Standards-Setting and Regulatory Perspective,” (speech, 125th Anniversary of the American Institute of Certified Public Accountants, Washington, DC, May 17, 2012), https://pcaobus.org/news-events/speeches/speech-detail/the-future-of-financial-and-business-reporting-from-a-standards-setting-and-regulatory-perspective_405.

the audit and its fulfillment. This gap threatens the future relevance of the [audit] profession's work, as well as public confidence in its credibility," Doty said in the speech.¹⁷¹

Doty's assessment was remarkable less for its substance than for its source: auditing's lead U.S. regulator. As chairman of the PCAOB, Doty had special insight into the agency's inspections of audit firms. He also had a special vantage point on how much regulators could and couldn't accomplish under the current system.

At least one audit firm, Grant Thornton, seemed open to the idea of mandatory rotation.¹⁷² For Grant Thornton, term limits could create new opportunities. It could give second-tier firms more of a chance to compete with the Big Four audit firms that dominate audits of publicly traded companies.

The Big Four and many of their corporate clients rallied against term limits.¹⁷³ They argued that requiring companies to periodically change audit firms would reduce the quality of audits, because audit firms face a steep learning curve when they take on a new company. One executive seemed to cast doubt on audits performed during the first few years of an audit firm's tenure.

"The requisite level of knowledge cannot be effectively gained over a period of a few years. It is built over a much longer period of time," Valarie L. Sheppard, who was senior vice president and comptroller of Proctor & Gamble, told the PCAOB.¹⁷⁴

¹⁷¹ Doty, "The Future of Financial and Business Reporting from a Standards-Setting and Regulatory Perspective," [see note 170].

¹⁷² Grant Thornton to the Office of the Secretary of the Public Company Accounting Oversight Board, Comment on PCAOB Rulemaking Docket 037 [see note 32].

¹⁷³ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012, 169-172, 176, 187-190, 392, 397, 407-408, 414-415 [see note 3]. American Institute of CPAs to the Office of the Secretary of the Public Company Accounting Oversight Board, Comment on PCAOB Rulemaking Docket Matter No. 37 (December 14, 2011), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/413_aicpa.pdf; U.S. Chamber of Commerce to the Secretary of the Public Company Accounting Oversight Board, Comment on PCAOB Rulemaking Docket Matter No. 37 (October 20, 2011), https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket037/033_chamber.pdf.

¹⁷⁴ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012, 181 [see note 3].

(Reacting to testimony by Sheppard and others, John C. Bogle, founder of The Vanguard Group, giped, “They make an unbelievably powerful case that auditors should never be rotated. Never.”)¹⁷⁵

Opponents of term limits also argued that companies would have difficulty rotating audit firms because there are so few options. Only four firms are big enough to audit multinational companies, they argued, and some of them could be disqualified from taking on the audit of a particular company because they already provide other services to the company. (Big accounting firms sell an array of consulting services.)

The opposition further argued that putting new teams in place around the world to audit a global company would be costly, difficult, disruptive, and time-consuming. They also argued that not all audit firms would have the industry-specific expertise to take on all clients.

Doty himself pointed out one of the ways mandatory rotation could fall short: Audit firms could protect each other — engage in mutual back-scratching — instead of serving as a check on each other’s work.¹⁷⁶

There may be precedent for that. Before the PCAOB was created and tasked with inspecting audits of public companies, audit firms inspected each other under a system known as peer review. No major firm ever failed a peer review, and, in the midst of the Enron debacle, the Arthur Andersen firm passed a peer review by rival Deloitte.¹⁷⁷

¹⁷⁵ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 238 [see note 3].

¹⁷⁶ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 320 [see note 3].

¹⁷⁷ Scot J. Paltrow, “Accounting Scandals Have Some Peering at Industry’s Self-Policing,” *Wall Street Journal*, January 14, 2002, <https://www.wsj.com/articles/SB1010963336547708960>; David S. Hilzenrath, “Andersen Passes Peer Review,” *Washington Post*, January 3, 2002, <https://www.washingtonpost.com/archive/business/2002/01/03/andersen-passes-peer-review/9689dcf8-6011-4e6e-b777-105f0839a108/>; The American Institute of Certified Public Accountants (AICPA), an industry group, maintains a peer review system for audits of private companies. American Institute of Certified Public Accountants, “Peer Review Home Page,” accessed June 22, 2022, <https://peerreview.aicpa.org/>; *Going Concern* reported in 2012 that, within the AICPA peer review program, Deloitte had become “the first Big 4 firm to have a non-clean report in the history of the Big 4.” Caleb Newquist, “Deloitte Achieves Another Unflattering Milestone in Audit Quality,” *Going Concern*, July 16, 2012, <https://www.goingconcern.com/deloitte-achieves-another-unflattering-milestone-audit-quality/>.

The risk of “I’ll scratch your back if you’ll scratch mine” would be heightened if, in the rotation as a particular company’s auditor, Audit Firm #1 could not only precede Audit Firm #2 but also follow it.

Richard Breeden, a former chairman of the SEC, questioned how much difference term limits would make if the terms were “reasonably long.”

“The guy who loses the audit in year two or three of a ten-year period is going to be just as disadvantaged internally in the firm as a person who might lose it in later years without rotation,” Breeden said. “Ultimately, rotation would replace one set of somewhat conflicted audit partners with another set of partners with exactly the same issue.”¹⁷⁸

That might have been an unintended argument for shorter terms.

Breeden raised another issue. He warned that mandating rotation through regulatory action could be “challenged under the statutes requiring cost-benefit analysis.”¹⁷⁹ In other words, it could be hard to marshal the economic data needed to show a court that benefits would outweigh costs.

That observation highlighted a Catch-22: If something has never been tried, it’s hard to prove what will happen if it’s tried.

Suggested alternatives to term limits included empowering a regulator to force a change of auditors if the incumbent were performing poorly, requiring companies to periodically put their audit out for competitive bids, requiring companies to periodically put more than one audit firm on the ballot for a binding shareholder vote,¹⁸⁰ or giving companies a choice: either replace their audit firm periodically or, after a specified number of years, publicly justify keeping the incumbent.¹⁸¹

Those ideas seemed like weak substitutes for term limits, off-ramps from the road to major reform.

¹⁷⁸ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 50-51 [see note 3].

¹⁷⁹ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 70 [see note 3].

¹⁸⁰ Staff of Senate Committee on Government Operations, Subcommittee on Reports, Accounting, and Management, 94th Cong., *Summary of The Accounting Establishment* (Committee Print, December 1976), 19, https://www.sechistorical.org/collection/papers/1970/1976_1201_MetcalfSummaryT.pdf.

¹⁸¹ Breeden discussed the first and third of these three alternatives. Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 52-53 [see note 3]

Supporters of term limits argued that the doomsaying about costs and disruptions defied their experience when companies changed auditors. Added costs, if any, would be modest in the scheme of things — especially compared to the money companies pay their CEOs.¹⁸²

Further, the chance to win new clients formerly considered out of reach would prompt audit firms to develop any industry-specific expertise they might have been lacking, supporters argued.¹⁸³

Charles A. Bowsher, a former comptroller general of the United States who spent 25 years in public accountancy, told the PCAOB that he had always been suspicious of the concerns that audit firms taking on a new client face a steep learning curve.¹⁸⁴ But Bowsher pointed to a simple solution. During the final year of an audit firm's term, a company could obtain overlapping audits: one by the outgoing audit firm, and another by the incoming firm. Large companies "can easily afford this," Bowsher said.¹⁸⁵

Advocates of mandatory rotation included Paul A. Volcker, the former Federal Reserve Board chairman.

Volcker died in 2019. But his stature as a financial statesman is not the only reason to give weight to the advice he gave the PCAOB in 2012. Ten years earlier, reportedly working for free, Volcker led an unsuccessful effort to overhaul and rescue Enron's discredited auditor, the Arthur Andersen accounting firm.¹⁸⁶ In addition, Volcker served as a director of a company that changed auditors. The new auditor found a lot of weaknesses in the work of its predecessor, Volcker recounted.¹⁸⁷

¹⁸² Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012,, 274 [see note 3].

¹⁸³ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012, 340-341 [see note 3].

¹⁸⁴ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012, 37-38 [see note 3].

¹⁸⁵ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012, 39, [see note 3].

¹⁸⁶ Louis Uchitelle, "Enron's Many Strands: Outsider's View; Under Fire, Andersen Puts Trust In Volcker," *New York Times*, February 4, 2002, <https://www.nytimes.com/2002/02/04/business/enron-s-many-strands-outsider-s-view-under-fire-andersen-puts-trust-in-volcker.html>.

¹⁸⁷ Public Company Accounting Oversight Board, "Auditor Independence and Audit Firm Rotation, Public Meeting," Transcript, March 21, 2012, 32 [see note 3].

“I understand why it makes an auditing firm perhaps uneasy to know that its term as auditor may be up and another firm is going to come and look over the work, but I think that is a useful point of uneasiness,” Volcker told the PCAOB.¹⁸⁸

Volcker added that, when assessing term limits for auditors, the usual cost-benefit analysis doesn’t apply.

“What we’re worried about is a breakdown in the auditing process that leads to damage to the firm, may lead to the end of the firm, may lead to enormous reputational problems, which you can’t equate in any normal cost-benefit analysis. You have got a continuing stream of relatively small cost” — the audit fees — “with the risk of a huge catastrophe for the company. I don’t think that is susceptible to normal cost-benefit,” Volcker said.¹⁸⁹

Getting away from the client-pays system and addressing the conflict-of-interest problem more directly “would be fundamentally important if you could do it,” Volcker said, “but I don’t know how.”¹⁹⁰

Politically, the 2012 battle over mandatory rotation wasn’t a fair fight. As Berkeley’s Don Moore noted, those with a vested interest in the status quo mobilized to thwart change, while the countless, diffuse members of the public who stood to benefit from reform weren’t tuned in or aware of their stake in the matter.¹⁹¹

Ultimately, the House of Representatives passed a bill that would have prohibited mandatory rotation.¹⁹² The Senate did not follow the House’s example, and the bill did not become law, but the shot across the bow of the PCAOB seemed to have had the intended effect of killing the PCAOB’s initiative.¹⁹³ The PCAOB adopted more incremental reforms.

¹⁸⁸ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 33-34 [see note 3].

¹⁸⁹ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 67-68 [see note 3].

¹⁹⁰ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 76 [see note 3].

¹⁹¹ Public Company Accounting Oversight Board, “Auditor Independence and Audit Firm Rotation, Public Meeting,” Transcript, March 21, 2012, 295 [see note 3].

¹⁹² Audit Integrity and Job Protection Act., H.R. 1564, 113th Cong. (2013), <https://www.congress.gov/bill/113th-congress/house-bill/1564>.

¹⁹³ SEC Historical Society, “James R. Doty - Oral History,” video, April 8, 2021, 18:43, <https://www.youtube.com/watch?v=B-TVYFK0NYY>.

It required audit firms to disclose to the PCAOB the name of the partner in charge of each public company audit,¹⁹⁴ and it created a database disclosing that information to the public.¹⁹⁵ It required audit firms to disclose in their audit reports how long they had been auditing the client.¹⁹⁶ It also required auditors to identify in their reports so-called critical audit matters — issues that involved “especially challenging, subjective, or complex auditor judgment.”¹⁹⁷ In other words, it required audit firms to provide a roadmap to where trouble might be lurking.

Term Limits and Their Limits — Looking Forward

Doty has stated in an oral history that he still thinks mandatory rotation has merit and that its day may come.

“It frames the limits of what is possible now,” Doty said in the April 2021 interview. “It is the ultimate way of limiting ... the influence of the client payer model, and for that reason it may be one of the most important results for the auditing profession to come to in the fullness of time,” Doty said.¹⁹⁸

Critics sympathetic to Doty’s effort have argued that term limits wouldn’t go far enough. They’ve argued that mandatory rotation would leave the fundamental conflict of interest intact: Audit firms would still work for their clients.

Professor John C. Coffee Jr. of Columbia Law School has written that mandatory rotation “is a necessary element in any package of reforms,” but it is insufficient and “no panacea.”¹⁹⁹

¹⁹⁴ Securities and Exchange Commission, “Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards,” Release No. 34-77787, File No. PCAOB-2016-01, May 9, 2016, <https://www.sec.gov/rules/pcaob/2016/34-77787.pdf>.

¹⁹⁵ Public Company Accounting Oversight Board, “AuditorSearch,” <https://pcaobus.org/resources/auditorsearch>.

¹⁹⁶ Public Company Accounting Oversight Board, *Staff Guidance; Changes to the Auditor’s Report Effective for Audits of Fiscal Years Ending On or After December 15, 2017* (updated December 28, 2017), 4, <https://pcaobus.org/Standards/Archived/Documents/PCAOB-Auditors-Report-Guidance-12-28-17.pdf>.

¹⁹⁷ Public Company Accounting Oversight Board, *The Auditor’s Report On An Audit of Financial Statements When The Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 034, PCAOB Release No. 2017-001 (June 1, 2017), 16, <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket034/2017-001-auditors-report-final-rule.pdf>.

¹⁹⁸ SEC Historical Society, “James R. Doty - Oral History,” 19:35 [see note 193].

¹⁹⁹ John C. Coffee, “Why do auditors fail? What might work? What won’t?,” *Accounting and Business Research* 49, no. 5 (2019): 555, <https://doi.org/10.1080/00014788.2019.1611715>.

“The danger, of course, is that if [corporate] management dominates the process, it may seek the most accommodating and deferential of the various candidates for the position of replacement auditor,” Coffee wrote.²⁰⁰

Mandatory rotation should be combined with other reforms designed to make auditors more accountable to investors, Coffee wrote. Shareholders representing, say, 10% of a company’s ownership should have the power to put an alternative auditor to a shareholder vote, and, to inform investors, an audit regulator should grade auditors on a curve showing how they compare, Coffee proposed.²⁰¹

Coffee was writing for a U.K. audience, but his views apply in the United States as well.

In an email to POGO, Coffee cautioned that, once they hold stock in a company, many shareholders wouldn’t want to be told that the company’s financial statements are unreliable. They wouldn’t want the value of their shares to take a hit.²⁰²

Meanwhile, a lot has changed since companies like Procter & Gamble warned the PCAOB that it could be difficult to put big new audit teams in place for multinational corporations. It’s worth exploring how technological changes, such as the rise of Zoom and remote work, could ease transitions.

For mandatory rotation to work as intended, audit firms would need to know that their corporate client couldn’t fire them before their term is up. At least, not without cause — or intervention from the audit regulator.

Something would have to be done to prevent the incoming audit firm from simply hiring the same team of people who audited the company for the outgoing audit firm and keeping them on the job.

What’s more, audit firms would have to be prohibited from providing non-audit services, if only to eliminate the specific business relationships that would disqualify them from competing for many companies’ audits.

Eleanor Bloxham, who advises corporate executives and directors as head of The Value Alliance and Corporate Governance Alliance, sees mandatory rotation as part of a larger plan. It should be administered by a new, independent federal agency — not the PCAOB, and not the company being audited or members of its board of directors, Bloxham said in an email to POGO.²⁰³ In Bloxham’s vision, unlike the PCAOB’s

²⁰⁰ John C. Coffee, “Why do auditors fail” 555 [see note 199].

²⁰¹ Coffee, “Why do auditors fail?” 557 [see note 199].

²⁰² Email from John C. Coffee Jr. to David Hilzenrath, March 22, 2022.

²⁰³ Email from Eleanor Bloxham to David Hilzenrath, March 29, 2022.

leadership, the new federal agency's board would have no ties to audit firms or companies.

"An entire system is required to achieve truly independent audits. One finger in the dike will not solve the problem," Bloxham said.²⁰⁴

Tell the Truth

If the road to audit reform is otherwise blocked, there's one simple step the government could take.

Stop lying.

Don't dilute auditors' responsibilities or weaken the already weak "independence rules."

But, at long last, for a change, tell the public the truth about audits.

Abandon the illusion or self-delusion and stop calling dependent auditors independent.

²⁰⁴ Email from Eleanor Bloxham to David Hilzenrath, March 29, 2022.



PROJECT ON GOVERNMENT OVERSIGHT

1100 G Street NW, Suite 500

Washington, DC 20005

WWW.POGO.ORG

