[Fordham Journal of Corporate & Financial Law](https://ir.lawnet.fordham.edu/jcfl)

Volume 9 | Issue 2 Article 2

2004

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ARTICLES

BREAKING THE MARKET'S DEPENDENCE ON INDEPENDENCE: AN ALTERNATIVE TO THE "INDEPENDENT" OUTSIDE AUDITOR

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INTRODUCTION

A cornerstone of financial reporting by public companies is the requirement that their annual financial statements be audited by independent outside auditors. As a result of the rising tide of financial misstatements by public companies, however, there have been serious concerns as to whether outside auditors adequately carried out their responsibilities and, in particular, whether their independence was compromised. The resulting Sarbanes-Oxley Act attempts to provide regulatory reform to the accounting industry.[1] The reform includes the creation of an accounting oversight board and restrictions on an outside auditor of a public company from providing the same company with certain consulting services.

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I would like to thank Joyce Neils Chan and Erik Lillya for their review of the article and for their comments. I am also grateful to my colleagues at the Midwest Regional Office, including David Medow, Donald Ryba and Scott Hlavacek, who shared with me their insights and expertise on the issues discussed in the article.

1. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley Act].

Professional and regulatory requirements of independence, however, are not effective when outside auditors are seduced by large fees. Although the Sarbanes-Oxley Act seeks to restrict consulting fees, a cause for the breakdown of independence, and further regulate the accounting industry, the Act leaves untouched several fundamental facts regarding an outside auditor. First, an outside auditor can never truly be independent since they are paid and selected by the same corporations that are being audited. Second, and related to the first fact, an outside auditor is only financially motivated to do what is minimally required, based on Generally Accepted Auditing Standards ("GAAS")[2], in auditing the financial statements of a company. As a result, an outside auditor has little financial incentive to take innovative or comprehensive steps, such as forensic procedures, to ensure that a company's books are accurate. This Article reviews recent SEC enforcement actions and other civil litigation against outside auditors regarding corporate financial misstatements. The review shows that despite a vigorous enforcement effort, it is difficult to deter audit firms from violating, in repeated and systemic fashion, the federal securities laws and professional standards, including rules requiring independence by auditors. The review of these cases shows that lucrative fees almost always played a role in the violations. This Article also reviews various behavioral research studies showing that company-hired auditors' strong and subconscious bias in favor of their employers greatly dilutes the effectiveness of deterrence.

This Article explores whether there can be an alternative to the current system of relying on independent outside auditors retained by corporations themselves to audit corporate financial statements. One alternative is to take advantage of the fact that there are outside parties, such as institutional investors, that have a strong financial interest in determining the accurate financial condition of public companies. Specifically, this Article proposes a system in which institutional investors and other outside parties would retain accounting or other financial professionals ("investor-hired auditors") to audit or otherwise review the financial data of the public companies. The financial interest

2. *See* SEC v. Price Waterhouse, 797 F. Supp. 1217, 1222–23 n.17 (S.D.N.Y. 1992) (noting that GAAS are "standards prescribed by the Auditing Standards Board of the [American Institute of Certified Public Accountants] for the conduct of auditors in the performance of an examination").

of these investor-hired auditors will be aligned with the financial interests of the investors. They will be financially motivated not to do the minimum, but to do their utmost, including finding innovative steps, to determine the most accurate picture of a public company's financial condition. As a result, the quality of financial data will also improve.

Such a system, however, is not possible today because the public, and any investor-hired auditor, unlike auditors retained by public companies, do not have access to public companies' raw financial data to perform any meaningful analysis. In addition, compared to auditors hired by the companies, the public does not have the same level of access to management to question or have discussions regarding the companies' financial condition. Thus, a system in which it will be feasible for outside parties to retain financial professionals meaningfully to review and analyze public companies must enable such professionals to have:

- access to public companies' raw financial data; and
- access to management to discuss specific accounting questions or issues.

Advances in Internet technology make such access feasible. This Article proposes that public companies be required to provide public access to its raw financial data by maintaining its financial records on the Internet on a real time basis. It also proposes that public companies be required to respond, in a limited fashion, to written questions posted on the Internet by the public regarding its financial data. If outside parties, such as institutional investors, can use their own accountants or financial experts to audit or analyze a company's financial data, there will be less of a need for company- hired auditors to be independent. It may then be reasonable to relax the restrictions on company-hired auditors' ability to provide consulting services, as currently mandated under the Sarbanes-Oxley Act. Under this proposal, the Securities and Exchange Commission ("SEC") will play a central role in establishing requirements for such access and to prevent abuse or frivolous use of such access. In addition, legislation will also be necessary to ameliorate possible risks and harms from such public access. In particular, it will be necessary to create legal safe harbors to decrease the litigation risk that may accompany what will effectively be additional disclosure of material information to the public.

Thus, rather then creating further regulations to force company-hired auditors to go against their financial instincts, the Article proposes regulations that will empower the market to take the necessary steps to ensure that it has an accurate picture of the financial conditions of public companies.

I. THE INDEPENDENT OUTSIDE AUDITOR: A CORNERSTONE OF CORPORATE FINANCIAL DISCLOSURE

The federal securities laws require that "independent" public accountants certify financial statements filed with the SEC by public companies.[3] The purpose of the requirement is to provide assurance that "outside experts have examined a filer's financial statements and have arrived at objective opinions about whether the filer's financial position, results of operations, and cash flows are presented fairly in conformity with [Generally Accepted Accounting Principles]."[4] Such independent audits will ideally make the financial statements more reliable and credible.[5] The specific requirement that the auditing firm be independent is based on the policy view that lack, or perceived lack, of auditor independence will undermine public confidence in financial reporting, to the detriment of the securities markets.[6] Although the auditor's client is the public company it audits, the current system views the auditor's role to be that of a "public watchdog" with "ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."[7] The SEC over the years has implemented rules and issued interpretations regarding what constitute violations of the independence requirements.[8] Article 2 of the SEC's Regulation S-X contains the SEC's rules regarding the independence of auditors.[9]

3. In the Matter of KPMG Peat Marwick LLP, Exchange Act Release No. 43862/ Accounting and Auditing Enforcement Release No. 1360, Admin. Proc. File No. 3-9500, at 14 & n.53 (Jan. 19, 2001), *available at* http://www.sec.gov/litigation/opinions/34-43862.htm (last visited Nov. 10, 2003). *See* ¶¶ 25, 26 of Schedule A, Securities Act of 1933, 15 U.S.C. § 77aa(25) and (26).

4. *Id.* at 13.

5. *Id.*

6. *Id.*

7. *Id.* at 14 (quoting U.S. v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984)).

8. FRANK C. MINTER et al., HANDBOOK OF ACCOUNTING & AUDITING B1-18, B1-19 (2000) [hereinafter HANDBOOK OF ACCOUNTING].

9. *Id.* at F1-8.

The accounting industry's own professional standards for auditing, GAAS, and accompanying rules for GAAS, also require auditors to be independent.[10] One of the standards in GAAS is that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."[11] The American Institute of Certified Accountants ("AICPA") promulgated rules of the Code of Professional Conduct that provide detailed examples of impairment of auditor independence, such as having a direct financial interest or material indirect interest in the client. [12] The AICPA also provides detailed interpretations addressing situations affecting independence, including family relationships and litigation involving auditor and client.[13] These SEC and professional rules and requirements shall be referred as the "independence rules."

Although an outside auditor is required to be "independent" as defined by the independence rules, a public company has complete discretion in selecting its outside auditor. In particular, management plays an influential role deciding which auditor to select and whether or not the company's current auditor should be retained. Specifically, the selection of an outside auditor involves the following: a company's management proposes the selection of a firm that should serve as the outside auditor, the company's audit committee, empowered by the full board, confirms management's selection, and shareholders ratify the selection.[14] Each year, the audit committee evaluates the performance of the outside auditor, but its evaluation depends largely on management's views regarding the auditor.[15]

II. A CRISIS OF CONFIDENCE: FAILURE OF OUTSIDE AUDITORS TO DETECT AND PREVENT CORPORATE FINANCIAL SCANDALS

The corporate financial scandals in recent years show that the current system of relying on company-hired auditors to audit corporate financial statements is not working. Regardless of whether they were deserving of blame, outside auditors failed to prevent a significant

10. *Id.* at B1-17, B1-18.
11. General Standards 2, GAAS.
12. Handbook of Accounting, *supra* note 8, at B1-18.
13. *Id.*
14. *Id.* at B2-7, B2-27.
15. *Id.* at pp. B2-7, B2-8.

increase in financial misstatements. These misstatements were often blatant and massive. They resulted in large market losses and ultimately shook the investing public's confidence in the U.S. securities markets. The need to change the status quo is thus real and urgent.

A review of the number and nature of corporate financial restatements, i.e., when a company revises public financial information that was previously reported, shows the magnitude of the recent financial scandals. According to a recent report by the United States General Accounting Office, from 1997 through June 2002, the number of restatements of financial results due to accounting irregularities increased by approximately 145 percent.[16] In 1997, there were 92 corporate restatements, but by 2001, there were 225 restatements.[17] Increasingly, large mainstream public corporations, as opposed to small, high-tech companies, are the companies issuing financial restatements.[18] For instance, the average market capitalization of a restating company increased from $500 million in 1997 to $2 billion in 2002.[19] The number of restatements from NYSE-listed companies also increased during this period.[20]

Outside auditors failed to prevent massive and arguably obvious financial misstatements. Corporate financial scandals such as Enron, WorldCom, Adelphia and Xerox involved apparent breach of the federal securities laws and, in particular, blatant fraudulent misconduct of

16. U.S. GEN. ACCOUNTING OFFICE, FINANCIAL RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO-03-138, at 4 (Oct. 2002) [hereinafter GAO REPORT].

17. *Id.*

18. *Id.* at 17.

19. *Id.* (The median increased from $143 million to $351 million).

20. *Id.*

massive proportions.[21] In some cases, corporate officials were accused of outright looting of corporate assets.[22]

The outside auditors' failure to prevent the financial misstatements resulted in significant economic losses.[23] These financial scandals severely damaged the American economy.[24] For instance, some of the corporate financial failures led to the loss of "approximately $5 trillion in market capitalization from the U.S. capital markets since its high in March 2000," or approximately $60,000 per U.S. household.[25] Equally disturbing is that the financial misstatements have severely shaken investor confidence in the U.S. securities markets.[26] For instance, surveys show that since February 2002, investors polled identified questionable accounting practices as the leading reason for a significant decline in investor optimism about the market.[27]

The economic incentives for financial misstatements continue to exist. The financial fraud has been caused in large part by pressure for corporate management to meet or exceed analysts' expectations of corporate earnings. Even if a corporation has a profitable quarter, its stock price may decrease if analysts earlier had predicted stronger earnings.[28] By the end of a quarter, the stock price has already

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21. *See generally* GAO REPORT, *supra* note 16, at Appendix V *et seq.*; William Powers, Jr., Raymond S. Troubh & Herbert S. Winokur, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (Feb. 1, 2002) (letter and report from Chairman of the Board, William Powers, Jr.); SEC v. WorldCom, Inc., Civ. Action No. 02-CV-4963 (JSR), Lit. Release No. 17829 (Nov. 1, 2002)/Accounting and Auditing Enforcement Release No. 1658 (Nov. 5, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17829.htm (last visited Nov. 25, 2003).

22. For instance, Adelphia officers were accused, among other things, of using corporate funds to pay for personal ownership of the Buffalo Sabres hockey team. Joseph Nocera et al., *System Failure: Corporate America Has Lost Its Way. Here's a Roadmap to Restoring Confidence*, FORTUNE, June 9, 2002, at 62.

23. *See generally* GAO REPORT, *supra* note 16; Paul S. Atkins, Remarks at the Federalist Society 20th Annual Convention (Nov. 14, 2002), *available at* http://www.sec.gov/news/speech/spch111402psa.htm (last visited Nov. 10, 2003).

24. *See generally* GAO REPORT, *supra* note 16; Atkins, *supra* note 23.

25. Atkins, *supra* note 23.

26. GAO REPORT, *supra* note 16, at 32–41.

27. *Id.* at 34.

28. Norman S. Johnson, Speech by then SEC Commissioner at the Utah State Bar Mid-Year Convention (Mar. 6, 1999), *available at*

incorporated the analysts' expectation of what the earnings should be.[29] Thus, regardless of whether a company is profitable, if actual earnings do not meet expectations, the stock price will adjust accordingly.[30] Coupled with the emphasis in stock options for compensating executives, there is tremendous pressure for management to meet analyst expectations.[31] As a result, despite current enforcement actions against financial fraud, there continues to be a strong incentive for corporate management to "fudge" the numbers.[32]

III. LEGISLATIVE RESPONSE TO CORPORATE FINANCIAL SCANDALS: THE SARBANES-OXLEY ACT

To address the corporate financial scandals and the resulting crisis in investor confidence, one of the primary goals of the Sarbanes-Oxley Act is to provide greater assurance of auditor independence in addition to improving the quality of audits.[33] First, the Sarbanes-Oxley Act establishes the Public Company Accounting Oversight Board to regulate accountants who perform audits of public companies.[34] The Board has the authority to establish rules regarding auditing, quality control, and independence standards for public accounting firms.[35] Further, it is responsible for conducting periodic inspections of public accounting firms to assess the firms' and associated persons' compliance with applicable rules and standards.[36] It is also responsible for conducting investigations and instituting disciplinary proceedings against the public accounting firms or their associated persons for violation of any applicable rules and standards.[37]

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http://www.sec.gov/news/speech/speecharchive/1999/spch264.htm (last visited Nov. 10, 2003). In fact, Commissioner Johnson identified pressure to meet analyst expectations as the "single most important cause" of earnings management. *Id.*

29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*
33. *See* GAO REPORT, *supra* note 16, at 244.
34. Sarbanes-Oxley Act, *supra* note 1, at §§ 101–09.
35. *Id.* at § 103.
36. *Id.* at § 104.
37. *Id.* at § 105.

Second, the Sarbanes-Oxley Act also addresses the concern regarding auditor independence by placing restrictions on auditors' ability to perform non-audit services for their audit clients.[38] Section 201(a) of the Sarbanes-Oxley Act prohibits a registered public accounting firm that performs an audit of a public company's financial statements (and any person associated with such a firm) to provide to that public company, "contemporaneously with the audit, any non-audit services."[39] The Sarbanes-Oxley Act identifies nine specific categories of prohibited services. They are: (i) bookkeeping or other services related to the accounting records or financial statements of the audit client; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management or human resources functions; (vii) broker or dealer, investment adviser, or investment banking services; (viii) legal services and expert services unrelated to the audit; and (ix) any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.[40] As part of this section, the SEC has implemented rules toward defining and prohibiting such services.[41] The Sarbanes-Oxley Act and the SEC's rules under that Act allow accountants to continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, subject to certain audit committee pre-approval requirements.[42] Additionally, the rules require audited companies to disclose the amount of fees paid to the accounting firm for tax services.[43]

38. *See* GAO REPORT, *supra* note 16, at 244.

39. Sarbanes-Oxley Act, *supra* note 1, at § 201(a).

40. *Id.*

41. Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68, File No. S7-49-02 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm (last visited Nov. 25, 2003).

42. *Id.*

43. *Id.*

IV. THE RELATIONSHIP BETWEEN LACK OF AUDITOR INDEPENDENCE AND FINANCIAL MISSTATEMENTS

Facts alleged in SEC enforcement actions and private civil lawsuits strongly suggest that lack of independence played an important role in auditors' failure to prevent some of the financial misstatements. The problem appears to be systemic since a majority of the large audit firms have been accused of significant violations. In addition, the fact that a number of audit firms allegedly violated the federal securities laws and/or the independence rules despite prior enforcement sanctions indicates that SEC enforcement actions and independence rules, by themselves, cannot ensure auditor independence when auditors are seduced by lucrative fees and financial incentives.

A. Arthur Andersen

In *Newby v. Enron*,[44] class action plaintiffs alleged that Arthur Andersen, as Enron's outside auditor, violated the federal securities laws because it "knew, was concerned about, yet covered up or ignored fraudulent accounting practices by Enron."[45] According to the complaint, a primary reason for Arthur Andersen's alleged misconduct was its lack of independence.[46] The complaint also alleged that Enron was Arthur Andersen's second largest client, generating approximately $50 million in fees annually for Arthur Andersen.[47] Finally, according to the complaint, the audit firm pressured its audit partner to solicit and market lucrative consulting services to Enron, resulting in a conflict of interest.[48]

Enron was not Arthur Andersen's first exposure to allegations of massive audit failure. Anderson was accused of improper audits in financial scandals including Waste Management, Sunbeam Corporation and Baptist Foundation of Arizona, resulting in the firm paying large sums for settlement.[49]

44. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

45. *See id.* at 679.

46. *Id.* at 676–77.

47. *Id.* at 673.

48. *Id.* at 676–77.

49. *Id.* at 675.

B. KPMG

In 2003, the SEC filed a civil injunctive action against KPMG alleging that it violated the antifraud provision of the federal securities laws in connection with its audit of Xerox Corporation.[50] The SEC alleged that KPMG affiliate offices in Europe, Brazil, Canada and Japan, as well as KPMG auditors in the United States, repeatedly warned the KPMG engagement partners for Xerox "that manipulative actions taken by Xerox to improve revenues and earnings were unnecessary, were not adequately tested, and distorted true business results."[51] The KPMG partners, "who worked near Xerox headquarters in Stamford, Connecticut, or at KPMG's New York headquarters, gave little weight to these warnings from on-the-scene KPMG affiliates and did not demand that Xerox justify the reasons for departures from historic accounting methods or establish the accuracy of the new, manipulative practices."[52] According to the SEC, although KPMG "occasionally voiced concern to Xerox management about the 'topside accounting devices' developed and manipulated by senior corporate financial managers to increase revenue and earnings, the defendants did little or nothing when Xerox ignored their concerns and continued manipulating its financial results."[53] The SEC alleged that the "defendants then knowingly or recklessly set aside their reservations, failed in their professional duties as auditors, and gave a clean bill of health to Xerox's financial statements."[54]

Significantly, the SEC identified lucrative fees as a motive for KPMG's misconduct.[55] According to the SEC complaint, KPMG was paid $26 million for auditing Xerox's financial results for fiscal years

50. SEC v. KPMG LLP, 2003 WL 1842871 (S.D.N.Y. Apr. 9, 2003). *See also* SEC Litig. Release No. 17954 (Jan. 29, 2003)/SEC Accounting & Auditing Enforcement Release No. 1709 (Jan. 29, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr17954.htm (last visited Nov. 21, 2003) [hereinafter SEC Release No. 17954].

51. SEC Release No. 17954, *supra* note 50.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

1997 through 2000.[56] It was paid $56 million for non-audit services during that period.[57] As a result, "[r]ather than put at risk a lucrative financial relationship with a premier client, the defendants failed to challenge Xerox's improper accounting actions and make the company accurately report its financial results."[58]

The 2003 action against KPMG again shows the difficulty in deterring auditor misconduct linked to independence failure because the SEC had previously sanctioned KPMG for violations of independence rules. In January 2001, as part of its review of an appeal from an earlier SEC administrative proceeding, the Commission concluded that KPMG violated independence rules in 1996 because of its business arrangements with a corporation that it audited.[59] Specifically, the Commission concluded that KPMG was not independent when it audited a public corporation's financial statements and issued audit reports while loans from KPMG to a corporate officer were outstanding and when KPMG had the right to receive a fee contingent on the corporation's financial success.[60] Among other things, the Commission found that KPMG violated Rule 2-02(b) of Regulation S-X, by having transactions, interests, or relationships that will impair its independence under Rule 2-01 of Regulation S-X or under GAAS.[61]

C. PricewaterhouseCoopers

In 2002, the SEC instituted an enforcement action against PricewaterhouseCoopers ("PwC") for violating the independence rules with regard to a number of its audit clients. This was the first SEC enforcement action alleging that an auditor's independence violation

56. SEC v. KPMG LLP, No. 03-671, 2003 WL 1842871 ¶ 11 (S.D.N.Y. April 9, 2003), *available at* http://www.sec.gov/litigation/complaints/comp17954.htm (last visited Nov. 21, 2003) [hereinafter SEC Complaint No. 03-671].

57. *Id.* at ¶ 131.

58. SEC Release No. 17954, *supra* note 50.

59. In the Matter of KPMG Peat Marwick LLP, Exchange Act Release No. 43862/Accounting & Auditing Enforcement Release No. AE-1360, Admin. Proc. File No. 3-9500 (Jan. 19, 2001), *available at* 2001 WL 34138819.

60. *Id.*

61. *Id.*

was directly connected to actual financial misstatements by a company.[62] The SEC administrative order alleged that PwC failed to be independent because it had lucrative financial interests that were tied to its audit clients.[63]

First, PwC charged contingent fees to a number of its audit clients, in direct violation of independence rules.[64] In 14 instances, a securities firm wholly owned by PwC performed investment banking services for public audit clients of PwC pursuant to arrangements under which the clients would pay a contingent fee.[65] These fees violated the express prohibition on contingent fees contained in Rule 302 of the AICPA Code of Professional Conduct and caused PwC to lack the requisite independence when the audits were performed for the public audit clients in question.[66]

Second, PwC audited non-audit fees paid by the audit client to PwC itself.[67] PwC issued an unqualified audit report on Pinnacle's 1999 financial statements and performed interim reviews of Pinnacle's quarterly reports for the first three quarters of 2000.[68] As part of its audit and quarterly reviews of Pinnacle, PwC caused Pinnacle's failure to account properly for certain costs, including non-audit fees paid by Pinnacle to PwC.[69] The fees were related to Pinnacle's acquisition of communications site space from Motorola, Inc.[70] Pinnacle improperly established at least $24 million in liabilities and improperly capitalized approximately $8.5 million in costs, of which approximately $6.8 million involved fees paid to PwC for non-audit services.[71] As a result, PwC was a cause of Pinnacle's periodic reporting, books and records, and internal control violations. PwC also failed to exercise objective and impartial judgment as required by the independence rules and therefore

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62. In the Matter of PricewaterhouseCoopers LLP and PricewaterhouseCoopers Securities LLC/Accounting and Auditing Enforcement Release No. 1596 (July 17, 2002); Admin. Proc. File No. 3-10835, *available at* http://www.sec.gov/litigation/admin/34-46216.htm (last visited Nov. 25, 2003).

63. *Id.*

64. *Id.* at ¶ III.C.

65. *Id.*

66. *Id.*

67. *Id.* at ¶ III.D.

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

lacked the requisite independence in its audit of Pinnacle's 1999 financial statements and in its interim reviews of Pinnacle's quarterly reports for the first three quarters of 2000.[72]

Third, PwC performed improper accounting for a software project performed by PwC consultants. Specifically, PwC issued an unqualified audit report on Avon's 1999 financial statements.[73] In connection with the audit, PwC was a cause of Avon's failure to write off all of the capitalized costs of an uncompleted software project that PwC consultants had been developing for Avon, but which Avon stopped and wound down.[74] In violation of GAAP, Avon wrote off only part of the project's $42 million of costs, improperly retaining on its books $26 million that was comprised mostly of PwC's own consulting fees.[75] As a result, PwC was a cause of Avon's reporting and record keeping violations and failed to exercise objective and impartial judgment as required by the independence rules and therefore lacked the requisite independence in its audit of Avon's 1999 financial statements.[76]

The SEC found that PwC: (a) failed to comply with the independence requirements of Regulation S-X; (b) was a cause of violations of periodic filing and books and records provisions of Section 13(a) and (b) of the Exchange Act and the rules thereunder by public issuers who were PwC audit clients; and (c) engaged in improper professional conduct under Rule 102(e).[77] The SEC also found that PwC violated Regulation S-X, and caused its clients' violations of periodic filing provisions in Exchange Act Section 13(a) and Rule 13a-1.[78]

The 2002 action against PwC shows that enforcement action was not entirely effective in deterring PwC from violating the independence rules because it was not the first time PwC was caught with widespread, systemic violation of the independence rules. In 1999, the SEC instituted an administrative enforcement action against PwC for violation of the

72. *Id.*
73. *Id.* at ¶ III.E.
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.* at ¶ IV.

SEC's independence rules.[79] In that case, the SEC found that PwC partners and employees violated independence rules by owning shares of PwC's audit clients.[80] Specifically, in four instances, certain PwC professionals owned securities of publicly-held audit clients for which they provided professional services.[81] In 31 instances, individual PwC partners owned securities of publicly-held audit clients for which the partners provided no professional services and individual managers owned securities of publicly-held audit clients of their office for which the managers provided no professional services.[82] In 45 instances, a retirement plan associated with PwC owned securities of publicly-held audit clients.[83] Each of these instances was contrary to Rule 2-01(b) of Regulation S-X and GAAS, which require, among other things, that public accounting firms and their partners and certain professionals not have, or commit to acquire, any direct or material indirect financial interest in their audit clients.[84] PwC settled with the SEC by consent to an administrative order, which involved undertakings to reform the firm's procedures regarding securities trading by its employees.[85]

D. Ernst & Young

Ernst & Young was also accused of violating independence rules in connection with its client's financial misstatements. In 2002, the SEC instituted an administrative proceeding against Ernst & Young LLP ("E&Y"). In that action, the SEC's Division of Enforcement alleged that E&Y audited the financial statements of PeopleSoft, Inc. in fiscal years 1994 through 1999 while E&Y and PeopleSoft engaged in joint business relationships.[86] As a result, E&Y was alleged to have violated

79. In the Matter of PricewaterhouseCoopers LLP, Exchange Act Release No. 40945 (Jan. 14, 1999); Accounting and Auditing Enforcement Release No. 1098 (Jan. 14, 1999), Admin. Proc. File No. 3-9809, *available at* http://www.sec.gov/litigation/admin/34-40945.txt (last visited Dec. 18, 2003).

80. *Id.*

81. *Id.* at ¶ III.A.2.

82. *Id.*

83. *Id.*

84. *Id.* at ¶¶ III.B, III.C and IV.

85. *Id.* at ¶ V.

86. In the Matter of Ernst & Young LLP, Exchange Act Release No. 46710 (Oct. 23, 2002)/Accounting and Auditing Enforcement Release No. 1654 (Oct. 23, 2002),

auditor independence requirements.[87] In addition, it was accused of causing PeopleSoft's alleged violations of the Exchange Act, and engaging in improper professional conduct.[88]

E. The Difficulty of Enforcing Independence

The above cases show that, despite a vigorous enforcement effort, it is difficult to force an auditor to be independent when there are strong financial incentives for the auditor not to be so. First, a common theme in these cases is that lucrative financial gains played a role in causing the auditors to violate the independence rules. Second, these cases show that lack of independence is a widespread and systemic problem in the accounting industry, despite the existence of independence rules. The enforcement actions above reflect violations or possible violations by four of the major accounting firms. The violations were not committed by a few rotten apples but instead were either widespread within the firms or approved by senior members of the firm. Third, a number of the enforcement actions involved blatant violations of clear-cut prohibitions of the independence rules and thus one can argue that the auditors violated the rules with open-eyes. Finally, as in the case of PwC, prior enforcement actions against independence rules violations did not deter the firms from further misconduct.

One may argue that the threat of harsher sanctions may overcome the lure of lucrative consulting fees and thus adequately enforce compliance of auditor independence rules. The reality is that enforcement actions require resources. When tougher enforcement sanctions are sought, the auditing firms will have a greater incentive to pursue litigation as opposed to settlement. Further, draconian sanctions, particularly against a firm, may create unintended victims.[89]

Admin. Proc. File No. 3-10786, *available at* http://www.sec.gov/litigation/opinions/34-46710.htm (last visited Dec. 22, 2003).

87. *Id.*

88. *Id.*

89. For instance, the criminal conviction of Arthur Andersen for obstruction of justice effectively ended the firm's auditing business, resulting in more than 25,000 Andersen employees losing their jobs at the firm. *Arthur Andersen Closing the Book on Its Auditing Business*, HOUSTON CHRONICLE, Sept. 1, 2002, at 3.

Of course, there are ways to increase sanctions against accounting firms without ending their existence. For instance, in the Ernst & Young litigation, the SEC's Division of

Nor will additional rules and restrictions necessarily result in actual independence on the part of company-hired auditors. Although the Sarbanes-Oxley Act establishes more restrictions on consulting fees, such regulations may merely result in auditors finding ways to evade the rules rather than increasing their efforts at improving their independence. As one commentator noted, the recent financial scandals "are not so much a failure of laws and regulations as they are a failure of behavior."[90] One danger of having more rules to regulate corporate or professional behavior is that regulated parties will focus on "navigating around the regulations" without actually violating them," in other words, complying with the letter but ignoring the spirit of the regulations.[91] Similarly, SEC Commissioner Paul Atkins, commenting generally about the Sarbanes-Oxley Act, warned of the danger of merely reacting in an effort "to do something," as opposed to addressing the underlying problems.[92] The above analysis of past enforcement actions on auditor independence shows that auditors did not merely evade then existing independence rules, but blatantly violated them, and did so in a widespread manner. The apparent motive of many of the clear-cut violations is the auditors' desire for lucrative consulting fees. Thus, past history indicates that auditing firms, rather than amending their behavior, may violate independence rules under the Sarbanes-Oxley Act, or vigorously fight the enforcement of these restrictions.

Enforcement is seeking to prevent the firm from accepting new clients for six months, a remedy that a commentator characterizes as experimental. Paula Dwyer, *The Big Four: Too Few To Fail?*, BUS. WK., Sept. 1, 2003, at 30. To create additional incentives for auditing firms to ensure that their employees comply with relevant rules, the SEC's Division of Enforcement has embarked on a policy of suing auditing firms based solely on liability imputed from their employees. Speech by Stephen M. Cutler, Director, Division of Enforcement, SEC, *Remarks Before the American Institute of Certified Public Accountants*, (Dec. 12 2002), *available at* http://www.sec.gov/news/speech/spch121202smc.htm (last visited Dec. 18, 2003). The SEC applied this policy against PricewaterhouseCoopers, LLP in a settled administrative action in May 2003. Matter of PricewaterhouseCoopers LLP, Securities Exchange Act Release No. 47900/Accounting and Auditing Enforcement Release No. 1787, Admin. Proc. No. 3-11132 (May 22, 2003), *available at* http://www.sec.gov/litigation/admin/34-47900.htm (last visited Dec. 18, 2003).

90. Jeffrey L. Seglin, *Will More Rules Yield Better Corporate Behavior?*, N.Y. TIMES, Nov. 17, 2002, at 4.

91. *Id.*

92. Atkins, *supra* note 23.

V. THE ILLUSION OF INDEPENDENCE: OUTSIDE AUDITORS' FINANCIAL TIES TO CORPORATIONS

The root problem of the current system of company-hired outside auditors is that there is a misalignment of financial interests. Outside auditors' financial interests are not necessarily aligned with the financial interests of the investing public, i.e., the party with the greatest interest in the accuracy of corporate financial interest. None of the previous or recent laws and regulations addresses the fundamental conflict of interest of an outside auditor: a public company selects and pays the auditor that audits the company. Under the current system, the company, through its board of directors, nominates the outside auditor and the nomination must be approved by shareholder votes. Despite the requirement of shareholder votes, corporate management's choice carries a great deal of weight in the ultimate decision. Management participates, as part of the board, in the board's nomination. Typically, only one candidate is presented to the shareholders for vote.[93] As a result, it is likely under this system that management's choice will be affirmed by shareholders. Just as important is the fact that the public company holds the outside auditor's purse strings with respect to fees for outside audits, even though the ban on consulting services may have cut off one source of temptation. In fact, as a result of the recent backlash against corporate financial fraud, audit fees have increased significantly and thus continue to be a fundamental source of conflict for an outside auditor.[94] While the Sarbanes-Oxley Act may reduce the

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93. For similar reasons, one commentator opined that independent directors are not truly independent:

> For the overwhelming majority of corporations, board independence is a chimera . . . . The problem is that board members are not selected by the shareholders that they are supposed to represent. Instead, directors are chosen by a nominating committee usually consisting solely of board members and usually including the CEO as a key participant . . . . But the committee will in all cases wind up nominating one person for each vacancy. The choices are then submitted to shareholders for a "vote" . . . . [F]ew people vote, but more importantly, since there is no contested vacancy, brokers who hold your shares will vote them for the board's nominees if you do nothing. The brokers are, in fact, obliged to do so.

David Gale, *How to Create Truly Independent Boards*, WALL ST. J., Aug. 12, 2002, at A10.

94. Calmetta Coleman & Cassell Bryan-Low, *Audit Fees Rise, And Investors May Pay Price*, WALL ST. J., Aug. 12, 2002, at C1; *Tough New World: The Accounting*

pressure on audit partners to generate fees through their consulting business, the pressure for audit partners to generate fees still exists, and the pressure is intense.[95] For instance, at Arthur Andersen, the very structure and culture of auditing firms were designed to force out partners who did not generate sufficient revenue:

> Traditionally, Andersen partners each had a pyramid of employees reporting to them—from rookie accountants to senior audit managers. Partners' compensation was based on the number of shares they owned in the partnership—called "units." The more units you had, the higher your pay. And the easiest way to increase the value of each unit was to limit the number of partners divvying up the profits . . . . Greene was in charge of Andersen's West Coast audit business . . . . He saw the need to reduce costs, and responded by making cuts, as partners were transferred or counseled to look for jobs elsewhere. But "it never seemed to be enough," he said.[96]

In light of the constant pressure to generate revenue, corporate management continues to have a strong influence over auditors because management continues to affect the decisions regarding whether or not to retain an auditor and regarding the size of the audit fee. Restricting consulting fees merely shifts the pressure back to audit fees.

The fact that a corporation pays the fees of the auditor not only may cause the integrity of the audit to be compromised, it may also cause the quality of the audit to be compromised. Because it holds the purse strings, corporate management often is able to put pressure on the audit team to complete audits within severe time and budget constraints.[97] Such pressure places stress on the audit team and may affect the quality of the audit.[98] In some cases, such pressures "may have contributed to the auditors' failure to detect material misstatements."[99] As shown by

Industry Expects More Litigation and Higher Audit Fees, ECONOMIST, Aug. 3, 2002, at 58.

95. *Tough New World: The Accounting Industry Expects More Litigation and Higher Audit Fees*, *supra* note 94.

96. Flynn McRoberts, *Civil War Splits Andersen*, CHI. TRIB., Sept. 2, 2002, at 1.

97. The Pub. Oversight Board, The Panel On Audit Effectiveness: Report and Recommendations, at 105 (Aug. 31, 2000), *available at* http://www.pobauditpanel.org (last visited Nov. 23, 2003).

98. *Id.* at 105–06.

99. *Id.* at 106.

the recent cases of massive audit failures, auditors succumb to the pressure despite the threat of liability from class action litigation.

In addition, despite the trend toward higher audit fees, as long as a public company pays the auditor's fees, the financial incentive is for outside auditors to do no more than is required by GAAS. There is no financial incentive for public auditors to "go the extra mile" and perform additional audits or take creative or innovative steps to review or analyze the public company's financial data. In fact, there are disincentives from taking steps beyond what is required by GAAS because the auditor may have a difficult time convincing management that the additional fees are justified.

The lack of financial incentives to do more than is required by GAAS is problematic because GAAS are not sufficient to detect fraud in financial reporting. First, GAAS do not require outside auditors to perform forensic accounting, i.e., auditing procedures designed to detect fraud.[100] Second, the provisions under GAAS to address potential fraud are deficient. Specifically, GAAS require auditors to assess the risk of fraud in planning their audits, including assessing risk factors such as "management's characteristics and influence over the control environment, some of which relate to the motivation for management to engage in fraudulent financial reporting, and personal characteristics bearing on integrity and management style."[101] In reality, however, the risk factors identified under GAAS for audit planning are subjective.[102] Further, even when certain risk factors exist, whether or not to undertake certain audit procedures, such as forensic procedures and techniques, depends very much on the judgment of the auditor.[103] In fact, according to the Panel on Audit Effectiveness, a panel appointed by the Public Oversight Board to study the effectiveness of the auditing profession, the risk assessment approach under GAAS is not effective in detecting fraud because GAAS fail to identify or direct auditing procedures toward fraud detection.[104] For instance, the panel found that GAAS assume that collusion among corporate officers and employees to commit financial fraud as "impossible" and assumes that management

100. *Id.* at 76.
101. *Id.* (citing Statement on Auditing Standards (SAS) No. 82).
102. *Id.*
103. *Id.*
104. *Id.* at 86.

possesses integrity.[105] In light of the insufficient emphasis under GAAS to detect fraud, the Panel found some auditors to be uncertain about their responsibility and ability to detect fraud in their audits.[106] The Panel also found little evidence of any significant use of forensic auditing techniques in GAAS audits.[107]

Further, unless the auditor can point to a specific "red flag" or suspicious transaction, he or she will risk offending management who may view the additional procedures to reflect doubts about management's veracity. Considering the fact that management has a primary role in paying audit fees and also in selecting auditors, an auditor simply has no incentive to do any more than is perceived to be the minimum required by GAAS.

In addition, it is unlikely under the current system that an outside auditor will express suspicion of improper activities unless it has concrete evidence, since any discussion of suspicion or concern may incur the wrath of management, the same management that selects and pays the auditor.

Behavioral research (based on psychology and related disciplines) regarding auditor behavior also suggests that auditors are willing to compromise their audits in order to please their corporate clients. Reviewing a number of behavioral studies and experiments regarding auditors from the field of psychology, decision theory, behavioral finance and behavioral economics, Professor Robert Prentice concludes that auditors' work is affected by their "self-serving bias."[108] According to Professor Prentice, these studies and experiments show that auditors are "reluctant to issue qualified opinions regarding their clients, reluctant to refuse their clients' requests for improper accounting treatment, and

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105. *Id.*

106. *Id.* at 85.

107. *Id.* at 85–86. In late 2002, the AICPA adopted SAS No. 99 to provide further guidance for detecting fraud during audits, including consideration of management's ability to override internal control to perpetrate fraud. Statement of Auditing Standards No. 99 (Dec. 15, 2002). While providing more detailed guidance, the factors listed in SAS No. 99 are still subjective and the application depends very much on judgments of the auditors. *Id.*

108. Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, at 1669 (2000).

reluctant to drop clients seeking such improper treatment for fear of imperiling a stream of revenue."[109]

Even when economic factors create incentives for auditing firms to perform audits adequately, individual members of the auditing team may have incentives to do otherwise. Professor Prentice, in reviewing behavioral studies, noted that an audit partner may be more willing than an audit firm as a whole to take risks with an audit client.[110] The reason is that the financial benefits from serving a client are concentrated with a few partners and offices, while the costs of litigation tend to be more distributed across the firm.[111] Similarly, one can imagine a partner under the threat of being "forced out" for generating insufficient revenue, may be more willing than the firm as a whole to accepting a client's questionable accounting treatment.

Auditors' biases in favor of their clients, the corporations, are particularly powerful, and difficult to curb by regulation, because they are often subconscious. Based on behavioral experiments, Professors Bazerman, Loewenstein and Moore, argue that because of the subjective nature of accounting, and the close financial and personal ties of auditors and corporate managers, "even the most honest and meticulous of auditors can unintentionally distort the numbers in ways that mask a company's true financial status . . . ."[112] In addition, "[u]nlike conscious corruption, unconscious bias cannot be deterred by threats of jail time."[113] In a study of 139 auditors employed at large U.S. accounting firms, half of the participants were asked to assume that they were auditors hired by the company while the other half were asked to assume they were hired by another company that conducts business with the audited company.[114] With respect to five given ambiguous auditing vignettes, auditors who were hypothetically hired by the audited company were on the average 30% more likely to find the financial reports complied with GAAP.[115]

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109. *Id.* at 1604.

110. Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 184 (2000).

111. *Id.*

112. Bazerman, Loewenstein and Moore, *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., at 3 (Nov. 2002).

113. *Id.*

114. *Id.* at 6. The study was conducted with Prof. Lloyd Tanlu.

115. *Id.*

In light of similar struggles in the legal profession, it is not surprising that auditors struggle to maintain independence when corporate management holds the purse strings. An attorney is expected to represent his client zealously because it is his or her fiduciary duty under the ethical rules of the profession. Just as importantly, an attorney is motivated to represent his client's interest because the client pays him or her legal fees. However, when the financial interests are not aligned, the attorney's willingness to represent the client's interest becomes clouded. For instance, in situations where insurance companies select and pay for attorneys to represent the insured, conflicts of interest may result, often to the detriment of the insured party's interest.[116] Regulations and ethical rules can only do so much against powerful financial interests.

Since additional regulation cannot ensure auditor independence, what then, if any, are the alternatives to a corporate financial reporting system that depends on supposedly independent, but fundamentally biased, auditors? While government-run audits will be truly independent from corporate management, this solution has been dismissed as too costly and inefficient.[117] On the other hand, Professor Joshua Ronen proposed a more market-oriented approach where insurers providing corporations with liability insurance for financial misstatements will hire auditors to assess the accuracy of the covered corporation's financial statements.[118] Although the auditor in that proposed system will owe allegiance to the insurance company, it does not adequately address the influence of management. While the

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116. *See generally* THOMAS D. MORGAN & RONALD D. ROTUNDA, PROFESSIONAL RESPONSIBILITIES: PROBLEMS AND MATERIALS, at 95–101 (1987).

117. *See, e.g.*, HANDBOOK OF ACCOUNTING, *supra* note 8, at A1-10:

> In theory, the most reliable way of guaranteeing auditor independence would be to establish a public authority, vest it with the responsibility for conducting audits, and charge all publicly held firms an annual fee for the service. The disadvantages of such a system would, however, ultimately outweigh the benefits of guaranteeing auditor independence. In particular, economic pressure for audit efficiency would be reduced for both parties if the company were not paying directly for services rendered. The removal of the economic incentive for efficiency, and the presumed weakening of communication links between the assigned auditor and client, would likely contribute to more expensive and less thorough, albeit more independent, financial reports.

Id.

118. Joshua Ronen, *A Market Solution to the Accounting Crisis*, N.Y. TIMES, Mar. 8, 2002, at A21.

insurance company will have an incentive to avoid risk of covering a company that misstates its financials, it also has the financial incentive to earn premiums from the company. For instance, an insurance company known for hiring aggressive auditors may lose its business to a competitor that hires more lenient auditors. In addition, the same behavioral bias described above will still exist, albeit in milder form. In sum, the governmental approach is too costly and the insurance company approach does not go far enough.

Professor Ronen's market-oriented approach, while it does not adequately resolve financial dependence on corporate management, does point in the right direction. As discussed below, a system in which auditors are hired by investors, a system where the auditors' interests are totally aligned with the investors' interests, provides the best alternative to the current system of company-hired auditors.

VI. HIRE YOUR OWN AUDITOR

Rather than struggling with maintaining the independence of the auditor of a company, one possible approach is to create an environment for interested parties, such as institutional investors, to hire their own accountants or other financial professionals to review and analyze the financial data of public corporations. These professionals will not be independent. Instead, they will have a clear economic incentive to protect the interest of their employers. As a result, it will be in their financial interest to ensure that the financial statements of a corporation accurately reflect the corporation's financial condition.

A. Likely Existence of Demand by the Public to Hire Its Own Auditors

There are many parties outside of a public corporation, such as institutional investors, that have an interest in determining the true financial status of the corporation. By making available to the public a company's underlying financial data, there will likely be a large number of entities or persons, beyond a corporation's auditor or audit committee, who will want to retain their own accountants or financial experts to audit or review the raw financial data and question management about the data. These individuals and institutions have the resources and motivations to hire such experts as their auditors. For instance, the large holdings in public companies by institutional investors, particularly public pension funds and union pension funds, have made such entities increasingly active in the governance of public corporations.[119] The same institutional investors have also been victims in the recent financial scandals. For instance, the Regents of the University of California and the Washington State Investment Board are plaintiffs in class action suits regarding Enron.[120] Their participation in the massive litigation suggests that the same institutional investors would be keen to expend resources to obtain accurate financial information and avoid the losses such as those from the Enron debacle. Securities professionals, such as broker-dealers, would want to have accurate financial information to provide the proper recommendations to their customers. Portfolio managers of mutual funds will want the same accurate information to make the best decision for the funds. In light of the large number of individual investors in this country, the media has an interest also, since providing correct assessment of a corporation's financial health will attract readers or viewers. Even individuals or entities without sufficient funds may be able to pool their resources to hire an auditor. Finally, an audit firm may provide its analyses and reports to investor subscribers.

Institutional investors' demand for conflict-free stock research and analysis is a strong indication of their likely interest in hiring their own auditors. Recent cases indicate that stock analysts at investment banks may have compromised their supposed independent research to provide favorable coverage of companies to obtain or maintain investment-banking business from such companies. As a result, institutional investors are increasingly willing to pay and obtain stock research from analyst firms that do not have ties to investment banking.[121]

119. *See* Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 278 (2000) (reporting that the number of poison pill resolutions declined between 1991 and 1994).

120. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

121. David Rynecki, *The Bernstein Way: There Is a Firm That Does Research Right*, FORTUNE, June 10, 2002, at 85 (discussing why approximately 5,000 institutional investors retained the analyst firm Sanford C. Bernstein, a firm with no ties to investment banking businesses, for its "conflict-free" stock research reports).

B. Prerequisite for Investor-Hired Auditors: Access to Corporate Financial Information and Corporate Management

Institutional investors and others in the public may find it desirable to have their own accountants audit or otherwise review the financial statements of public companies in which they invest. However, such investor-hired accountants will be able to do little since they will not have access to the same level of corporate financial information as the outside auditor hired by the company. The reality is that corporate financial data that exists within a company, and is accessible to its auditor, is far better, both in details and in timeliness, than the financial information available to the public.

1. Financial Information Available to the Public

The federal securities laws require a public corporation to file with the Securities and Exchange Commission its quarterly financial statements, Forms 10-Q, at the end of each quarter.[122] They also require a public corporation to file its audited annual financial statements, Forms 10-K, at the end of each fiscal year.[123] In turn, the SEC makes these statements available to the public. The corporation itself is responsible for ensuring that Forms 10-Q and 10-K are prepared pursuant to GAAP. However, these statements represent corporate management's summary of the corporate financial data. In addition, since they are only released quarterly and annually, an investor cannot get up-to-date financial statements during the period between their releases.

Aside from the filing of Forms 10-K and 10-Q, corporate management may occasionally issue public statements regarding its financial condition.[124] For instance, sometimes management issues such statements when it does not believe that it will meet analyst expectations. Management does so to decrease the inevitable fall in the

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122. Sections 13 and 15(d) of Securities Exchange Act, 15 U.S.C. §§ 78m, 78o(d) (2002).

123. *Id.*

124. Robert M. Lawless et al., *The Influence of Legal Liability on Corporate Financial Signaling*, 23 IOWA J. CORP. L. 209, 210 (1998) (stating thatr a firm's managers "can elect to disclose their data directly with investors and shareholders through a public announcement such as a press release").

stock price when actual earnings are announced and the market realizes that the earnings failed to meet expectations. The federal securities laws provide for a safe harbor against civil liability for such forward-looking statements, but only if certain specific conditions are met.[125] Because of concerns with legal liability, corporate managers often send out vague signals regarding a company's financial condition rather than to issue an explicit press statement.[126] Because management does not issue such statements on a regular or frequent basis, it is difficult for investors to depend on these statements to make investment decisions. They also tend to be less reliable than financial statements because they generally are not as detailed as a financial statement. In addition, they are unreliable because management uses such releases primarily to influence stock price.

2. The Financial Information Monopoly: Financial Information Available Within a Corporation

A company typically maintains a general journal or book of original entry to record, as they occur, events that affect the company financially.[127] For instance, on the same day Company A sells a widget, a corporate employee would make a journal entry in the company's general journal to record the sale.[128] A company also maintains a ledger to keep track of specific items or accounts, such as accounts showing how much customers owe the company, i.e., accounts receivable, or how much the company owes its suppliers, i.e., accounts payable. Anytime a journal entry is made, the ledger is updated to reflect resulting changes in any accounts.[129] The company then summarizes data from its general journal and its ledger in its monthly, quarterly and annual financial statements, consisting of an income statement, a balance sheet and a

125. Section 21E of Securities Exchange Act of 1934, 15 U.S.C.A. § 77k (1998).

126. Lawless, *supra* note 124, at 219.

127. Steven A. Finkler, FINANCE & ACCOUNTING FOR NONFINANCIAL MANAGERS, 57–58 (1992).

128. In this scenario, the sale occurs at a specific point in time and thus is recorded as it occurs. Some financial events occur continuously over time, such as the accumulation of interest. Instead of making daily journal entries to record these continuous events, the corporation makes adjusting entries shortly prior to a quarterly or annual financial statement to bring these accounts up-to-date. *Id.* at 69, 71.

129. *Id.* at 72–74.

statement of cash flows.[130] Corporations with subsidiaries or divisions consolidate the financial statements from these subsidiaries or divisions into a single set of financial statements. In addition, a company obviously will have data, in the form of its bank and brokerage statements, that reflect cash and securities it holds in accounts at banks and securities broker-dealer firms, and any transactions in these accounts. A public corporation is not required to disclose to the public its general journal, its ledger or its monthly financial statements, nor is it required to disclose its financial information on an unconsolidated basis. It is also not required to disclose its bank or brokerage account statements to the public.

3. *Financial Information Available to the Outside Auditor Hired by the Audited Company*

In performing its audit of a public corporation's financial statements, an outside auditor has access to the financial data that are available within the corporation, even though such data may not be available to the public.[131] For example, the principal means of auditing a corporation's financial statements is to compare the statement figures to the corporation's internal accounting records and to the original evidence of transactions.[132] As a result, when an auditor attempts to verify an amount in the corporation's financial statements, he may do so by reviewing the corporation's accounting records by tracing the amount through the ledgers and to the journals. In addition, the auditor may review source documentary records maintained by the corporation, such

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130. *Id.* at 74–85.

131. Generally, auditors gather a variety of evidence to verify corporate financial statements, including:

1. physical evidence, e.g., inspection of property, inventory and assets;
2. documents provided by corporation or by others outside the corporation;
3. the underlying accounting records;
4. evidence from analytical procedures;
5. evidence from computations;
6. evidence provided by specialists;
7. oral evidence, e.g., discussions with corporate managers; and
8. evidence from client representation letters.

RAY WHITTINGTON & KURT PANY, PRINCIPLES OF AUDITING 125–26 (11th ed. 1995).

132. *Id.* at 40.

as a paid check or invoice.[133] The auditor may also review documents that the corporation received from other entities, such as bank statements and stock and bond certificates.[134] Such data are available to the auditor throughout the audit, and prior to the corporation's release of the financial statements to the public.

C. Access to Corporate Management

Another reason why investor-hired auditors, under the current system, may not be able to do much in auditing or otherwise analyzing corporate financial statements is that the accountants will not have the same level of access to corporate management to ask questions or otherwise discuss relevant financial issues.

1. Company-Hired Auditor's Access to Management

A company-hired auditor typically has frequent discussions with corporate managers. For instance, just to plan an audit and in order to have an understanding of the corporation's business and operations, the auditor would usually have discussions with key corporate officers about the corporation's "history, size, operations, accounting records, and internal controls."[135] Throughout an audit, the auditor usually poses many questions to the corporation's officers and employees, such as questions regarding the "location of records and documents, reasons underlying an unusual accounting procedure", or determination as to whether an account receivable is collectible.[136] Such discussions with corporate management and employees make it more likely for auditors to have a better understanding of and make better judgments regarding the financial data they review.

2. The Public's Access to Management: The Effect of Regulation FD

Compared to a public company's outside auditors, the public has much less access to question management about a company's financial

133. *Id.* at 129.
134. *Id.* at 128.
135. *Id.* at 150.
136. *Id.* at 132.

condition. Regulation FD[137] is designed to provide the public with fair access to management, but it is not clear whether the regulation improves the quality or quantity of information the public may obtain from management.[138] Thus, it is likely that without additional requirements, there will continue to be a gap between the public's and company-hired auditors' access to management.

Regulation FD is meant to provide the public and analysts with equal access to information provided by management.[139] Generally, managers and executives of a public company are not legally required to respond to questions from the public or to otherwise discuss the company's financial condition. Nevertheless, corporate management often chooses to have discussions with analysts who provide recommendations regarding the company's stock.[140] During such discussions, management often answers questions regarding the company's financial performance.[141] Corporate managers previously were not legally required to share the same information with the public.[142] On August 15, 2000, the SEC adopted Regulation FD in an attempt to curb selective disclosure of material nonpublic information by issuers to analysts and institutional investors.[143] The regulation specifically requires that when an issuer discloses material information, e.g., to analysts, it must also disclose the same information to the public.[144]

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137. SEC Regulation FD, 17 C.F.R. § 243.100–04 (2003).

138. *See* Laura S. Unger, Special Study: Regulation Fair Disclosure Revisited (Dec. 2001), *available at* http://www.sec.gov/news/studies/regfdstudy.htm (last visited Dec. 18, 2003) (examining the effectiveness of Regulation FD at its one-year mark, taking into account the concerns of parties affected by Regulation FD and making recommendations to increase the Regulation's effectiveness).

139. 17 C.F.R. § 243.100(a).

140. *See* Proposed Rule: Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7787, 34-42259, IC-24209 (Dec. 20, 1999), 1999 SEC LEXIS 2696, at 8 n.11 (citing examples of selective disclosure reported on by the media).

141. *Id.* at 8 ("Commonly, these situations involve advance notice of the issuer's quarterly earnings or sales figures.").

142. *Id.* (describing the habit of selective disclosure and its potential negative impact on market integrity as the main reason for the proposed Regulation FD).

143. Final Rule: Selective Disclosure and Insider Trading, Securities Act Release no. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (subsequently codified at 17 C.F.R. §§ 243.100–03).

144. *Id.*

The effects of Regulation FD on voluntary corporate disclosure are unclear. According to a December 2001 special study by then SEC Commissioner Laura Unger, there is a potential that, in order to avoid violating Regulation FD, public companies may reduce the quantity of information they disclose.[145] For instance, although experiences varied, some participants in the study indicated that public companies have used Regulation FD as a "shield" to justify refusal to provide disclosure to analysts.[146] Others have noted that Regulation FD resulted in more "boilerplate" disclosure and more release of "useless" information, resulting in fewer questions being asked by analysts and answered by management.[147] On the other hand, another study on the effect of Regulation FD found no evidence that the regulation impaired the quality and quantity of investor information from public companies.[148] In fact, the study found an increase in the frequency of voluntary corporate disclosure.[149]

Under the current environment, if an institutional investor or others retain a financial professional to audit or review a company's financial data, that professional's work may be materially hampered by simple broad-based refusals by corporate management to answer questions or otherwise provide explanations regarding specific accounting decisions and issues. Although unclear, it is possible that corporate managers may refuse to answer questions from such a professional to avoid violating Regulation FD, or use the regulation as an excuse not to respond to questions.

VII. MAKING IT FEASIBLE FOR INSTITUTIONAL INVESTORS AND OTHERS TO HIRE THEIR OWN AUDITORS: MANDATING PUBLIC ACCESS TO CORPORATE FINANCIAL DATA AND TO CORPORATE MANAGEMENT

Imagine the following scenario:

> It is two days before the end of the first quarter of a closely followed Fortune 500 corporation. Earlier, the CEO of this corporation

145. Unger, *supra* note 138, at III.B.1.
146. *Id.* at II.C.
147. *Id.* at III.B.2.
148. Frank Heflin et al., *Regulation FD and the Financial Information: Early Evidence*, 78 ACCT. REV. 1, 4 (Jan. 2003).
149. *Id.*

> announced in a press conference that the company is on track to exceed analysts' first quarter earnings forecasts. Meanwhile, the controller of the corporation enters a fictitious sale of $30 million worth of the corporation's products as an accounts receivable journal entry in the company's computer, when, in fact, no such sale has taken place. At the same time, in another location, a financial professional hired by a mutual fund sees the same journal entry by reviewing the corporation's general accounts journal on the corporation's web site. Clicking through earlier journal entries, he notices that a large amount of the corporation's sales for the first quarter took place during the last weeks of the quarter. He also notices that a large number of accounts receivable that were entered at the end of previous quarters remain uncollected. The financial professional smells a rat. He realizes that he has just identified tell-tale signs that a corporation may be engaging in improper revenue recognition, e.g., booking non-existent sales artificially to boost earnings to meet analysts' expectations. He contacts, through the Internet, the corporation's management for an explanation and found the response to be evasive. As a result, he contacts the portfolio manager of the mutual fund who decides against purchasing the shares of the corporation. Others in the public observe on the Internet the financial professional's question and the company's response and reacted accordingly.

The above scenario cannot occur today because, as discussed earlier, the public has limited access to a corporation's raw financial data or to its management. Internet technology, however, now makes it possible for the public to have real-time access to a public corporation's internal financial records, if the corporation maintains the data in electronic form on the Internet. Internet technology also makes it possible for investor-hired auditors to have transparent and immediate questioning and discussion of such financial data with corporate management.

This Article proposes that public corporations be required to maintain their financial records on a real time basis on web sites accessible to the general public. The public, like corporate managers, will then be able to find out about relevant financial events, such as sales to customers or purchases from suppliers, as these events are recorded on the company's books that are maintained on its web site. The corporation's bank and securities account data will also be available on the Internet.

The idea of putting a company's raw financial data on the Internet for public review is not new. Andy Kessler, a former hedge-fund manager, is a proponent of requiring companies to maintain their books on the Internet and he argues that the technology is available to do so. As he commented in a Wall Street Journal Op-Ed:

> The technology is already out there. PeopleSoft and Siebel and Oracle make a killing—or so they say—selling an alphabet soup of software: CRM (Customer Relationship Management), ERP (Engineering and Resource Planning), and SCM (Supply Chain Management) software. A CEO can track how the company is doing on a day-by-day, heck minute-by-minute basis . . . .
>
> Give me the password, and let me watch your numbers in real time. Sure it's too much information, but I want it, I crave it . . . . Like sushi, I like my numbers raw, and with them, I get a virtual seat on the board. My vote is binding via buy and sell orders.[150]

Just having the raw numbers, however, is not enough to provide the public and investor-hired auditors the ability to audit or review a company's financial data. An integral part of an auditor's job is to be able to question management to better understand the data and the accounting method used by management. This Article also proposes that corporate management be required to respond, within defined parameters, to questions from investors or investor-hired auditors regarding a company's financial data. Rather than relying on private initiatives to effectuate this plan, this Article proposes that the government, particularly the Securities and Exchange Commission, take the leading role in promulgating the reform.

Requiring a corporation to maintain its books and to respond to questions on the Internet will break corporate management's monopoly over corporate financial data. The financial statements will continue to be an important source of information for the public to evaluate a corporation's financial health. With greater access to a corporation's financial data and to its management, however, the public, such as institutional investors, will be able to hire their own auditors to audit or otherwise evaluate objectively the accuracy of the financial statements.

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150. Andy Kessler, Editorial, *Show Me the Books*, WALL ST. J., July 19, 2002, at A-10.

In such an environment, it will be difficult for corporate managers to engage in improper earnings management.

In particular, such access may unleash the full power and resources of the market to ensure that corporate financial information is accurate. By providing parties outside of the corporation access to corporate financial information, accountants, analysts and other financial experts will all compete in the market place to obtain the most accurate corporate financial picture for institutional investors. The same market forces will fuel innovation in accounting and analytical techniques, or innovation in technology, such as audit software. Instead of one company-hired audit firm auditing a corporation's financial statement in accordance with GAAS, the proposal may result in numerous experts using a variety of methods and tools to ascertain the accuracy of the corporation's financial condition.

There are obvious drawbacks to this proposal. Companies will incur costs in setting up the accounting system on the Internet and in defending litigation that will inevitably accompany any corporate disclosures. A company may lose its competitive advantage if it discloses confidential business information as a result of detailed disclosure of financial data. However, the potential benefits outweigh these possible drawbacks. In any event, proper legislation or rulemaking may be able to address some of these concerns.

A. It is Feasible to Maintain and Display a Company's Raw Financial Data on the Internet

The technology is available for companies feasibly to maintain their financial books and records on the Internet on a real-time basis. Most companies today have computerized their bookkeeping systems so that they no longer have actual ledger books.[151] The challenge is thus to make the financial data that are stored in a company's internal information system available on the Internet. There are number of ways this process can feasibly take place based on existing technology. First, there is a variety of software and technologies that specialize in linking internal information systems to the Internet. In addition, instead of storing these electronic data in a company's internal computer system, a company can store the same data in an Internet server. For instance, one

151. Finkler, *supra* note 127, at 73.

service provider offers Internet accounting to businesses by storing electronic data at the company's server. Any authorized user can access the accounting system through the service provider's website. The service can limit certain persons' access to specific functions. Presumably, it can thus limit some users to reviewing while allowing other users to input or revise data in the accounting system.[152]

In addition to the available technology, many public corporations have already been developing innovative ways to convey to the public corporate information through the Internet. The proposal will thus be a natural extension of the current corporate trend. Several years ago, the Financial Accounting Standards Board (FASB) published a report regarding how corporations are using the Internet to distribute business information to the public.[153] According to the report, 84 percent of public companies in the United States had web sites in 1996.[154] At the time of the report, 99 of the Fortune 100 companies had web sites of which 93 included some form of financial web pages.[155] Generally, these web sites provide financial information that will otherwise be available on paper, such as annual reports and SEC filings.[156] Some of the web sites, however, involved more innovative presentation of financial information. For instance, some corporate web sites provide video conference calls with and management presentations to analysts.[157] Some of the web sites provide for easy analysis of the financial information they supply. For instance, some of the corporate websites allow for financial information to be downloaded.[158] Some even provide for downloadable spreadsheets.[159] While these innovations make more accessible to the public information that will otherwise be in paper form, none of the corporate web sites allows for access to the raw financial data of the company.[160]

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152. *See, e.g.*, http://www.s1-software.com (last visited Dec. 18, 2003).

153. Financial Accounting Standards Board, Business Reporting Research Project, Electronic Distribution of Business Reporting Information (2000) [hereinafter FASB Report].

154. *Id.* at 7.

155. *Id.* at 18.

156. *Id.* at 11.

157. *Id.* at 12, 41–42.

158. *Id.* at 12.

159. *Id.* at 41–42.

160. *Id.* at 45.

B. Requiring Public Access to Corporate Raw Financial Data and Public Inquiries of Management on the Internet Will Provide Investor-Hired Auditors with Effective Tools to Audit and Review Corporate Financial Data

This Article proposes that the federal securities laws be amended to require public companies to maintain their financial data, including their general journals and ledgers in electronic form on the Internet. It will also require that companies provide the public with Internet access to information regarding their bank and securities brokerage accounts. To the extent a public company has any subsidiaries, divisions or affiliates, the proposal will require these entities to maintain their general journals and ledgers and monthly financial statements on the Internet. Thus, the public will be able to see every financial event that occurs and also see how the events affect the accounts in the general ledger. For instance, the public will be able to observe a sale by the company in the general journal and also observe the corresponding increase in the accounts receivable account and the corresponding decrease in the inventory account maintained in the company's general ledger.

The company must maintain these financial data on a real-time basis. For instance, an accounting clerk in a division of a public company will make a general entry of a sale directly into the company's Internet general journal. Thus, the public can see that entry on the Internet as it is being made and, at the same time, observe the corresponding changes in the various accounts in the company's general ledger. In short, the proposal will allow the public to look into a company's financial data the same way a corporate manager could.

The proposal also requires that corporations respond to reasonable inquiries on the Internet regarding its financial records and that such questions and answers should be posted on the corporations' websites. As a result, the corporate responses, and the quality of the responses, will provide further public insight regarding a company's financial condition.

As long as an auditor has access to the underlying computerized financial data of a company, he or she can perform a meaningful audit or review. Many accounting firms have already taken advantage of the fact that corporations maintain their financial records in computerized form. For instance, many large accounting firms have developed generalized audit software to audit the computer financial data of a company by conducting independent processing and analysis of the "live data."[161] Thus auditors can use the software to rearrange the computerized data into a format that is more useful to the auditors.[162] Using such software to audit computerized financial data also makes it possible for the auditor to expand greatly the size of the sample transactions to be tested.[163]

Significantly, an investor-hired auditor with access to a company's electronic data on a real-time basis will have the incentive to develop innovative software or procedures to determine the accuracy of a company's financial statements. GAAS, of course, do not require the company-hired auditor to develop innovative software or procedures even when innovations are possible. As a result, there is little incentive for a company-hired auditor to do so. For instance, if a company-hired auditor applies aggressive forensic detection software to audit a company, applications that are not required by GAAS, management may object to the cost of such "unnecessary" procedures and take offense by viewing the fraud-detecting procedures to reflect the auditor's negative view of management integrity. Freed from such constraints, an investor-hired auditor may develop software that is designed to analyze the corporate financial data continuously and identify and detect patterns or red flags of possible financial misstatements. The securities industry already has a history of developing and applying such software to detect possible employee misconduct. For instance, a broker-dealer's compliance department often has "exception" reports to identify suspicious trading activities. Applying the same genre of software, an investor-hired auditor may be able to create periodic exception reports to identify types of financial misstatements. One form of financial fraud is improper revenue recognition, including using fictitious sales to boost revenue. Since a sale is fictitious, the account receivable for that sale will typically not be paid. An investor-hired auditor can create a computer exception report to identify unusual patterns of uncollected receivables to detect possible improper revenue recognition.[164]

161. Whittington & Pany, *supra* note 131, at 255.

162. *Id.*

163. *Id.*

164. For instance, computer software already exists to reorganize account receivable files into the format of an aged trial balance. *Id.* at 257.

By having real-time access to the journal entries, an investor-hired auditor will be able to determine whether a company's financial statements reconcile with the underlying journal entries or whether entries have been changed. It will thus be difficult for senior managers to adjust improperly entries after the fact, or to falsify the ledgers, *i.e.*, the summary of the entries.

Further, by having real-time access to the company's bank and brokerage account records, an investor-hired auditor will be able to identify any large or unusual cash or securities transaction. It will thus be difficult for managers to embezzle from the company or otherwise misappropriate corporate assets. It will also allow investor-hired auditors to identify any discrepancy between a company's cash/securities holdings with financial data in its ledgers.

The ability of investor-hired auditors to question management will allow management to explain or clarify questionable accounting practices or entries, and to avoid false alarms. At the same time, management's inability to justify questionable accounting practices, or its evasiveness in doing so, will likely confirm the auditors' concerns or suspicions. Because the questions and answers will be posted on the company's website, one investor-hired auditor's suspicion or concern will be quickly disseminated throughout the market. Management, if it has a good answer, will thus have a strong incentive to be as responsive as possible to avoid negative market impact.

Under such vigorous public scrutiny, the company-hired outside auditor will have a better incentive and opportunity to perform its audit in a thorough manner. Knowing that the interested parties have the ability to review the underlying financial data of a company, an auditor will have the incentive to discover problems before others do. In addition, public scrutiny or questions of certain entries may alert the company's auditor to review the same entries. Importantly, the same questions and responses, because they will be posted on corporate websites, will quickly alert the public to the questionable practices or entries.

Providing the public with access to a company's underlying financial data and to its management will not absolutely prevent motivated wrongdoers from perpetrating schemes to mislead the public about a company's financial status. Making such financial data available to the public, however, will effectively increase greatly the sets of eyes that will be reviewing a company's financials. More parties reviewing financials will increase the chance of detecting fraudulent and improper accounting.

Providing greater access to corporate financial information will result in a number of benefits that are associated with a transparent market. For instance, it will lead to a more efficient and better-informed market. In turn, better investment decisions will promote a more efficient market and more accurate allocation of investment capital to companies that are doing well as opposed to companies that are doing poorly.[165] By providing a more up-to-date picture of a company's financial condition, the market may also become less volatile. The more information investors possess about a company prior to earnings announcement, the less change there will be to the company's stock price after earnings announcements.[166] The proposal will provide the market, including analysts, with more precise information regarding a company's financial status, which will likely result in more accurate predictions by analysts of a corporation's earnings.[167] When analysts'

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165. There are various theories regarding how to determine the value of a company. For instance, the fundamental analysis approach assumes that a company has an intrinsic value and that value can be determined by an analysis of relevant data. The Efficient Capital Market Theory (semi-strong) assumes that a company's stock price reflects all available facts relevant to a company and thus the stock price fairly reflects the value of the company. Under either approach, greater access to up-to-date information will result in more efficient allocation of capital to performing companies.

166. In their study regarding the effect of Regulation FD, Heflin et al. attempted to determine whether Regulation FD promoted more or less information prior to earnings announcements by studying price variation after announcements, based on the theory that the more information prior to earnings announcements, the less price volatility after earnings announcements. Heflin et al., *supra* note 148, at 5–17. They concluded that Regulation FD resulted in a smaller gap between stock prices prior to earnings announcement and stock prices after announcement and that Regulation FD provided the market with more information prior to earnings announcement. *Id.* at 17. These results suggest that increased information flow will decrease market volatility by narrowing price gaps.

167. Instead of describing stock price swings as a reaction to corporate management not meeting such earnings expectations, it may be more accurate to describe the stock price swing as a reaction to analysts' earnings forecasts being inaccurate. Because a stock analyst does not have up-to-date and detailed financial data that is maintained internally, their predictions or expectations of a company's earnings do not always match the actual earnings the company announces quarterly and annually. The wild swings result from the market adjusting from its prior inaccurate expectation to the earnings announcement.

expectations match with actual earnings results, it is less likely that there will be wild swings of stock price during the release of the quarterly and annual financial statements. To a certain degree, it may even reduce the pressure for corporate management to manage earnings improperly to match with incorrect analysts' expectations.

C. Relaxing Independence Rules on Company-Hired Outside Auditors

If investors and others can effectively hire their own accounting and financial professionals to audit or analyze corporate financial data, there will be less of a need to enforce the supposed independence of company-hired outside auditors. To the extent a company's outside auditor does not adequately perform an audit because of lack of independence, or for any other reasons, investor-hired auditors will likely spot the deficiencies.

Under this scenario, Congress and the SEC should amend the Sarbanes-Oxley Act and accompanying SEC rules to relax restrictions against consulting services provided by a company's auditor. Since the system proposed by this Article does not rely on the independence of company-hired auditors, it will make sense to allow companies to enjoy the full benefits of consulting services provided by their own auditors who are intimately familiar with the companies' business and culture.

D. The Government, Particularly the SEC, Should Take a Leading Role in Setting Regulations For Internet Access to Corporate Financial Data and Corporate Management.

Government involvement is necessary to effectuate Internet access to corporate financial data and to corporate management. The management of a public corporation has very little incentive to disclose voluntarily its raw financial data on the Internet on a real-time basis, i.e., to give up its monopoly of financial data. In particular, it will lose a great deal of its power to shape and summarize financial information to the public, in the form of press announcements and financial statements. Disclosing its raw financial data on a real-time basis will subject management to greater and more frequent public scrutiny of the financial condition of the corporation.

The SEC already has a successful experience leading the private sector to adopt technological changes in disclosing corporate financial data, as the SEC has done in promoting the EDGAR system. The SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system enables corporations to file electronically documents required to be filed under the Securities Act, the Exchange Act, the Public Utility Act, the Trust Indenture Act, and the Investment Company Act. The SEC, in turn, disseminates EDGAR filings electronically. Currently, all public companies, absent an exemption, are required to file through EDGAR and these filings are available electronically and displayed on the SEC web sit at http://www.sec.gov/index.htm.

The SEC took a two-step approach in prodding public corporations to file through EDGAR. It first provided companies with the opportunity to file through EDGAR on a voluntary basis, to experiment with the filing and to become adjusted to doing so. At a certain point, after public companies and the SEC identified and resolved problems associated with EDGAR filings, it issued rules requiring that all corporations file through EDGAR. In 1984, the SEC began the voluntary phase by allowing corporations voluntarily to file through EDGAR.[168] After approximately 12 years of experimentation and changes, the SEC in 1996 required all corporations to file through EDGAR.[169] The SEC continues to use this two-step approach in its efforts to modernize EDGAR. In 1999, the SEC adopted rules to modernize the EDGAR system in light of the emergence of the Internet. For instance, in June 1999, it began allowing filers to submit, on a voluntary basis, documents to EDGAR in HyperText Markup Language (HTML) format and to accompany their required filings with unofficial copies in Portable Document Format (PDF).[170] By February 2000, the SEC had already began preparing public corporations for the likelihood that they would be required to file documents in HTML format and encouraged corporations to "gain experience" using the format in the meantime.[171] The SEC may thus be able to use the same two-step

168. Proposed Rule: Rulemaking for EDGAR System, Release Nos. 33-7803; 34-42462; 35-27142; 39-2382; IC-24319, at I.A. (Feb. 25, 2000), *available at* http://www.sec.gov/rules/proposed/34-42462.htm (last visited Nov. 25, 2003).

169. *Id.*

170. Rulemaking for EDGAR System, Release Nos. 33-7684; 34-41410; IC-23843 [64 FR 27888] (May 17, 1999) *available at* http://www.sec.gov/rules/final/33-7684.txt (last visited Nov. 25, 2003).

171. Rulemaking for EDGAR System, 65 Fed, Reg, 11,507, 11,509 (proposed March 3, 2000) (to be codified at 17 C.F.R. pts. 228, 229, 230, 232, 239, 240, 249, 250,

approach, i.e., voluntary experimentation followed by requirement, in pushing public corporations to disclose its financial data on the Internet on a real-time basis.

The SEC may also be the natural choice for leading the initiative toward real-time corporate disclosure of raw financial data on the Internet because such an initiative will complement existing efforts by the SEC to improve the quality and timeliness of a corporation's financial disclosure. For instance, in September 2002, the SEC implemented a rule to accelerate the filing of quarterly reports and annual reports by certain public corporations.[172] At the same time the SEC also proposed a rule requiring such corporations to disclose in their annual reports, among other things, whether they make available free of charge on their Internet websites, if they have websites, their 10-Ks, 10-Qs and 8-K filings.[173] If one of these corporations does not disclose the specific filings on its website, the rule requires the corporation to disclose the reasons why it does not do so including, if applicable, that it does not have a website.[174]

The policy bases behind these rules should similarly justify the SEC taking the initiative to push companies to disclose their underlying financial data on a real-time basis on the Internet. First, the SEC has implemented a rule to accelerate corporate filings because of concerns

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259, 260, 269, 270, and 274) ("We have not and are not now proposing to require the use of HTML for filings. However, we expect to require HTML for most filings in the future, so we encourage filers to use it and gain experience with this format if they do not have it already.").

172. Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Exchange Act Release No. 33,8128, 67 Fed. Reg. 58,480 (Sept. 16, 2002) (codified at 17 C.F.R. pts. 210, 229, 240 and 249) [hereinafter Rule on Acceleration of Periodic Reports]. Specifically, the rule accelerates the filing of quarterly reports and annual reports as required by the Exchange Act by domestic reporting companies that have a public float of at least $75 million, that have been subject to the Exchange Act reporting requirements for at least 12 calendar months, and that previously have filed at least one annual report. *Id.* The rule shortens the filing deadlines from 45 to 30 calendar days after period end for quarterly reports and from 90 to 60 calendar days after fiscal year end for annual reports. *Id.* The rule also provide for a 3-year transition period for companies to phase in compliance. *Id.*

173. *Id.* at 58,481, 58,492.

174. *Id.* at 58,492 (requiring the disclosure of whether Internet access is available follows the SEC's time-tested method of using initial encouragement, rather than immediate requirement, in pushing corporations toward adopting technologically new methods of disclosure).

that, by the time the filings are available to the public, these filings are already "stale."[175] Second, the SEC implemented the disclosure rule regarding Internet access to corporate filings because it believes that, in light of technological developments involving the Internet, providing information on a corporation's Internet website is an efficient and economical method to make corporate information available to many investors.[176]

> Modernizing the disclosure system under the federal securities laws involves recognizing the importance of the Internet in fostering prompt and more widespread dissemination of information. [citation omitted] We believe company disclosure should be more readily available to investors on a timely basis in a variety of locations to facilitate investor access to that information. We believe it is important for companies to make investors aware of the different sources that provide access to company information. We applaud those that already provide access to their Commission filings through their websites, and encourage every reporting company to do so.[177]

Based on these same reasons, an initiative for a corporation to provide its underlying financial data on a real-time basis should be the next logical step.

The SEC will also be suited to requiring management to respond to reasonable inquiries regarding its financial condition. In particular, such duties will resemble the SEC's current role in administering proxy rules. For example, the SEC's Division of Corporation Finance processes hundreds of no-action requests based on Rule 14a-8 from public companies that do not wish to place certain proposals from

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175. It is further noted that:

> We believe that periodic reports contain valuable information for investors. Commentators have long remarked, however, that because due dates for periodic reports are so lengthy, the information included in the reports often is stale by the time the reports are filed. (citation omitted) While quarterly and annual reports at present generally reflect historical information, it is important that a lengthy delay before that information becomes available does not make the information less valuable to investors.

Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, 67 Fed. Reg. 19,896, 19,897 (proposed Apr. 23, 2002) (to be codified at 17 C.F.R. 229, 240, and 249) [hereinafter Proposed Rule on Acceleration of Periodic Reports].

176. *Id.* at 19,903.

177. *See* Rule on Acceleration of Periodic Reports, *supra* note 172, at 58,492.

shareholders.[178] Rule 14a-8 allows a public company to exclude a shareholder proposal based on one of 13 specified reasons.[179] For instance, a company may exclude a shareholder proposal that duplicates a proposal submitted by another shareholder that will be included in the company's proxy materials for the same meeting.[180] It also establishes specific deadlines for the shareholder proposal process.[181] When it receives a no-action request, the Division of Corporation Finance analyzes each of the bases for exclusion that a company asserts, along with arguments that the shareholder sets forth, and determines whether it concurs with the company's decision to exclude.[182]

Similarly, this Article proposes that the SEC implement rules to ensure that management is not overwhelmed by questions and that the process is not abused by frivolous or overly burdensome inquiries. For instance, the SEC may implement rules to limit the time period, perhaps to several days each quarter, when the public may pose questions on the Internet to avoid excessively occupying time and resources of management. The rules may also limit the number of questions posed by each person or entity. The rules may also provide for management not to answer questions that were already answered, questions that are not relevant to the company's financial data or questions that involve trade secrets. The SEC may review the management's refusal to respond in a manner that is similar to its no-action process for proxy rules. Another alternative is for the SEC to set up a process where questioners will have the right to petition the SEC to compel responses if refusals to respond are not justified, similar to a motion to compel in the discovery process under the Federal Rules of Civil Procedures.

178. SEC Division of Corporate Finance, *Shareholder Proposals,* Staff Legal Bulletin No. 14 (July 13, 2001), *available at* http://www.sec.gov/interps/legal/cfslb14.htm (last visited Dec. 1, 2003).

179. *Id.* at § B.1.

180. *Id.*.

181. *Id.* at § B.3.

182. *Id.* at §§ B.5, and B.6.

E. Litigation Risk, Confidentiality and Cost

1. Increased Litigation Risk

One danger to providing raw financial data on a real-time basis on the Internet is that inaccurate data will be provided to the investing public, since the company will have had few opportunities to review the data for accuracy. If the scope of the inaccuracies is material, the company may be subject to civil litigation and regulatory sanctions for disclosing inaccurate information to the public.

Providing a legislative safe harbor from such litigation and regulatory action should alleviate the litigation risk.[183] However, such a safe harbor will increase the risk that unscrupulous managers will take advantage of the safe harbor and purposely disseminate false data to increase the company's stock price. Thus the safe harbor should not apply if the inaccurate data is a result of intentional or reckless conduct. Further, the safe harbor should not be available if a plaintiff can show that the company had inadequate internal control, thus creating additional incentives for company to maintain internal control which, in turn, may reduce the risk of disclosing inaccurate data as a result of mistakes.

In addition, a company should be required to correct any inaccuracies in the raw data as soon as such inaccuracies are discovered. Such a requirement will alleviate any harm that may result from disclosing inaccurate data. To a certain extent, how frequent a company makes corrections also provides the opportunity for the investing public to assess a company's internal control with respect to its financial data.

2. Disclosing Confidential Information

Another concern with disclosing raw financial data on the Internet is that a company may be forced to divulge otherwise confidential information that will jeopardize its competitive advantage. For instance, businesses are often protective of information regarding their customers,

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183. Such a safe harbor provision would be similar to Section 21E of the Exchange Act, *supra* note 125, which provides a safe harbor from private actions for forward-looking statements under specified conditions, such as lack of materiality or actual knowledge as related to misstatements or omissions.

including their identities. If the information is disclosed, competitors may take advantage of the information and "poach" the customers. Companies often include customer information in their journal entries and thus a requirement to disclose journal entries will disclose otherwise confidential customer information. In addition, disclosure of raw financial data, such as journal entries, may disclose information that a customer will consider confidential. For instance, information regarding components a manufacturing customer purchases may disclose trade secrets regarding the customer's manufacturing process.

This concern, however, may not be as troubling for several reasons. First, regardless of whether there is Internet access to a company's financial data, most state corporate laws allow for shareholders to examine the books and records of a company.[184] Second, the SEC can certainly implement rules to provide for companies, when well justified, to withhold customer identities, e.g., by replacing names with codes, or other sensitive information, while still disclosing the underlying financial information.

3. Cost

Another possible objection to the proposal is that of costs. Particularly in the beginning, companies will incur cost in setting up the necessary structure to provide Internet access to its financial data. In addition, companies will incur cost in the form of additional personnel to process and respond to questions from the public regarding its financial data.

Balanced against such costs, however, are the benefits of a more transparent market. Considering the decline in both market capitalization and investor confidence that resulted from the recent financial scandals, one can reasonably argue that such costs are well justified, particularly over the long term.

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184. *See* Catherine Reese, *Avoiding the Next Enron*, FORTUNE, Apr. 15, 2002, at 358 (explaining shareholders' access to the company can range from board meetings' minutes to internal company emails). A shareholder must first determine the place of the company's incorporation and then send a letter to the company's headquarters requesting specific records and reason for request. *Id.*

CONCLUSION

Company-hired, yet supposedly independent, outside auditors failed to detect and prevent the massive and blatant corporate financial scandals that have recently rocked the U.S. securities markets. There are strong indications that misaligned financial incentives caused many of these audit failures. The Sarbanes-Oxley Act's approach of creating additional restrictions on consulting fees may improve the quality of audits. However, this restrictive regulatory approach will continue to face an uphill battle, because it is difficult to force auditors to go against their very powerful and subconscious financial instincts, i.e., to be vigilant over their own employers.

Instead, Congress and the SEC should fashion laws to align the interest of auditors with those who have the greatest interest in accurate financial reporting, the investing public. Advances in Internet technology now make it feasible for investor-hired auditors to perform meaningful audits or reviews of corporate financial data. Congress and the SEC should implement laws and regulations that will provide the public access to such data and to management through the Internet, in order to create an environment that will foster the emergence of investor-hired auditors. Regulations should also be directed toward ameliorating any negative effects associated with such increased access, including regulations designed to reduce litigation risks. The market will take care of the rest.

Notes & Observations