Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay

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Executive compensation abruptly shifted in the United States during the 1990s, moving from a cash-based system to an equity-based system. More importantly, this shift was not accompanied by any compensating change in corporate governance to control the predictably perverse incentives that reliance on stock options can create.1

INTRODUCTION

Financial markets are in crisis again and almost certainly are on the way to another layer of regulation. While the current crisis is complex and mostly related to excessive risk taking, the historical record shows that market crashes also invariably coincide with epidemics of securities fraud.2 In turn, the

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2. The most salient fraud exposed during the current market crisis is the giant securities “Ponzi” scheme designed by the financier Bernard Madoff, which has cost investors no less than fifty billion dollars. Although Madoff’s enterprise was not a public corporation it still raises questions about the role of gatekeepers. See, e.g., Chad Bray et al., Prosecutors Seek to Jail Madoff—Fianncier Accused of Mailing Valuables to Family, Friends: New Victims Emerge, WALL ST. J., Jan. 6, 2009, at A1. Fraud was also arguably part of the reason for the collapse of financial services giant Lehman Brothers. See, e.g., Leslie Wayne, New Jersey Sues over Its
revelation of fraud leads to increased regulation.\(^3\) The purpose of this Article is to propose an incentive scheme for gatekeepers as an alternative to possible anti-fraud regulation. The term “gatekeepers” refers to certain agents, such as auditors and legal counsel, who are in a position to prevent corporate wrongdoing, including misreporting.\(^4\)

The proposed incentive scheme for gatekeepers is justified by recent developments in executive incentive pay, which were not accompanied by any corresponding change in corporate governance that could control the harsh side effects. Indeed, the surge in executive incentive compensation is perhaps the most salient corporate phenomenon of the last fifteen years.\(^5\) The old practice of compensating managers with a fixed salary and bonus has virtually disappeared, and executive pay today consists in large part of stock options and other methods of pay-for-performance.\(^6\) Pay-for-performance has been the cause of the more than tripling of total compensation for top executives in the

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\(^5\) The Economics of Executive Compensation (Kevin F. Hallock & Kevin J. Murphy eds., 1999) (reporting a surge in the number of papers discussing executive compensation in the 1990s).

last fifteen years.\footnote{Brian J. Hall & Kevin J. Murphy, The Trouble with Stock Options, J. ECON. PERSP, 49, Summer 2003, at 49, 51 (reporting and discussing executive option grants) see also Walker, supra note 6, at 18 fig.3 (reporting the growing percentage of equity-based compensation out of total executive compensation during the 1990s).}
The change in compensation practice was revolutionary. While in 1985, the value of stock options granted was only 8 percent of the average CEO total compensation,\footnote{Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 IND. L.J, 59, 64 (1992) (reviewing the compensation practices of eight hundred public firms).} between 1992 and 1998 the value rose from 25 percent to 40 percent,\footnote{Brian J. Hall & Kevin J. Murphy, Optimal Exercise Prices for Executive Stock Options, 90 AM. ECON. REV. 209 (2000); see also Tod Perry & Marc Zenner, CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?, 35 WAKE FOREST L. REV. 123, 131 (2000) (reporting similar findings); Kevin J. Murphy, Politics, Economics, and Executive Compensation, 63 U. CHI. L. REV. 713, 719 (1995) (reviewing executive compensation practices among one thousand large public firms, revealing, among other issues, that the top five paid executives had an average total compensation of $1.3 million, of which options comprised 23 percent).} with equity-based compensation peaking in 2000 at 78 percent of the average total compensation among S&P 500 firms.\footnote{Lucian Bebchuk & Yaniv Grinstein, The Growth of Executive Pay, 21 OXFORD REV. ECON. POL’Y 283, 290 tbl.4 (2005); see also Kevin J. Murphy, Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options, 69 U. CHI. L. REV. 847, 848 (2002).}
Moreover, while only 57 percent of the top executives held options in their firms in 1980, this had risen to 87 percent by 1994;\footnote{See Hall & Liebman, supra note 6, at 663.} in 1999, 94 percent of the largest companies granted options to their executives.\footnote{See Brian J. Hall & Kevin J. Murphy, Stock Options for Undiversified Executives, 33 J. ACCT. & ECON. 3, 4 (2002) (reviewing executive compensation in the 500 largest U.S. firms); see also FREDERICK W. COOK & CO., INC., LONG-TERM AND STOCK-BASED GRANT PRACTICES FOR EXECUTIVES AND DIRECTORS (1996) (reporting that, in 1996, in a sample of 250 large public firms, 94 percent of the companies used stock-option compensation).}

While the practice of equity-based compensation carries certain benefits,\footnote{See e.g., Jap Efendi, Anup Srivastava & Edward P. Swanson, Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors, 85 J. FIN. ECON. 667 (2007) (showing that executives at firms that restated their financial statements received more stock-based compensation than those at a matching sample of firms that did not restate their earnings); Shane A. Johnson, Harley E. Ryan, Jr. & Yisong S. Tian, Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter, 13 REV. FIN. 115 (2009) (showing that executives at firms charged with accounting fraud received more stock-based compensation than those at a matching sample of firms unsuspected of securities fraud). See also discussion infra Part I. The view that equity-based compensation encourages financial misreporting is also widely held amongst public figures and within financial circles. For example, Senator John McCain has publicly linked the accounting misconduct of Enron’s managers to their compensation scheme. 148 Cong. Rec. S6628 (daily ed. July 11, 2002) (statement of Sen. McCain).} it also produces undesirable incentives that encourage executives to commit securities fraud or at least sugarcoat financial reporting.\footnote{See infra note 48.} Stock-based compensation typically accounts for a sizable proportion of executives’ asset
portfolios, and when the corporation’s stock is overvalued by the market, managers can reap a sizable profit.\textsuperscript{15} For this reason, the practice of paying managers with stock and stock options has been described as “throwing gasoline” onto the market “fire.”\textsuperscript{16} Given these circumstances, it was only a matter of time until crisis occurred.

It is unsurprising, therefore, that the twenty-first century has witnessed a series of unprecedented financial debacles involving such American giants as Enron, Global Crossing, WorldCom, and Tyco, as well as Lehman Brothers and other financial giants during the 2008 crisis.\textsuperscript{17} These events have proved, however, to be only the tip of the iceberg when it comes to misreporting by firms.\textsuperscript{18} These financial scandals were one of several factors that led to the securities market bubble and its subsequent burst at the beginning of the century.\textsuperscript{19} As explained above, managers—especially those armed with options and other types of stock-based compensation—benefit from misreporting that can artificially inflate the market value of their enterprise, even if the stock prices eventually fall.\textsuperscript{20}

The Sarbanes-Oxley Act of 2002 targeted this very conflict of interest between managers and shareholders, introducing a variety of mechanisms aimed at improving transparency and accuracy of financial reporting.\textsuperscript{21} The legislation also intensively regulated third parties, such as external auditors and

\begin{itemize}
  \item \textsuperscript{15} See \textsc{Lucian Bebchuk \& Jesse Fried}, \textit{Pay Without Performance: The Unfulfilled Promise of Executive Compensation} 174–79 (2004) (explaining the common practices of executive stock-option grants, vesting, and exercise).
  \item \textsuperscript{16} Michael C. Jensen, \textit{Agency Costs of Overvalued Equity}, 34 \textit{Fin. Mgmt.} 5, 14 (2005).
  \item \textsuperscript{17} The current financial crisis does not seem to stem from fraud alone, but securities fraud allegations have been raised in some of the most salient corporate failures of this crisis. See, e.g., Julia Kollewe, \textit{FBI Investigates Four Wall Street Firms over Sub-Prime Meltdown}, \textsc{Guardian UK}, Sep 24, 2008, \textsc{http://www.guardian.co.uk/business/2008/sep/24/wallstreet.freddiemacandfanniemae} (reporting that the FBI is investigating financial giants Lehman Brothers, AIG, Fannie Mae, and Freddie Mac for fraud in connection with the 2008 economic crisis on Wall Street).
  \item \textsuperscript{18} According to the Corporate Fraud Task Force, since the passage of the Sarbanes-Oxley Act, no less than 214 CEOs, 53 CFOs, and 23 corporate counsels and attorneys have been convicted in the United States for corporate fraud. Wrongdoing is, of course, a much larger phenomenon than these conviction cases directly indicate. See Kate Plourd, \textit{Quick: How Many CFOs Have Been Convicted?}, \textsc{ CFO.com}, July 18, 2007, \textsc{http://www.cfo.com/article.cfm/9502734/c_9512631?f=home_todayinfinance}; see also \textsc{Corporate Fraud Task Force, Second Year Report to the President} (2004), \textit{available at} \textsc{http://www.justice.gov/archive/dag/cftf/2nd_yr_fraud_report.pdf}.
  \item \textsuperscript{19} Gerding, \textit{supra} note 3 (using a historical survey to demonstrate that stock market bubbles almost invariably coincide with securities fraud epidemics).
  \item \textsuperscript{20} For robust empirical evidence, see \textit{infra} Part I.B.
\end{itemize}


23. For instance, SOX requires increased disclosure of off-balance sheet transactions. 15 U.S.C. § 78m(j) (2006) (SOX §401(j)).

24. Perhaps the most salient requirement in this area is that all listed companies create audit committees comprised solely of independent directors. 15 U.S.C. § 78j-1(m) (2006) (SOX § 301).

25. Among the steps taken is the creation of a public board to oversee auditors. 15 U.S.C. § 7211 (2006) (SOX § 101). For a discussion on the auditor independence requirements, see infra Part II.C.

26. Given the beneficial incentives that equity-based compensation provides to executives, even the fiercest opponents of current managerial pay practices do not suggest abolishing this type of remuneration. See Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. CHI. L. REV. 751, 792 (2002) (“The managerial power approach does not question the desirability of using options to compensate executives. Options provide managers with greater incentive to create shareholder value, and thus the use of options in executive compensation might well be beneficial to shareholders.”). While these critiques suggest ways to improve managerial pay schemes, this Article offers to create an external force that would overcome the dark side of managerial incentive pay.

27. There have been discussions in the recent literature of offering rewards to gatekeepers that would encourage them to fight fraud. This Article diverges from these discussions in its proposal to use a novel equity-based system to the same end. For other perspectives on this issue, see Lawrence A. Cunningham, Beyond Liability: Rewarding Effective Gatekeepers, 92 MINN. L. REV. 707 (2002) (suggesting rewards in lieu of penalties to promote effective capital market gatekeeping); Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 MICH. L. REV. 1677 (2007) (discussing rewards versus liability).
respond thus far.28 The purpose of this proposed compensation scheme is to combat the noted conflict of interest between managers and shareholders by creating incentives for auditors to fend off any misleading reporting by the corporation. In order to counter managers’ incentives to inflate share prices, a properly designed stock-based compensation plan for gatekeepers would create incentives for the latter to deflate share prices. A codified principle of corporate governance holds that auditors should be precluded from stock-based compensation in the corporation they work for as such a compensation scheme would compromise auditor independence.29 Independence, however, may not be sufficient to ensure that auditors combat corporate fraud. While I do believe that auditors are concerned with professional ethics, legal liability, and their own reputation, the infamous failure of the Arthur Anderson audit firm demonstrated the potential inadequacy of these constraints.30

More generally, since accounting and auditing standards involve many uncertainties and a fair amount of unpublicized information, the quality of much of the auditor’s work is often unverifiable, unobservable, and, consequently, protected from legal penalty and even reputation backfire.

This Article argues, however, that auditors can and should have an incentive to perform their task well, even when their efforts are unobservable to outsiders. Stock-based compensation for auditors would be instrumental in creating those incentives. Whereas stock-based compensation for managers may lead them to pursue and back artificially inflated stock prices, my proposed scheme for auditors would have the opposite effect, as this Article explains.

My proposal also addresses a fundamental problem with the way that auditors and executives interact. Negotiations between the auditor and client firm are conducted behind closed doors, and both sides have significant private knowledge regarding the firm. The private and sophisticated nature of this interaction and the imprecise nature of accounting shield the auditor from most reputational damage and legal liability. This reality enhances the need for adequate structuring of auditor incentives, which has only intensified since executives began receiving equity-based compensation. Indeed, not only must

28. See Coffee, supra note 1, at 202 (“[W]hen one pays the CEO with stock options, one creates incentives for short-term financial manipulation and accounting gamesmanship.”).

29. Qualifications of Accountants, 17 C.F.R. § 210.2-01 (2009); see also Sankar De & Pradyot K. Sen, Is Auditor Moral Hazard the Only Reason to Ban Contingent Fees for Audit Services?, 1 INT. J. AUDIT 175 (1997) (discussing reasons for the legal prohibition on auditor contingent fees); Ronald A. Dye et al., Contingent Fees for Audit Firms, 28 J. ACCT. RES. 239 (1990) (developing the moral hazard argument against contingent auditor fees).

auditors be independent of management, but auditor compensation should be partially dependent on the future value of the stock, thereby incentivizing them to guard against earnings manipulation and bad-faith disclosure. Ultimately, I recommend that the Securities and Exchange Commission (SEC) should create a safe harbor for a novel stock-based compensation scheme for auditors. The SEC may further provide some incentives to adopt the proposed scheme, such as an exemption from part of the cumbersome requirements of the Sarbanes-Oxley Act. After all, once auditors have the right incentives in place, there may be no need for such elaborate and expensive regulations for auditors.

An appropriate stock-based compensation plan could take several forms.31 In this Article, I introduce one type of plan that would link auditors’ fate to that of future shareholders who are at risk of buying overpriced shares.

To illustrate, suppose that a corporation announces that it has hired a new auditor with a compensation agreement under which the latter (or, alternatively, the lead audit partner) agrees to work for the corporation for a maximum specified period (say, three years).32 During this time the auditor will defer a certain fraction of its compensation (say, 50 percent) until it signs and issues the last audit report for the client. A trustee will hold the deferred compensation during the holding period and will then use the money to buy for the auditor (or the lead audit partner) shares in the firm on the market following the signing of the last audit report.33 For example, if the market value of one share on the day following the release of the last audited report by the issuer is $30, and the amount of the deferred compensation is $30 million,34 then the auditor (or the

31. There are other schemes besides the one discussed here, including granting put options to auditors or placing them in a short position on the client’s stock. Each type of plan has a different payout structure, but they all create incentives to counter inflated share prices (and favor deflated prices). Similar to the market decision to grant executives certain types of stock-based compensation (including options, restricted stock, SARs, RSUs, etc.), the market should also make a decision on a certain type or mixture of auditor stock-based compensation. However, since stock-based compensation for auditors is currently illegal, the SEC must craft a safe harbor to allow the usage of such plans. Given this challenge, I consider it advantageous from a political economy perspective to pursue the type of plan I highlight in the text, which hopefully does not create the image of turning auditors into speculators.

32. Audit partner rotation is, in any case, an existing legal requirement. Section 203 of the Sarbanes-Oxley Act mandates this practice, providing:
   
   It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

33. Alternatively, the deferred compensation would be transferred and held by a trustee who would return the money to the issuer in exchange for shares issued to the auditor based on the market price of those shares at the time of issuance.

34. The above example sets the annual audit fee at $20 million. In reality, the audit fee varies tremendously amongst firms due to several factors such as firm size and complexity. The largest and most complex U.S. corporations pay audit-related fees that may even exceed $100 million per year. See, e.g., American International Group, Inc., Proxy Statement (Form DEF 14A) at 54 (Apr. 6, 2007) available at http://www.ezonlinedocuments.com/aig/2007/proxy/images/
relevant audit partner) will receive one million shares. Moreover, under this compensation scheme, the trustee will hold the stock for a “holding period” that ranges between eighteen and twenty-four months following its purchase. Following the holding period, and once the auditor sells its entire holdings of the firm’s stock, the auditor becomes eligible to be reappointed as the firm’s auditor. Finally, the trustee’s instructions would be that if the issuer corporation collapses prior to the date of the stock purchase, then the accrued amount will be released to the auditor in cash. This safety measure would both prevent harm to the auditor in extreme scenarios and eliminate the perverse incentive to conceal such Enron-like cases from the public.

My proposal has some unique benefits. Because the scheme requires that the auditor invest a good portion of its compensation in the stock of the corporation it audits, the auditor’s fees become contingent on its success at preventing financial misreporting. If the auditor does not adequately perform its duties, the resulting financial misreporting may drive the price of the firm’s stock above its bona fide value, and consequently, the auditor will overpay for the stock it is compelled to purchase under the compensation scheme. And since the shares are restricted and the auditor cannot divest of its holdings upon receipt, information regarding the true state of the company may be revealed over time, causing the stock that the auditor received in lieu of cash compensation to drop in value. This effect would be augmented by the auditor’s exclusion from working for the corporation for as long as the auditor does not sell its shares. The auditor, no longer actively involved with the firm, cannot help to maintain the artificial elevation of the stock prices. Simultaneously, the new auditor has an incentive to correct its predecessor’s mistakes as soon as possible in order to avoid suffering from the inflated prices down the line.

During the entire period that an auditor works for a corporation, the market value of the shares could fluctuate for reasons unrelated to financial misreporting. Thus, the value of the shares in the above example could vary during the auditor’s three-year appointment due to firm performance, for better or for worse, as well as due to macro-economic factors and frictions that affect the entire market. Importantly, however, under the proposed compensation scheme, the auditor does not bear risks that stem from such market-value fluctuations, whatever their cause may be. Because the auditor receives its deferred compensation in shares based on their market price following its period of service for the corporation, previous stock price variations do not influence the overall value of its compensation package. The number of shares issued to the auditor will be set with this goal in mind; the auditor will receive fewer shares

AIG_Proxy2007.pdf (fees paid by AIG in 2006 were $91.9 million); see also General Electric Co., Proxy Statement (Form DEF 14A) at 37 (Feb. 28, 2007), available at http://www.sec.gov/Archives/edgar/data/40545/000119312507040510/ddef14a.htm (fees paid by GE in 2006 were $115.4 million).
if the price per share increases and vice versa if it drops. This means that the auditor bears no investment risk during the period it works for the firm, but must still be alert to any misreporting that could inflate the value of the shares and possibly hurt its compensation when it eventually does sell its shares.

The proposed scheme does, however, involve some risk-related costs for the auditor that arise during the period in which the auditor is required to retain its stock. Since the auditor is compelled to invest a large sum of money in the stock of a single corporation, it will likely demand compensation for this risk, leading to higher overall auditor compensation levels than what auditors currently receive in cash.  

The larger the auditor and the more firms it works for with a similar compensation scheme, the lower the premium it would require for accepting this method of compensation. Yet, even a substantial premium may be justified, considering the multibillion-dollar costs of financial misrepresentations. If the incentive scheme described in this Article is beneficial, the resulting efficiency gains would compensate all parties involved. Moreover, I do not argue that this compensation proposal would suit all companies and all gatekeepers. Rather, my point is that there is no justification for the existing blanket prohibition on stock compensation for auditors, and that the market should be aware of the possible benefits that may evolve once such compensation is allowed.

Importantly, some of the triggers of fraud and misreporting may, in fact, also prevent firms from adopting the proposed mechanism. Therefore, the sticks and carrots necessary to bring these firms into the fold may come from various actors. Misreporting may harm the corporation’s creditors and future shareholders while enriching its existing shareholders. This proposal should, therefore, be advanced by institutional shareholders and banks, which have large stakes of equity and debt that are vulnerable to misreporting and as such should be motivated to search for ways to ameliorate the problem. As we shall see below, it is also important and appropriate for the SEC to encourage the use

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35. I therefore expect that risky or volatile firms would not qualify as good candidates for the proposed scheme. Recall that the proposed auditor compensation scheme is not mandatory. Further, due to the deferred compensation nature of the scheme, the first years of the program may cause audit firms to be cash constrained. Gradual implementation of the program throughout the firm’s client base may alleviate this problem.

36. Audit firms, and particularly the so-called “Big Four Firms” (KPMG, Deloitte, Ernst & Young, and PricewaterhouseCoopers), are giants with many clients and revenues in the billions. In 2007, each of the Big Four had revenues of approximately $20 billion or more. The Big Four Blog, http://bigfouralumni.blogspot.com/ (Dec. 4, 2007, 11:59 EST).

37. Diversification takes away risks related to the single firms. But one cannot diversify away the market risk unless the compensation is indexed to some market measure. For a discussion on market (systematic) risk and diversification, see Richard A. Brealey, Stewart C. Myers & Franklin Allen, Corporate Finance 154–72 (8th ed. 2005). Still, an auditor could replace its existing portfolio of stock, assuming it holds such a portfolio as an investment, with the stock generated by the proposed type of compensation and hence bear similar risks to the ones it currently faces.
of the proposed plan by instituting certain exemptions from Sarbanes-Oxley reporting requirements.

Finally, the 2008 sub-prime mortgage crises has put the spotlight on another important class of gatekeeper—the credit rating agencies. Specifically, rating agencies stand accused of granting favorable ratings to toxic financial instruments.\(^{38}\) Much of the criticism was attributable to the ill-structured incentives of the rating agencies, which receive their compensation from the issuers they are supposed to monitor.\(^{39}\) As this Article explains, however, properly structured incentive compensation can overcome this sort of bias. Hence, one possible application of the fee structure for auditors advocated in this Article could substantially alleviate the biases of the rating industry as well.

This Article progresses as follows: Part I begins by briefly discussing the proliferation of executive stock option plans (and other equity-based compensation) in the United States, the ongoing debate regarding such incentive pay schemes, and how they exacerbate the misreporting and overvalued equity problems. Part II then examines the notion of gatekeepers and gatekeeper regulation and, in particular, the Sarbanes-Oxley Act provisions and the auditor independence requirements. Part III sets out the proposed auditor compensation method, explaining why this scheme would respond to the ongoing trends in executive compensation practices and how it is compatible with existing gatekeeper regulation.

I EXECUTIVE COMPENSATION AND SECURITIES MISREPORTING

This Article aims to preserve the beneficial aspects of executive incentive pay while reining in the misconduct that incentive pay encourages. By allowing a manager to buy a company’s stock, equity-based compensation aligns a manager’s incentive with a company’s fortunes. As one scholar explained, “If their management of the firm induces stock price to rise, the managers cash in valuable options and make money. If their management of the firm doesn’t induce its stock price to rise, then the managers’ options are without value.”\(^{40}\)

This type of compensation, however, may incentivize managers to artificially report improved results.

\(^{38}\) See, e.g., Hearing on Credit Rating Agencies and the Financial Crisis Before the H. Comm. on Oversight and Government Reform, 110th Cong. (2008) (statement of Chairman Waxman) (suggesting that credit rating agencies failed to accurately rate complex financial products while enjoying high revenues from rating these products).

\(^{39}\) See, e.g., Franklin Strier, Rating the Raters: Conflicts of Interest in the Credit Rating Firms, 113 BUS. & SOC’y REV. 533 (2008) (“Because the rating agencies are compensated by the issuers whose CDO bonds they rate, this relationship creates a prima facie conflict of interest, one that is compounded when the rating agency also consults for the issuers on designing the CDOs.”).

\(^{40}\) Mark J. Roe, The Institutions of Corporate Governance, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371, 383 (Claude Ménard & Mary M. Shirley eds., 2005).
To understand how to decouple the benefits from the adverse effects of equity-based compensation, this Part begins with an examination of the surge in executive compensation and the revolution in equity-based compensation that caused it. It then presents the recent and growing body of empirical evidence linking stock-based compensation to earnings management and financial scandals.\(^\text{41}\) This evidence represents only some of the perverse effects of equity compensation, as much of the whitewashing and selective reporting is hard to detect and verify. These effects may occur in perfectly rational markets but intensify in irrational markets that place more emphasis on accounting presentation. This Part looks at some of the enormous body of evidence indicating that our capital markets suffer from such irrational episodes and shows that even an optimal compensation scheme would leave a wide opening for misreporting. In particular, even if managers’ incentives are perfectly aligned with the incentives of existing shareholders, they may still opt for financial misrepresentation at the expense of creditors and future shareholders.

A. The Growth in Executive Pay and Equity-Based Compensation

Much has changed since 1990, when business administration professors Michael Jensen and Kevin Murphy first made their claim that American CEOs are paid “like bureaucrats.”\(^\text{42}\) Between the years 1980 and 1994, the average executive compensation rose by 209 percent, and between 1992 and 1998, it almost tripled, with average compensation to the top five executives in the largest 500 U.S. companies climbing from roughly $2.34 million to $6.55 million.\(^\text{43}\) The increase in average CEO total compensation was even more stunning between 1993 and 2000, growing from $3.7 million to $17.4 million, respectively.\(^\text{44}\)

This striking rise in executive compensation can be attributed in large part to the parallel dramatic increase in option grants to executives. As already noted, in 1985 the value of equity-based executive compensation amounted to

\(^{41}\) The literature is also quite clear about the huge social cost of inflated or inaccurate stock prices. See generally Jensen, supra note 16; Marcel Kahan, Securities Laws and Social Costs of “Inaccurate” Stock Prices, 41 DUKE L.J. 977 (1992) (discussing the decrease in allocative market efficiency associated with inaccurate share prices); Andrei Shleifer & Robert W. Vishny, Stock Market Driven Acquisitions, 70 J. FIN. ECON. 295 (2003) (arguing that inflated stock prices bring about inferior acquisitions).

\(^{42}\) Jensen & Murphy, supra note 6, at 138 (reviewing U.S. executive compensation from 1969 and 1983); Hall & Liebman, supra note 6, at 655 (reviewing compensation practices of the four hundred largest public firms and concluding that executives are no longer paid like bureaucrats).

\(^{43}\) Murphy, supra note 10, at 848 (discussing growth of executive compensation); Susan J. Stabile, One For A, Two For B, and Four Hundred For C: The Widening Gap in Pay Between Executives and Rank and File Employees, 36 U. MICH. J.L. REFORM 115 (2002) (discussing and criticizing growth of executive compensation); see also Perry & Zenner, supra note 9, at 124.

\(^{44}\) Bebchuk & Grinstein, supra note 10, at 285 tbl.1; see also Hall & Murphy, supra note 7, at 51 (reporting and discussing executive option grants).
only 8 percent of the average total CEO compensation in the largest U.S. companies, but that figure grew steadily, peaking at 78 percent in 2000 among S&P 500 companies. Moreover, whereas in 1980 only 57 percent of the executives of top firms held options, in the year 1999 alone 94 percent of the largest companies granted options to their executives. The radical shift in executive pay practices ignited a debate about the efficacy of these new practices. Proponents argue that the practice of linking pay to performance is the result of an efficient bargain between firms (and, indirectly, the shareholders) and their executives. Opponents assert, among other things, that this scheme favors executives who have the power to manipulate pay-setting mechanisms in their favor and thereby ensure that they receive high pay without high performance. But even under the most optimistic view of stock-based compensation, where it is assumed that managers have incentives to guard against harm to the firm, the incentives for earning manipulation and securities fraud are in no way negligible.

B. The Link Between Stock-Based Compensation and Financial Misreporting

In recent years, a growing body of empirical literature has exposed the link between stock-based compensation for executives and financial manipulation. This work is rather new since the practice of heavily

45. See Barris, supra note 8, at 64 (an empirical study of eight hundred public firms).


47. See Hall & Liebman, supra note 6, at 663; Hall & Murphy, supra note 12, at 4 (reviewing executive compensation in the largest five hundred U.S. firms); see also Mark A. Clawson & Thomas C. Klein, Indexed Stock Options: A Proposal for Compensation Commensurate with Performance, 3 STAN. J.L. BUS. & FIN. 31, 42 (1997) (reporting data of a 1996 study about the use of stock options in the United States’ largest 250 firms).

48. John E. Core, Wayne R. Guay & David F. Larcker, Executive Equity Compensation and Incentives: A Survey, ECON. POL’Y REV., Apr. 2003, at 27, 28 (“However, unless beliefs are systematically biased, we expect that compensation contracts are efficient, on average, and that average equity incentive levels across firms are neither ‘too high’ nor ‘too low.’”).

49. See BEBCHUK & FRIED, supra note 15 (developing the managerial power approach); Bebchuk, Fried, & Walker, supra note 26 (same); Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, J. ECON. PERSP., Summer 2003, at 71 (same).

compensating managers with equity has been widely used only in the last fifteen years. Rather than surveying the literature in its entirety, I outline below four empirical studies in this area that utilize different methodologies. Regardless of the approach, however, a clear and compelling picture emerges: stock-based compensation instigates fraud, earning management, and misreporting in general.

The first study focused on accounting restatements and their relation to the structure of executive pay. An accounting restatement is a remake of previous financial reports that occurs when the corporation, its auditor, or the SEC finds significant accounting errors that resulted in a substantial misrepresentation in those earlier financial reports. Cases of restatement can be the product of innocent mistakes but may also indicate fraud. This study found that the likelihood of a misstated financial statement increases greatly when the CEO has very sizable holdings of in-the-money options. Examining restatements announced during 2001 and 2002, the study compared a sample of ninety-five restating firms with a control sample matched by industry, size, and timeframe. The researchers measured many factors that could potentially vary between the restating firms and the control sample. They discovered that the CEO’s compensation structure and, specifically, the value of the CEO’s in-the-money stock options was the most influential factor on the presence of financial restatements. These findings were even more pronounced in the specific context of restatements involving major accounting irregularities and malfeasance.

The divergence between the restating firms and their non-restating peers was dramatic. The average value of CEO holdings at restating firms was more than $50 million, whereas the average for the control firms was under $9 million. Moreover, the average value of CEO holdings at restating firms where there was evidence of accounting malfeasance was strikingly higher, at more than $130 million, compared to the average of just under $15 million at

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51. While statistical correlation is easier to prove than actual causation, these high profile papers nevertheless conclude that equity-based compensation leads to misreporting. See, e.g., Qiang Cheng & Terry D. Warfield, Equity Incentives and Earnings Management, 80 ACCT. REV. 441, 441 (2005) (“Collectively, our results indicate that equity incentives lead to incentives for earnings management.”).
52. Efendi, Srivastava & Swanson, supra note 14.
53. Id. at 703. In-the-money options are options that have a strike price (the fixed price at which the owner of an option can purchase the stock) that is lower than the current market value of the company’s shares and, thus, if exercised reap an immediate profit.
54. Many of the restatements had an earning effect, meaning the restatement influenced the bottom line of the profit and loss report. A negative effect on the income, such as the gross revenue, occurred in seventy-two of the ninety-five sample firms (76 percent). Id. at 681.
55. Id. at 703–04.
56. Id. at 685.
similar firms that did not restate their financials. The study also found that restating firms’ CEOs benefited from the misreporting immediately by exercising their stock options when the share prices were artificially inflated prior to the restatement. CEOs at companies that issued accounting restatements (where there was accounting malfeasance) exercised options worth an annual average of $4,181,600 ($7,744,240); this exceeded the average of $436,930 ($2,616,210) at matched firms.

This CEO behavior is explained by the study’s finding that the restatements inflated the value of the restating companies’ stock (or at least backed an already-inflated value). Thus, the study found “that restating firms’ returns exceed the market by about 20% (27% for firms with accounting malfeasance); in comparison, matched control firms receive approximately the market return.” These findings allowed the researchers to comfortably conclude that managers with stock-based compensation inflate stock price through accounting manipulation.

A second study examined accounting restatements issued by 215 restating firms between 1995 and 2002 and the restatements’ relation to executive compensation. Like the first study, this research also demonstrated that stock options are keyed to many accounting inaccuracies, which eventually lead to a proliferation of restatements. This second study took the inquiry one step further by measuring the magnitude of the restatement in relation to the structure of manager compensation. The evidence showed a significant positive relationship between the fraction of executive option-based compensation and the magnitude of the restatement. Higher incentives from stock options were found to be associated not only with a higher propensity to misreport but also with greater magnitudes of misreporting, as measured by the effect of the restatement on the net income of the firm involved.

A third study examined whether executives who commit securities fraud face greater financial incentives to do so than their peers who refrained from committing securities fraud. The study included all firms that were included

57. Id. at 703.
58. Id.
59. Id. at 669.
61. Id. at 63.
62. Id. at 43, 46 (“The average effect of the restatement on net income is a reduction of $101.32 million . . . . The mean (median) effect on net income for restating firms that overstated net income is higher at $117.1 ($13.8) million.”).
63. Johnson, Ryan & Tian, supra note 14. Another recent paper focuses on fraud cases and their relation to executive compensation by examining cases that were subject to private securities action lawsuits, Lin Peng & Alisa Röell, Executive Pay and Shareholder Litigation, 12 Rev. Fin. 141 (2008); see also David J. Denis, Paul Hanouna, & Atulya Sarin, Is There a Dark Side to Incentive Compensation?, 12 J. Corp. Fin. 467 (2006) (finding a significant positive relationship between a firm’s use of option-based remuneration and securities fraud allegations from 1993 to 2002).
in the SEC’s Accounting and Auditing Enforcement Releases (“AAERs”) from 1992 to 2005, in which the Commission concluded that there was sufficient evidence of accounting fraud to indict the firms or their executives.\textsuperscript{64} In total, the study identified eighty-seven fraud events, and compared the group of fraudulent firms with a matched sample of firms that did not display evidence of fraud.\textsuperscript{65} Again, the evidence that emerged is compelling: “incentives from unrestricted stock for the median fraud executive are 54\% greater than those of the median control executive; at the 75th percentile, they are 84\% greater.”\textsuperscript{66} Moreover, during fraudulent years, the study showed that executives at fraudulent firms sell significantly more stocks than do control executives.\textsuperscript{67}

Finally, a fourth study examined stock-based compensation and ownership data from 1993 to 2000 to determine the characteristics of firms that met or just beat analysts’ forecasts.\textsuperscript{68} The researchers found that firms were more likely to meet or slightly exceed financial forecasts when they had higher managerial equity incentives.\textsuperscript{69} “[A] one standard deviation increase in unexercisable options increases by 16.3 percent the odds of meeting or just beating analysts’ forecasts . . .”\textsuperscript{70} More specifically, “[o]f 4,301 firm-years with equity incentives and earnings surprises in the period 1993–2000, 25\% have zero earnings surprises, i.e., meeting analysts’ forecasts, 17\% beat analysts’ forecasts by one cent, but less than nine percent miss analysts’ forecasts by one cent.”\textsuperscript{71}

Based on statistical analyses that controlled for firm performance and other variables, the authors concluded that their results were more consistent with earnings management induced by equity incentives rather than by improved firm performance. This study further showed that managers with high equity incentives sold more shares after meeting or beating analysts’ forecasts than after missing analysts’ forecasts. In contrast, it did not find any evidence of similar practices among managers with low equity incentives.\textsuperscript{72} Lastly, the study found that, on average, high equity-incentive managers used more
income-increasing accounting, and that managers sold more shares after taking these income-increasing measures.

These recent empirical studies all reveal a strong and consistent correlation between financial misreporting and manipulation and stock-based compensation. Perhaps pay-for-performance does, indeed, create beneficial incentives to improve the firm, but it also creates negative incentives to present false evidence of firm improvement or to hide adverse information.

Aside from creating incentives for illegal accounting practices, the market also irrationally hinges on the manner of accounting representation. By taking advantage of market biases, managers can influence the price of their companies’ shares simply by selecting a specific manner of disclosure, without the need to misreport, hide, or twist information. For example, one study indicates that companies issuing less prominent press releases of their restatements suffered less of a loss in share value and were less likely to be sued for securities fraud. The researchers controlled for differences in the severity of the accounting irregularity involved and the relevant transparency of the information, so the variation in consequences for the companies stemmed solely from the relative prominence of the restatement announcement.

There is also considerable evidence that firms choose income-increasing accounting treatments, even when these maneuvers are utterly transparent to

73. This is especially true for managers with less persistent equity incentives, presumably because they are less concerned with the reversal of such techniques. Id. at 467.

74. Id.


77. Some firms issue a press release that discloses the restatement in the headline; others give a press release headlined by a different subject (for example, “earnings news”) but discuss the misstatement in the text; a third tactic is to simply change the comparative-period amounts reported in an earnings release, with no direct mention of the restatement. In all three cases, there are immediately negative stock returns following the announcement, but they differ substantially in terms of prominence (-8.3 percent for the first type of restatement announcement, -4.0 percent for the second type, and -1.5 percent for the third group). Rebecca Files, Edward P. Swanson & Senyo Tse, Stealth Disclosure of Accounting Restatements, 84 ACCT. REV. 1495, 1496 (2009).

78. Id. at 25–26.
the market. Perhaps the two best-known examples are using the “pooling,” as opposed to the “purchase,” accounting treatment for acquisitions and resisting the expensing of employees’ stock-option grants. Pooling-of-interest accounting treatment for mergers generally allows firms to report higher income and earnings. For this reason, managers used to invest a lot of time, effort, and capital to ensure that their merger transactions met the requirements for pooling-of-interest accounting treatment; the evidence indicates that the market valued this approach. Since accounting treatment does not impact the intrinsic value of these transactions, this market response to managerial


80. In “purchase accounting” the acquisition of a target is treated as an arm’s length purchase reflecting the market values of the acquired assets and liabilities. The difference between the price paid for the acquisition and the value of the assets (minus liabilities) of the target is recorded as “goodwill” and amortized during the following years. When pooling accounting was applied, the combined enterprise was treated as a merger and the book values of the separate enterprises were carried over to the surviving entity. No goodwill was created. For a basic explanation see Dale A. Osterle, Mergers and Acquisitions in a Nutshell, 181–83 (2d ed., 2006).

81. Both examples are discussed at length in Fried, supra note 50, at 26–28.

82. The reason being that the goodwill recorded in the purchase accounting is amortized throughout the years following the acquisition, which lowers the reported profits. See Osterle, supra note 80.

behavior is a telling sign of the market’s obsession with accounting numbers rather than with fundamental values.

Regulators have also struggled to regulate the accounting treatment of stock-option compensation. Fierce resistance by managers has prevented several attempts to enact a requirement to expense stock options, although such a requirement now exists.\footnote{Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 123R (2004).}\footnote{See Fried, supra note 50, at 28–29.} Expensing stock-option compensation has a sharp impact on firms’ bottom line; for example, it would have reduced the earnings of S&P 500 firms by 21 percent in 2001.\footnote{See Executive Compensation Disclosure, SEC Release No. 33-6940, 17 C.F.R. §§ 229, 240 (June 23, 1992); Executive Compensation Disclosure, SEC Release No. 33-6962, 17 C.F.R. §§ 228, 229, 240, 249 (Oct. 16, 1992) (adoption); SEC Release No. 33-6966 (Nov. 9, 1992) (correction to adoption release); SEC Release No. 7032 (Nov. 22, 1993) (technical amendments).} However, even without a requirement to expense stock options for accounting purposes, managers cannot hide their cost since they must disclose the values of stock options regardless.\footnote{The link between irrational markets and managers’ incentives to cheat and take actions to manipulate earnings has been widely acknowledged in the literature. See, e.g., Jeremy C. Stein, \textit{Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior}, 104 Q.J. \textsc{Econ.} 655 (1989) (showing that when a market is in equilibrium, investors rationally expect managers to engage in earnings management, so they adjust for this in their inferences, but managers continue to behave myopically); see also Bar-Gill \& Bebchuk, Misreporting, supra note 50; Bar-Gill \& Bebchuk, Costs of Permitting, supra note 50; Fried, supra note 50; Jensen, supra note 16.} Nevertheless, it seems that both managers and the market care more about accounting net profits than any other type of disclosure that could convey the same information. This reality exacerbates the misreporting problem, as it can drive managers to bend accounting standards to increase net profits, even when such a distortion would not mislead a rational investor.\footnote{See \textit{Bebchuk \& Fried}, supra note 15 (concentrating on the disincentives to improve performance); Bebchuk, Fried \& Walker, supra note 26 (same); Coffee, supra note 30, at 297–98 (discussing perverse incentives to manipulate earnings).}

\textit{C. Executive Pay Reform as a Partial and Imperfect Solution}

compensation arrangement that could overcome the problem in its entirety, and moreover, any reform aimed at solving only part of the problem would entail costs of its own. Second, corporations do not have an adequate incentive to adopt the optimal pay structure since managers’ earnings manipulations sometimes benefit existing shareholders at the expense of creditors and future shareholders. These two limitations, discussed further below, provide background for the discussion in Part III, which examines the role of gatekeepers in diminishing the harmful incentives that exist for managers to misreport.

Executive compensation reform can and does alleviate some of the negative incentives influencing managers. For example, to address the problem of stock option backdating,⁹⁰ the Sarbanes-Oxley Act required immediate disclosure of stock grant dates, making it harder to play around with disclosures and backdate grants to take advantage of more favorable timing. ⁹¹ Another reform that can counteract managers’ incentives to manipulate financial reporting involves clawback provisions that confiscate profits earned through fraud or accounting errors that lead to restatements; section 304 of the Sarbanes-Oxley Act provides,

If an issuer is required to prepare an accounting restatement . . . as a result of misconduct . . . , the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—(1) any bonus or other incentive-based or equity-based compensation . . . ; (2) any

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⁹⁰ The SEC has launched investigations into more than one hundred companies with respect to the timing and pricing of stock options they granted during the boom years of the late 1990s and early 2000s. This phenomenon has been discussed in numerous papers, see Lucian A. Bebchuk, Yaniv Grinstein & Urs Peyer, Lucky CEOs (Harvard Law & Econ. Discussion Paper No. 566, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=945392; Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, Lucky Directors (Harvard Law & Econ. Discussion Paper No. 573, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952239; David I. Walker, Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal, 87 B.U. L. REV. 561 (2007); Randall A. Heron, Eric Lie & Tod Perry, On the Use (and Abuse) of Stock Option Grants, FIN. ANALYSTS J., May/June 2007, at 17. As expected, there is evidence that executive equity compensation was a major incentive for the practice of backdating. See Daniel W. Collins, Guojin Gong & Haidan Li, Corporate Governance and Backdating of Executive Stock Options, 26 CONTEM. ACCT. RES. 403, 405 (2009) (showing that the tendency to backdate is stronger when stock options have greater weight in CEO compensation and that firms with weaker governance structures that allow CEOs to exercise greater power over the board and its committees are more likely to engage in executive option backdating).

⁹¹ In fact, this is the factor that exposed backdating in the first place. The passage of the Sarbanes-Oxley Act reduced managers’ returns from option grants dramatically, causing researchers to search for the cause of the change. See, e.g., Eric Lie, On the Timing of CEO Stock Option Awards, 51 MGMT. SCi. 802, 805 n.3 (2005) (“[E]ffective August 29, 2002, the SEC changed the reporting regulations with respect to stock option grants. Specifically, firms must now report executive stock option grants within two business days. This is likely to affect the timing of stock option grants documented herein.”).
profits realized from the sale of securities of the issuer during that 12-month period.\textsuperscript{92}

These statutory provisions and similarly-formulated contractual arrangements reduce the incentive for managers to commit fraud, but they are hardly a comprehensive solution to the problem. Hypothetically, if all fraudulent activities eventually came to light, reputational concerns as well as fear of prosecution could prevent most managers from committing fraud.\textsuperscript{93} Because in reality not all fraud is discovered, managers most often simply hope that their actions will go unnoticed. Managers who inflate profits often believe that income will rise before their fraudulent actions are detected, or alternatively, they hide their actions by disclosing a steeper-than-actual fall in sales at a later period.\textsuperscript{94} Unfortunately, because the clawback provisions do not overcome the fundamental hurdle of fraud detection, they have only limited deterrent effect. Moreover, a considerable extent of financial reporting manipulation occurs in gray areas. Accounting is based on assessments and involves discretion;\textsuperscript{95} at times, a number of possible reporting standards are arguably legitimate, with one simply better suited to the financial status of the issuer. This reality of the accounting and financial disclosure practice leads to much bending, stretching, slanting, exaggerating, distorting, whitewashing, and selective reporting that does not necessarily result in accounting restatements or public exposure of the faulty behavior, but misleads investors nonetheless.

Another oft-suggested reform proposes setting extended holding periods for managers’ equity compensation, based on the notion that the effects of earning manipulation and fraud cannot last forever.\textsuperscript{96} Managers can hide a downturn in the firm’s profitability or survive missing one quarter of analyst expectations, but the firm’s true financial situation will eventually emerge.\textsuperscript{97} Lengthy holding periods could, therefore, reduce misreporting incentives since short-run deception would not be very profitable for managers. Yet this solution is also far from perfect: Any scheme would have to allow managers to

\textsuperscript{93} Exposed fraud cases are only the tip of the iceberg. See, e.g., Coffee, supra note 1, at 199 (“[O]ne suspects that these announced restatements were but the tip of the proverbial iceberg, with many more companies negotiating changes in their accounting practices with their outside auditors that averted a formal restatement.”).
\textsuperscript{94} See Coffee, supra note 30, at 277 (discussing misappropriation of future period earnings and premature income recognition).
\textsuperscript{95} As this Article will discuss below, accounting practice is moving towards even greater discretion as rules-based accounting is being replaced worldwide with principles-based accounting.
\textsuperscript{96} See Coffee, supra note 30, at 308 (“[T]he real problem here is not equity compensation . . . but rather excessive liquidity that allows managers to bail out at will. Only firm-specific answers, such as holding periods and retention ratios, seem likely to work effectively to solve this problem.”).
\textsuperscript{97} However, short-run misreporting frequently remains hidden since the firm can often postpone the timing of reporting certain economic outcomes for some time without detection.
sell their shares at some point, thus failing to eliminate all short-run incentives to cook the books.98

More importantly, even if extended holding periods could eliminate much of the incentive to misreport, it is unclear whether an optimal employment contract would include such a provision. Holding periods expose managers to the fundamental risk of fluctuations in the company’s value, and the longer the holding period, the greater the risk they bear.99 Since managers already invest their human capital and reputation in their firms, it might be excessive to require them to undertake extremely high risks vis-à-vis a considerable portion of their compensation and capital assets.100 In fact, the empirical evidence shows that managers fear holding too much of their firms’ equity for a lengthy period of time: One extensive study found that, on average, managers sold approximately 680 already-owned shares for every one thousand new options granted and sold 940 already-owned shares for every one thousand new restricted shares granted.101

These findings should serve as a warning sign. Precluding managers from selling their shares for extended periods of time comes at a significant cost.102 Moreover, there are other proposed remedies, such as this Article’s proposal, that merit consideration. Indeed, the optimal mix of remedies might require much shorter holding periods than those heretofore thought possible.103

Finally, it is essential to acknowledge that existing shareholders may not be concerned with managers who misreport financial data. Short-term inflation

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98. Theoretically it is possible to require managers to sell their equity stakes only following a certain period after they have left the company. However, risk-averse managers would substantially discount the value of such an equity grant, for two main reasons: (1) Once the manager has left the firm, she has no control over the business performance of the firm, which exposes her to the untested skill of the future managerial team; and (2) manager turnover is often the result of crisis, which would mean that the manager is required to sell at times when the firm equity is most likely to be worth the least.

99. For a discussion of the concept of fundamental risk, see Lamont & Thaler, supra note 76, at 229.

100. See, e.g., Cheng & Warfield, supra note 51, at 444–45 (“Due to these equity-based holdings, managers’ wealth is sensitive to their firms’ stock prices and managers therefore bear the idiosyncratic risk of the firm. . . . [F]rom the perspective of risk diversification, risk averse managers want to reduce their exposure to the idiosyncratic risk of the firm. Consequently, managers want to sell shares if the risk exposure level is higher than the equilibrium level.”).


102. This is perhaps the essence of agency cost theory: A rational investor would not want to invest one dollar in preventing harm caused by agency relations if such a measure would result in a less than one-dollar reduction in residual loss. See Jensen, supra note 16 (creating the framework of agency cost theory).

in share prices can benefit existing shareholders at the expense of future shareholders and creditors.\textsuperscript{104} Any artificial increase in share price leads to a transfer of value from a future shareholder who buys shares to a current a shareholder who decides to sell her shares. Therefore, the existing shareholder can benefit from management misreporting while enjoying immunity from any direct liability because she does not directly participate in the false disclosure. Moreover, backed by overvalued equity, the firm can raise additional capital by issuing shares at an inflated value, thereby diluting the stakes of existing shareholders far less than would be the case were issuance set at the accurate price. Unsurprisingly, then, shareholders lack perfect incentives to counter securities fraud and to oppose mechanisms that generate such behavior, such as skewed incentive pay programs.\textsuperscript{105}

Similar dynamics in the relationship between shareholders and creditors augment shareholder incentives to neglect their duty to oversee manager incentive compensation. Giving managers an incentive to inflate share prices and skew accounting figures can result in a better credit rating for the firm and avoidance of default provisions in its debt contracts. Both of these outcomes enable the firm to finance its operation at a lower cost to the benefit of its shareholders. Consequently, shareholders are not well-suited to the task of creating incentives for accurate disclosure of financial data.

The two hurdles discussed here—that even the optimal compensation scheme leaves ample incentives for managers to misreport and that shareholders cannot be relied upon to fight for an optimal compensation scheme—raise the question of what role gatekeepers play in capital markets. Gatekeepers purportedly guard against manager incentives to manipulate disclosure, even when the shareholder body has abandoned its watch. The next Part of this Article will discuss the role of gatekeepers and explain why they too often fail to provide the essential check on misrepresentation and fraud. In response, Part III suggests a proposal for reform that seeks to alter gatekeeper incentives so that they can better, and more consistently, perform their oversight function.

II

THE UNFULFILLED PROMISE OF AUDITOR INDEPENDENCE

The changing nature of executive pay that led to frequent financial misrepresentation provokes an examination of auditors’ role in the developments. This Part points out that throughout the 1990s and the beginning of the twenty-first century, gatekeepers and auditors in particular systematically

\textsuperscript{104} See, e.g., Steven L. Schwarcz, Temporal Perspectives: Resolving the Conflict Between Current and Future Investors, 89 MINN. L. REV. 1044 (2005) (discussing the tension between current and future shareholders).

\textsuperscript{105} In Fried’s terms, this shareholder tendency leads to a “current-owner bias” in corporate law. Fried, supra note 50 at 3.
failed to forestall the massive wave of fraud and misreporting. Given managers’ fraudulent activity and auditors’ inability to prevent it, the crises and, in turn, the regulatory response became inevitable. Indeed, the crisis that ensued after the exposure of fraudulent activities in mega firms such as Enron and WorldCom spurred aggressive legislation and regulatory responses aimed at improving securities disclosure. While the benefits of this intervention are debatable, it clearly entails high costs, including the sky-rocketing cost of audits. Understandably, a considerable part of the new regulations concentrated on auditors, and one important theme was to strengthen the ideal of auditor independence. As this Part explains, independence alone is insufficient to ensure that auditors withstand pressure from management to compromise the quality of financial statements.

A. Crisis and Failure

The term “gatekeepers,” which was adopted by jurists in the late 1980s and has since maintained its appeal in the corporate governance discourse, refers to certain agents, such as auditors and legal counsel, who are in a position to prevent corporate wrongdoing, including misreporting. Given management’s incentive to overstate earnings and the inability of compensation schemes to overcome this problem, gatekeepers have a sacrosanct role in corporate governance. Since gatekeepers are unaffected by the same perverse incentive structures that drive corporate insiders, concerned about their reputation, and typically possess deep pockets, corporate governance structures expect them to stand up to opportunistic behavior.

Unfortunately, gatekeepers failed to live up to their promise when they did not safeguard capital markets against the corporate fraud surge of the late 1990s and early 2000s. While executive pay skyrocketed, there was a veritable explosion in accounting restatements, a telltale symptom of financial irregularity. From an annual average of about fifty public company

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106. See Gerding, supra note 3.
107. See Kraakman, supra note 4.
108. See Kraakman supra note 4 and accompanying text. The SEC has also adopted the term “gatekeeper.” See, e.g., Securities Act Release No. 33-7870 (June 30, 2000) (“[T]he federal laws . . . make independent auditors ‘gatekeepers’ to the public securities markets.”).
109. Kraakman, supra note 4, at 70 (“One suspects, for example, that professionals—accountants, lawyers and doctors—make attractive legal gatekeepers in part because they have large and vulnerable investments in licenses and reputations; they stand to lose too much if their corruption is detected.”).
110. This notion is the essence of Coffee’s paper, What Caused Enron?, Coffee, supra note 30, at 280 (“In this light, the deeper question underlying Enron and related scandals is not: Why did some managers engage in fraud? Rather, it is: Why did the gatekeepers let them?”). The title of an earlier version of the same paper reflected the notion well. See John C. Coffee, Jr., Understanding Enron: “It’s About the Gatekeepers, Stupid”, 57 BUS. LAW, 1403 (2002).
111. For a report on exposed fraud and financial misrepresentation cases that were subject to enforcement actions, see Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Legal Penalties for Financial Misrepresentation (May 2, 2007) (unpublished manuscript available at
restatements during the first half of the 1990s, the beginning of the twenty-first century saw that number quadruple. All told, this amounted to an unimaginable volume of one in every ten U.S. public firms issuing at least one restatement between 1997 and 2002. Some argue that the actual number of restatements was even higher and in fact grew tenfold from 1990 to 2000. Recall also that restatements are only required in cases of the most acute form of accounting failure. Many, if not most, accounting schemes simply go unnoticed or fail to reach the extreme of requiring a restatement.

Lax accounting had devastating effects on the American market. The federal government’s accountability office estimated at least $100 billion in total market losses for restating firms, and one academic study showed that the restating firms is sampled had lost, on average, no less than 25 percent of their market value. Yet these numbers, too, are an understatement of the real loss. There was a reasonable belief among investors during this period that not all cases of fraud and financial irregularity had been exposed. Indeed, one study showed accounting restatements that adversely affect shareholder wealth at a restating firm also induce share price declines among non-restating firms in the same industry. Moreover, these declines correlate with factors in the accounting quality of the sampled firms. For instance, non-restating firms using the same external auditors as restating firms experienced a sharper drop in


115. Evidence for this argument is summarized in Coffee, supra note 1, at 201.


117. The discussed outcomes underestimate the amount of fraud that was occurring. One significant, scandalous matter, uncovered only a few years later, was the stock-option backdating that took place at the end of the 1990s and early 2000s. See Walker, supra note 90, at 563 (“In the year since the scandal was uncovered, the SEC has launched investigations into suspicious timing and pricing of stock options granted during the go-go years of the late 1990s and early 2000s at more than one hundred companies. . . . [R]ecent papers suggest that this figure represents only the tip of the iceberg—that perhaps 10% to 20% of options issued to senior executives during this period may have been backdated in order to reduce option exercise prices.”).

118. GAO, FINANCIAL RESTATMENTS, supra note 113, at 24.


share prices than other non-restating firms. The same result was true for non-restating firms with high discretionary accounting accruals. Together, the direct and indirect outcomes of financial fraud and misreporting contributed to the crash of U.S. capital markets, which, during the years 2001 and 2002, plummeted by 32 percent. Congress acted swiftly in response to these events, with "the Sarbanes-Oxley Act of 2002 understandably focus[ing] on gatekeepers." 

B. The Costs and Limits of the Sarbanes-Oxley Act

While the 2002 Sarbanes-Oxley Act has both its critics and proponents, there can be no doubt about the huge costs this legislation entails. Since the objective of this Article is to propose reform aimed at improving gatekeeper performance, one must first understand the ways in which my proposal diverges from the reform introduced by Sarbanes-Oxley. Indeed, the Act prescribed several new requirements relating to gatekeepers, placing great, albeit not exclusive, emphasis on auditors. To facilitate comparison between the Act and the reform proposed in this Article, this Part focuses on some of the Act’s provisions that address auditors and, more broadly, the preparation of financial statements.

The Sarbanes-Oxley Act constitutes the consolidation of a series of corporate governance initiatives and new disclosure requirements incorporated into federal securities laws alongside enhanced disclosure requirements. One measure introduced by the Act, discussed earlier in the context of the limits of executive pay reform, is the clawback provision, which requires the forfeit of compensation gained through fraud or misreporting.

121. Id. at 18.
123. Coffee, supra note 1, at 204.
124. See supra note 22 and accompanying text.
125. See infra note 141 and accompanying text.
129. See supra Part I.C.
Another important provision relating to financial reporting is the section 301 requirement that all public companies have an audit committee composed entirely of independent directors. Since the audit committee is a subcommittee of the board that oversees the corporation’s relationship with its auditor, this requirement aimed to improve the monitoring of management in the context of financial disclosure. While such a requirement is not necessarily a bad idea, the empirical literature has raised doubts as to whether audit committees with independent directors can actually overcome management’s skewed disclosure incentives.

In U.S. firms, corporate boards, including audit sub-committees, are already packed with independent directors. Moreover, the evidence has failed to show any correlation between board independence and firm performance. Professor Roberta Romano of Yale Law School has attacked the Sarbanes-Oxley Act based on her review of sixteen different studies on the link between audit committee independence and firm performance (including audit quality): the overwhelming majority showed no link between total independence of the audit committee members and performance.

These findings are hardly surprising given other available evidence. Independent directors do not have any intimate knowledge of the firm’s

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131. See Romano, supra note 22, at 1529–30 (“The rationale for the rule is that such directors can be expected to be effective monitors of management and thereby reduce the possibility of audit failure . . .”).


134. See Romano, supra note 22, at 1604 tbl.4. Romano’s criticism is based, at least in part, on her general view that one set of norms cannot possibly suit all corporations. See, e.g., Sanjai Bhagat, Brian Bolton & Roberta Romano, The Promise and Peril of Corporate Governance Indices, 108 Colum. L. Rev. 1803 (2008) (empirically showing that corporate governance is an area where a regulatory regime of ample flexibility across firms is particularly desirable). The findings were inconclusive regarding whether having a majority of independent directors on a committee be independent (the prevailing practice even prior to the Act) had any effect on firm performance. Romano, supra note 22, at 1532.
financial status. Auditor-client negotiations over the financial statements are conducted between two highly sophisticated and knowledgeable parties: the CFO and her staff on the one side and the audit partner and her staff on the other.\textsuperscript{135} The conclusion is that we should consider new strategies to improve the integrity of the financials. And, as this Article suggests, to truly improve the outcome of these negotiations, auditors’ incentives must be addressed directly. This will help counter executives’ perverse incentives, which are driven by the new model of executive incentive pay.

A third important provision in the Sarbanes-Oxley legislation is the requirement that executives certify financial statements in accordance with internal controls. The CEO and CFO of listed firms must certify that their firm’s periodic reports fairly represent its financial condition and results of operations.\textsuperscript{136} This requirement alone does not seem impressive, as these executives had always signed the company’s reports and had been subject to liability under securities laws.\textsuperscript{137} Its significance, however, lies in the duty it imposes on CFOs and CEOs to establish and maintain internal controls that can attest to the verity of both the financial reports and the executives’ certification thereof. Section 404 of the Act augments this requirement with an additional requirement: the filing of a report assessing the firm’s internal controls, which must include confirmation from an external auditor.\textsuperscript{138}

While these seemingly benign measures may have indeed improved the quality of disclosure,\textsuperscript{139} they have also imposed huge costs. One survey estimated that the cost of compliance with the certification requirement—audit fees, external consulting, and software expenses—would add up to about $2.9 million in additional fees for companies with annual revenues of over $5 billion;\textsuperscript{140} a more recent empirical work showed that the certification requirement alone practically doubled the relevant fees for the sampled

\textsuperscript{135} See infra Part III; see also Abigail Brown, Incentives for Auditor Collusion in Pre-Sarbanes-Oxley Regulatory Environment, 25 L. IN CONTEXT 178 (2007) (explicitly modeling the possibility of collusion between manager and outside auditor in a context where the outcome of the auditor-client negotiations is unverifiable).


\textsuperscript{137} 17 C.F.R. § 240.10b-5 (2007); see also Thomas Lee Hazen, The Law of Securities Regulation 199–207 (5th ed. 2005).

\textsuperscript{138} In its report, the registered public accounting firm must express an opinion concerning management’s assessment of the effectiveness of the firm’s internal controls over financial reporting, 15 U.S.C. § 7262 (2006) (SOX § 404).

\textsuperscript{139} The empirical data on this issue does not necessarily support the efficacy of these requirements. See Romano, supra note 22, at 1541–42 (summarizing the empirical literature and criticizing the certification requirement). But cf. Peter Iliev, The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices, J. FIN., (forthcoming 2010), available at http://ssrn.com/abstract=983772 (showing that the requirement for a certification report induced managers to cut back on discretionary accruals).

\textsuperscript{140} The survey, conducted by the Financial Executive International organization, is summarized in Romano, supra note 22, at 1587–88.
firms. In fact, the total costs of compliance with the Sarbanes-Oxley legislation are much higher, with one report finding an almost 350 percent increase in audit fees between 2001 and 2006. And these out-of-pocket expenses are certainly not an exhaustive list of the costs of compliance; in addition to the direct audit fees, consulting fees, software costs, increased insurance, and additional outside directors’ fees, there are indirect costs, from simple business disruption and increased rates of firms going private, to less frequent mergers and acquisitions activity due to fear of compliance problems in newly acquired divisions. Unsurprisingly, a recent study showed that U.S. firms experienced statistically significant negative abnormal returns around key Sarbanes-Oxley legislation events.

A proponent of the Sarbanes-Oxley Act might argue that these costs are worth the benefits produced by the legislation. For instance, one recent study showed that the proportion of securities fraud uncovered by auditors has risen substantially in the post Sarbanes-Oxley era. Prior to the legislation, auditors

141. Iliev, supra note 139 at 42 fig.2 (showing that firms with a public float of about $75 million dollars incurred double the annual audit fees relative to similar firms that were not subject to SOX due to the certification requirement, with audit fees increasing on average from $444,000 to $877,000).


143. James S. Linck, Jeffrey M. Netter & Tina Yang, Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors, 22 REV. FIN. STUD. 3287, 3289 (2009). Linck et al. found that following the enactment of Sarbanes-Oxley Act, the size of boards and proportion of independent directors on those boards have increased significantly. This increase in the size of boards implies additional directors’ fees, as well as potential harm to the board’s ability to act as a monitoring mechanism. See, e.g., David Yermack, Higher Market Valuation of Companies with a Small Board of Directors, 40 J. FIN. ECON. 185, 185 (1996) (finding “an inverse association between board size and firm value in a sample of 452 large U.S. industrial corporations between 1984 and 1991”).


145. See Romano, supra note 22, at 1589 (“[P]ublic firms are deterred from acquiring private and foreign firms (because the acquisition will make the acquirer responsible for certifying the accuracy of the entity’s not-yet-certified books and records) . . ..”).  


147. Sarbanes-Oxley is but a fraction of a much larger regulatory framework that entails huge cost but nevertheless persists for decades. The United States has over 115 federal and state agencies that are involved in regulating some aspect of financial services, with Congress contemplating adding new agencies to the list. See Elizabeth F. Brown, The Tyranny of the Multitude Is a Multiplied Tyranny: Is the United States Financial Regulatory Structure Undermining U.S. Competitiveness?, 2 BROOK. J. CORP. FIN. & COM. L. 369 (2008).

148. I.J. Alexander Dyck, Adair Morse & Luigi Zingales, Who Blows the Whistle on
were responsible for only 7.2 percent of all cases of exposed securities fraud, whereas subsequently this increased impressively to 28.9 percent.149

The next Part considers yet another important set of provisions of the Sarbanes-Oxley Act which seeks to ensure auditor independence. As I argue below, these provisions and the ideal of auditor independence as a whole fails to incentivize auditors to guard against financial fraud.

C. The Auditor Independence Requirement in Sarbanes-Oxley and Beyond

A central provision in the Sarbanes-Oxley Act, which addresses an issue that lays at the heart of the legislative deliberation,150 is the prohibition on accounting firms from providing the majority of non-auditing services to the firms they audit.151 This provision led to sweeping changes in the practices prevailing at the time of its legislation. For instance, in 2000, General Electric paid its auditor Klynveld, Peat, Marwick, Goerdeler, LLP (KPMG) $23.9 million for audit fees, $11.5 million for information system design and implementation, $13.8 million for tax services, $15.5 million for non-financial statement audit services (such as due diligence procedures associated with M&A activity), and $38.9 million for “all other services consisting primarily of information technology consulting . . . not associated with financial statements.”152 In 2005, there was a drastic shift as a result of the Sarbanes-Oxley prohibition, with GE paying the same auditor $100.8 million in audit-related fees, but only $8.4 million in tax fees and no other fees at all.153

149. Id. at 67 tbl.13; see also Mary Ellen Carter et al., Changes in Bonus Contracts in the Post-Sarbanes-Oxley Era, REV. ACCT. STUD., Dec. 21, 2007, available at http://accounting.wharton.upenn.edu/faculty/carter/clz_111507.pdf (showing that Sarbanes-Oxley and related reforms led to a decrease in earnings management and that firms responded by placing more weight on earnings in bonus contracts).

150. Romano, supra note 22, at 1549.


The rationale for this prohibition was that non-audit services can generate high fees, the prospect of which can, in turn, compromise the external auditor’s diligence in performing its task. This logic fits with a concept that is almost sacred in securities regulation: auditor independence. Critics of Sarbanes-Oxley argue that there is voluminous empirical literature showing that, by and large, not much improvement in audit quality can be achieved with the new restriction. This Article takes an entirely different approach, arguing that mere independence is simply not enough. Instead of fine-tuning the concept of auditor independence, as Sarbanes-Oxley attempted, regulation should focus on shaping incentives that rest on the quality of the auditor’s work.

The principal of auditor independence is anchored in the preamble to the SEC regulation prescribing auditor qualifications:

Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.

This independence requirement, while extensive, is fundamentally limited by its failure to provide an affirmative incentive for auditors to counter fraud and improve the quality of disclosure. Any independence requirement will merely reduce auditor incentives and inclination to favor executives. But any residual tendency by auditors toward executives, even if motivated only by a common socioeconomic group of reference, could substantially compromise auditor performance in the absence of a countervailing incentive to fight
manipulation and disorder in the firm.\textsuperscript{159} Simply put, under the current regulatory scheme, the auditor bears no immediate and real costs if she chooses to act collegially and avoid conflict. Auditor independence, therefore, cannot be relied upon to counter the social and psychological forces that may cause auditors to favor executives over the amorphous group of constituents that are harmed by imprecise disclosure.\textsuperscript{160}

As explained in Part III below, negotiations between the auditor and the firm-client are conducted behind closed doors with both sides privy to a significant amount of private information about the firm, since the auditors conduct an intensive auditing procedure.\textsuperscript{161} The private and sophisticated nature of this interaction and the imprecise nature of the accounting profession shield the auditor to a great degree from reputational damage and legal liability.\textsuperscript{162} This reality heightens the need for an adequate structuring of auditor incentives, a need that has only intensified since executives began to receive stock-based compensation. Indeed, the idea is to make auditors not only independent of management but also dependent on the fate of future shareholders who may be harmed by earnings manipulation and bad-faith disclosure.

III

THE CASE FOR AUDITOR INCENTIVE PAY

The previous Parts of this Article dealt with pervasive incidences of financial misreporting and the inability of the current regulation to overcome this challenge at a reasonable cost. As a response, this Part put forth an agenda for auditor incentive pay that should alleviate the problem of financial misrepresentation. Part III.A explains the special nature of audit-client

\textsuperscript{159} For analogous arguments regarding outside directors, see Jonathan R. Macey, Corporate Governance: Promises Kept, Promises Broken 64 (2008). See also Berchuk & Fried, supra note 15, at 4.

\textsuperscript{160} Self-serving bias causes people to overlook matters that can cause them disutility and, in our case, the necessity to engage in a conflict with management. See Jon D. Hanson & Douglas A. Kysar, Taking Behavioralism Seriously: The Problem of Market Manipulation, 74 N.Y.U. L. Rev. 630, 648–49 (1999) (describing an experiment in which students designated as either plaintiff or defendant were asked to make an objective assessment of the monetary judgment in the case, with assessments of those students designated as plaintiffs emerging as much higher than of those designated as defendants). See generally Norbert L. Kerr, Robert J. MacCoun & Geoffrey P. Kramer, Bias in Judgment: Comparing Individuals and Groups, 103 Psychol. Rev. 687 (1996) (discussing the operation of the self-serving bias in groups). Note, also, that social interactions and connections often translate into financial gain. Hence, a person would prefer to maintain a good relationship with an influential executive rather than make enemies in so-called corporate America.

\textsuperscript{161} See infra Part III.A.

\textsuperscript{162} Beyond the evidentiary difficulties, the conceptual possibility of auditors’ bearing legal liability is tenuous in the United States. See infra Part III.C. For a comparison of auditors’ legal liability in the United States and United Kingdom respectively, see generally Tim Bush, Shyam Sunder, & Stella Fearnley, Auditor Liability Reforms in the UK and the US: A Comparative Review (Aug. 2007) (unpublished manuscript, available at http://ssrn.com/abstract=1011235) (discussing reforms in auditor liability regimes).
negotiations, Part III.B is the heart of the Article, introducing the mechanism of the new auditor incentive pay scheme, and Part III.C discusses the legislative and regulatory modifications that the new scheme requires for implementation. Finally, Part IV.D deals with the possible ways to promote the proposed arrangement.

A. The Negotiations and Estimates Behind Audit Opinions

Any outsider to the corporate world who happens to read an audit opinion affirming the financial statements of a given corporation is bound to get the wrong impression. A literal reading of a typical audit opinion would wrongly imply that corporate insiders had produced the financial statements and that the audit firm, in turn, had conducted its audit and verified whether those financials accurately represent the financial status of the firm according to generally accepted accounting principles.163 Yahoo’s unqualified audit report, for example, is typical in its format and tone:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Yahoo! Inc. and its subsidiaries . . . . These financial statements and financial statement schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.164

This characterization of the audit process is far from accurate. In reality, corporate insiders, chiefly the CFO and her staff,165 negotiate with the audit

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164. See Yahoo Annual Report, supra note 163, at 49.

165. Michael Gibbins, Susan A. McCracken & Steve S. Salterio, The Chief Financial Officer’s Perspective on Auditor-Client Negotiations, 24 CONTEMP. ACCT. RES. 387 (2007) (“CFOs are the managers responsible for the financial statements used by markets and others . . . yet their views are largely absent from the accounting research literature.”). Interestingly enough, the members of the audit committee are not part of the above-mentioned negotiations. There is mounting evidence suggesting that audit committees play a passive role in resolving accounting disputes with the auditor. See, e.g., Jeffrey R. Cohen et al., Corporate Governance in the Post Sarbanes-Oxley Era: Auditor Experiences, CONTEMP. ACCT. RES. (forthcoming), available at http://ssrn.com/abstract=1014029 (showing that the auditor and the management usually try to resolve issues before they come to the attention of the audit committee); see Bradley Pomeroy, Audit Committee Member Investigation of Significant Accounting Decisions, AUDITING: J. PRAC. & THEORY (forthcoming 2010), available at http://ssrn.com/abstract=962783 (stating that recent research suggests audit committee members are not involved in material auditor-client
partner and her staff over the financial statements.166 And since financial reporting involves a great deal of evaluations, contingencies, appraisals, interpretations, and discretion, there is much to negotiate.

On the surface, there is nothing wrong with this practice. Insiders are typically biased in their firm’s favor, both knowingly and subconsciously gravitating towards smooth and positive numbers and representations,167 whereas auditors are professionals led by ethics and reputational concerns that, in theory, counterbalance insiders’ incentives.

Despite the competing concerns of the negotiating parties, however, it is extremely hard to determine from the outside whether the financial statements produced at the end of these negotiations actually constitute a fair representation of the corporation’s financial position.168 The creation of almost every section of the financial statements entails intricate assessments and discretion. This process, in turn, requires auditor-client negotiations that generate outcomes not easily assessed from the outside. Some elements of the financial report, such as contingent liabilities, which include pending liabilities that may result from litigation, leave room for considerable discretion on the part of the firm’s executives and auditors.169 Less obviously, this type of


167. Millstein noted prior to the market crash in the early 2000s that “[t]he current concern with financial reporting is primarily fueled by a perceived need for corporations to constantly ‘make the numbers’—to match or exceed analysts’ expectations and projections.” Ira M. Millstein, Introduction to the Report and the Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 BUS. LAW. 1057, 1059 (1999).

168. See Gibbins, McCracken & Salterio, Negotiations over Accounting, supra note 166, at 172 (stating that auditor-client management negotiations are “generally nonobservable” to researchers).

169. See, e.g., CLYDE P. STICKNEY ET AL., FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES 384–436 (10th ed. 2006) (discussing the concept of
discretion is, by and large, applied to almost all components of the financial report. For instance, the accounts receivable section of a financial report presumably details the amounts owed to the firm by its customers and hence would seem relatively easy to measure objectively. However, both accounting principles and the complicated nature of commerce render this presumption naïve.

First, doubtful debts, which are accounts receivable with a poor estimate for collection, are one source of ambiguity in the negotiation process. The corporation and, subsequently, its auditors must decide on the size of the deduction to be made for such items. This determination involves many assumptions, assessments, and evaluations, the reasonableness of which can be judged only by those intimately acquainted with the corporation’s business.

The complexity of the accounts receivable section does not end with doubtful debts. Some industries, including pharmaceuticals and computer hardware, are highly competitive. Due to the rapid pace of innovation and the uncertain scope of patent protection, supply pressure from competitors can substantially and quickly drive down prices. This phenomenon causes distributors and retailers to order less than optimal levels of inventory so that they can fully enjoy future price cuts.

To address this problem, manufacturers frequently commit to return to clients the amount of any price reduction in their previously purchased inventory. Where such a commitment exists, the manufacturer’s financial statements must include an allowance for this possibility (an “account payable”), and deduct it from accounts receivable (and the firm’s profit). This leaves companies with ample discretion to significantly alter the entire operations’ results; any increase in this allowance will reduce the representation of the firm’s profits and any decrease will increase the figure. The reasonableness of the size of this allowance can be determined only with an understanding of the nature of the firm’s business, anticipated future developments in the industry, and what reactions to these possible changes the firm is contemplating.

Upon completing the audit, the external auditor may then be equipped with the tools necessary to second-guess the decision made by the firm’s executives; from the outside, however, it is virtually impossible to ascertain the fairness of the outcome of this non-transparent procedure. Although it will eventually become clear whether the firm’s assessments were correct, it will be contingent liabilities).

170. See STICKNEY, ET AL., supra note 169, at 864.

171. For instance, at the world’s largest pharmaceutical manufacturer of generic products, this allowance is almost 50 percent of the accounts receivable in the firm’s balance sheet. See TEVA Pharmaceutical Industries Limited, Notes to Condensed Consolidated Financial Statements (Form 6-K), at 5 n.5 (Nov. 2007), available at http://www.sec.gov/Archives/edgar/data/818686/000119312507232932/d6k.htm.
extremely hard to hold the firm or auditor accountable for its inability to make accurate determinations. Believing in the verity of financial statements therefore requires much faith in the integrity of the auditor-client negotiations.

Unfortunately, however, these negotiations have ceased to be conducted on a level playing field. As discussed above, executives are increasingly compensated with stock and stock options, creating strong incentives to exaggerate firm performance and value, while auditors are paid a fixed amount, making them “independent” at best, complicit at worst. The traditional balance in negotiations between corporate insiders and auditors has thus tipped dramatically as the former group has become highly motivated to show improved results, artificial or genuine. The evidence presented in the previous parts of this Article indicates that this shift caused a major disorder that threatened the integrity of U.S. capital markets. The Sarbanes-Oxley Act responded to this disparity in the auditor-client balance of power with extensive and expensive measures, although the scheme’s benefits and justifications are still hotly debated. Accordingly, the main purpose of this Article is to suggest a different measure for restoring this balance: calibrating auditor compensation to counter the undesirable results of management incentives. While the costs of my proposed arrangement are difficult to predict prior to implementation, the doubts raised regarding the costs of the existing Sarbanes-Oxley regulation justify allowing firms to opt for the suggested scheme.

The fact that auditors are paid a fixed amount that is not linked in any direct way to their performance as gatekeepers is in itself an oddity. In the U.S. economy, pay-for-performance is increasingly becoming the norm. According to one study, the percentage of performance-pay jobs grew from 15 percent to 40 percent in the period between 1976 and 1998. Consulting companies specializing in performance-pay compensation have grown tremendously over the past thirty years, and SAP, a major supplier of software used to monitor worker performance, has multiplied its sales from $60 million in 1985 to $8.8 billion in 2006. Pay-for-performance is even more pronounced within senior management, as already discussed, and similar arrangements appear in agreements between firms and service providers, including legal contingent fee arrangements and payment in stock and stock options to lawyers. It thus seems reasonable to explore the possibility of

172. The argument that monitoring employees to enhance their performance can achieve substantial gains can be traced back to the beginning of the twentieth century. See Frederick Winslow Taylor, The Principles of Scientific Management (1911).
174. Id. at 7.
175. See supra Part I.A.
176. For a discussion on lawyer contingent fees see Peter Melamed, An Alternative to the
compensating the firm’s external auditor or audit partner by using some form of variable pay aimed at fostering its performance as gatekeeper.

B. The Mechanism of the Proposed Gatekeeper Compensation Plan

The main mission of auditors is to ensure that a firm’s financial statements fairly represent its financial position. Instituting pay-for-performance would therefore make audit fees contingent on the auditor’s success at preventing misreporting, fraud, and irregularities. Fraud and misreporting can support or lift share prices in the short run but not over the long term. Eventually, the manipulation or mistake is either openly exposed or loses its effect. Thus, a drop in sales could be hidden for one or two quarters, but if the trend persisted, it would ultimately surface. Similarly, a shortage in the cash flow could be concealed for a certain time, but at some point creditors would discover it.

Because the effectiveness of financial misrepresentation is generally short-lived, a stock-based mechanism could incentivize auditors to eliminate irregularity. Exposing the auditor to a future drop in the firm’s share prices would induce it to work harder to prevent accounting irregularities. To prevent a price drop in its own stock, the auditor would increase its efforts even when no one outside the auditor-client relationship could accurately judge the quality of the financial statements. Although reputational concerns, professional ethics, and, to some degree, exposure to legal liability already ensure a certain level of adequate performance on the part of the auditor, stock-based compensation adds an incentive that operates even when the auditor’s actions cannot be easily


177. If fairness cannot be confirmed, the auditor must produce a qualified opinion or refrain from giving any opinion. Qualified opinions in themselves are a strong signal to the market, as they reveal major problems in the issuer’s financial statements. See Charles J.P. Chen, Xijia Su & Ronald Zhao, Market Reaction to Initial Qualified Audit Opinions in an Emerging Market: Evidence from the Shanghai Stock Exchange (Oct. 1999) (unpublished manuscript, available at http://ssrn.com/abstract=192091) (discussing the market reaction to qualified opinions). Qualified opinions, however, are rare as corporate insiders prefer and are required by law to correct faults that the auditor finds in the financials. See Securities Exchange Act of 1934, 15 U.S.C. § 78m(i) (“Each financial report . . . shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.”).

178. The concept of contingent auditor fees, although currently banned by federal legislation, is not that anomalous. In 1988, the FTC suggested lifting the ban on contingent fees as anticompetitive in that it narrowed the set of contracts that could be formulated between auditors and their clients. See Dye et al., supra note 29, at 1 (referencing the Wall Street Journal, Aug. 25, 1988).

179. See Coffee, Gatekeeper Reform, supra note 4, at 333.

180. See, e.g., Coffee, supra note 1, at 204 (“[M]anagers were systematically able to overestimate revenues and then recognize them prematurely in ways that ultimately compelled earnings restatements . . . .”); see also Coffee, Gatekeeper Reform, supra note 4, at 333.
observed. Put differently, a proper stock-based compensation mechanism would bind the auditor to its gatekeeper function, even when monitoring is difficult or impossible.

The idea, then, is to create an auditor-compensation mechanism that will be the mirror image of the existing structure of executive compensation and thereby create a countervailing force. 181 This Article’s proposal does not involve giving auditors put-options or making them short-sell the client stock, 182 but, rather, is founded on three other central elements: (1) deferred compensation that would channel a significant proportion of auditor compensation to this mechanism; (2) rotation of the audit partner, as currently required by law, or, better yet, rotation of the audit firm; and (3) conversion of the deferred compensation into shares of the corporate client following rotation and subject to a holding period that would expose the auditor to the risk of future price drops.

The first element of the scheme requires that a large proportion of the auditor’s total compensation be deferred (secured in the hands of a trustee). The precise proportion should be left to the parties to decide (a point to which I shall return), but it is important to keep in mind that, currently, over 50 percent of executive compensation is composed of stock and stock-based mechanisms. 183 As this Article demonstrated, this compensation structure has made executives quite zealous with regard to the firm’s value and, at times, overly aggressive in their disclosure practices. Therefore, an effective counter-scheme necessitates devoting a similarly large fraction of the audit fees to stock-based compensation.

Note that stock-based compensation involves the fundamental risk of fluctuation in share prices and, therefore, entails a cost. The literature has speculated that employees who receive options as compensation value each dollar’s worth of option at less than fifty cents. As such, those employees are

181. The framework suggested in the text must be accompanied by a safe-harbor rule set by the Securities and Exchange Commission. See infra Part III.B. The specific details of the arrangement adopted by each firm should be tailored to the firm’s needs as determined by its audit committee and the compensation consultants it hires. This procedure should be analogous to the process for setting executive compensation that is conducted by the compensation committee. Compensation committees often hire consultant firms such as Frederick Cook or Towers Perrin. See, e.g., Martin J. Conyon, Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom (May 2008) (unpublished manuscript, available at http://ssrn.com/abstract=1106729) (discussing the role of executive compensation consultants).

182. Since call options are the most common executive stock-based compensation, offering auditors put options seems the obvious method for creating an exact mirror image. Indeed, put-options would make the auditor benefit from revealing price-reducing information. While I do not necessarily object to the use of put options, I prefer to use the mechanism outlined in the text as the starting point of this discussion. In order for a proposal to survive public debate and be adopted by the SEC, I believe that it should be as uncontroversial as possible. Specifically, I do not want auditors who use this plan to be considered speculators, a title that sometimes attaches to traders who use price-perfecting mechanisms such as short sales and put options.

183. See supra Part I.A.
willing to receive much less in salary than they actually receive in stock options. This means that stock-based remuneration is more expensive to the firm than flat fees; the same is applicable to the mechanism proposed in this Article.

Nevertheless, corporate executives seem to be generally more vulnerable to this particular risk than typical auditors or accounting firms for several reasons. First, the executive is an individual whereas the auditing firm is a deep-pocket entity, making it much less risk-averse. Second, even if the audit partner as an individual were to be subject to a stock-based compensation mechanism, she could diversify her portfolio by accepting this type of compensation from several clients. Unlike the executive, therefore, all her eggs would not be placed in one basket. The diversification advantage is magnified at the accounting firm level. Although it protects auditors from vulnerability to risk, diversification does not undermine the incentives generated by the scheme to counter inflated share prices. Auditors will still have an incentive to maximize their profits from every single firm by ensuring that they do not receive shares with inflated values. Finally, the auditor compensation scheme suggested here requires shorter holding periods than those commonly used in executive compensation schemes, thus exposing

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184. Employees are typically risk averse. The value of stock-based compensation is highly contingent on risk factors and uncertainties far beyond the control of the recipient employees. Risk-averse employees therefore discount the value of stock-based compensation. Firms could substitute this type of compensation with a much lower payment in cash that does not entail uncertainty. The difference between the two alternatives is the cost, or the waste, involved in stock-based compensation. Several leading economists have tried to quantify this cost, concluding that, operating under reasonable assumptions about risk aversion and diversification, employees value options at "only about half of their cost to the firm." Brian J. Hall & Kevin J. Murphy, The Trouble with Stock Options, 1. ECON. PERSP., Summer 2003, at 49, 56; see also Hall & Murphy, supra note 8, at 211; Hall & Murphy, supra note 12, at 12–13. Another study estimated that, for every dollar worth of options, companies actually waste $0.64 to cover the risk premium for employees. Paul Oyer & Scott Schaefer, Why Do Some Firms Give Stock Options to All Employees? An Empirical Examination of Alternative Theories, 76 J. FIN. ECON. 99, 112–13 (2005). That employees tend to exercise their options before the expiration date also supports the notion that they are risk adverse. See J. Carr Bettis, John M. Biziak & Michael L. Lemmon, The Cost of Employee Stock Options 3 (Mar. 2003) (unpublished manuscript, available at http://papers.ssrn.com/abstract_id=376440) (finding that employees exercise options nearly five years prior to expiration and that employees in high-volatility firms exercise their options more than a year and a half earlier than employees in low-volatility firms).

185. See, e.g., Avraham D. Tabbach, Criminal Behavior, Sanctions, and Income Taxation: An Economic Analysis, 32 J. LEGAL STUD. 383, 392 (2003) ("Under the standard assumption of decreasing absolute risk aversion (DARA), that is, the assumption that individuals become more risk averse as they become poorer . . . .").

186. Diversification cannot alleviate the risk of the entire market fluctuations (so called systematic risk). For a discussion on market (systematic) risk and diversification, see Richard A. Brealey, Myers & Allen, supra note 37, at 154–72.

187. Systematic risk may be mitigated by indexing the proposed auditor stock based compensation to some market measure such as the average return of the other firms in the same industry. For a similar recommendation on indexing executive stock options see Berchuk & Fried, supra note 15, at 159–89.
auditors to less fundamental risk than that borne by executives.\footnote{Executives often receive equity-based compensation in addition to the cash amount of their previous salaries, and the switch between the two means of compensation is not often swift. This may be the result of the cash constraints on executives or the result of executive expropriation. This phenomenon makes equity-based compensation even more costly for shareholders. See Sharon Hannes, \textit{Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation}, 105 Mich. L. Rev. 1421, 1439–40 (2007).}

The second element of the proposed program requires rotation of auditors, either at an individual partner or firm-wide level.\footnote{Stock exchange corporate governance requirements also prefer audit firm rotation. See Final NYSE Corporate Governance Rules (approved Nov. 4, 2003) (to be codified at NYSE Company Manual § 303A) cmt. for section 303A.07(c)(3)(A), available at http://www.nyse.com/pdfs/finalcorpgovrules.pdf \textquoteleft\textquoteleft[T]he audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself.\textquoteright\textquoteright,} The Sarbanes-Oxley Act made auditor rotation mandatory, requiring that audit partners in charge of a client’s file not handle the same client for more than five years in a row.\footnote{15 U.S.C. § 78j-1(j) (2006) (SOX § 203); see also supra note 32.}

Section 207 of the Act also expressed an apparent preference for audit firm rotation in requiring the U.S. Comptroller General to “conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms.”\footnote{15 U.S.C. § 7232(a) (2006). Mandatory audit firm rotation exists in some non-U.S. jurisdictions, including Austria, Italy, Brazil, and, partially, Singapore. It was previously the norm in Spain and Canada. See U.S. GEN. ACCOUNTING OFFICE, \textit{PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION}, GAO-04-216, 48 (November 2003), available at http://www.gao.gov/new.items/d04216.pdf [hereinafter GAO, \textit{POTENTIAL EFFECTS}].} Unlike audit partner rotation, however, the audit firm rotation requirement has never been made mandatory;\footnote{In compliance with section 207 of the Sarbanes-Oxley Act, the U.S. General Accounting Office conducted an extensive survey of mandatory audit firm rotation and concluded that “the costs of mandatory audit firm rotation are likely to exceed the benefits” and suggested postponing the decision on mandatory rotation. See GAO, \textit{POTENTIAL EFFECTS}, supra note 191.} perhaps this will have to wait for the next corporate crisis.\footnote{One of the explanations given by the GAO for not making audit firm rotation mandatory was that it was necessary to first assess the full impact of the Sarbanes-Oxley reforms, since these reforms could be sufficient and serve as a proper alternative to audit-firm rotation. \textit{Id.} at 43. My guess is that insufficiency could be proven, if at all, only after another crisis occurs.}

The relevant literature presents a simple rationale for requiring audit rotation: without rotation, the auditor may develop a relationship with the firm and its executives that may compromise its ability to conduct the audit and scrutinize the financials. Furthermore, a new auditor ensures a fresh pair of eyes, whereas a long-time auditor might eventually fall asleep at the gate, especially if there have been no warning signs indicating that something is amiss for a number of years.\footnote{The potential benefits of long auditor tenure are the learning effect of prolonged audit services and the enhanced incentives to develop firm specific audit capabilities. Provisions calling for mandatory audit rotation have been debated intensively even before the Sarbanes-Oxley legislation, but most of the available empirical evidence is not conclusive. See, e.g., Richard Fairchild, \textit{Auditor Tenure, Managerial Fraud, and Report Qualification: A Game-Theoretic View}, 2004 corp. Gov. 97, 103.} Although there are benefits to long auditor
tenure such as familiarity with the business and increased willingness to make client-specific investments, some regard the advantages to audit rotation as capable of outweighing the benefits of protracted audit tenure.  

While the above-mentioned advantages are important, rotation itself is most crucial to my proposed mechanism because the scheme requires that the auditor be allowed to divest its stock-based compensation only after it has ceased to provide services to the firm. This requirement would give the auditor an incentive to flush out problems immediately, while still in the firm’s service, so as to prevent the possibility of a price drop in the value of its compensation after it is no longer auditing the company and can no longer conceal financial problems.

Since audit partner rotation was recently made a requirement under law, this Article’s proposed model would not necessitate changes to the existing audit partner tenure. However, the mechanism presented here would be best applied as an ambitious overall scheme covering the remuneration of the audit firm in its entirety, which would require audit firm rotation. Firm rotation is preferable here because loyalty between partners in the same accounting firm could operate against the incentives to uncover fraud and misreporting. In addition, it is harder to monitor the incentive scheme of the individual audit partner within her audit firm than the audit fee paid to the firm. Finally, the audit firm is a much better risk-bearer than the audit partner, due to its greater wealth and diversification ability. Nevertheless, since Sarbanes-Oxley did not mandate audit firm rotation, arguably because audit firms hate to lose clients, it is quite plausible that the scheme proposed here would have to be tailored to apply to the audit partner and not the audit firm.

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Approach, 5 IIFAI J. AUDIT PRACTICE 42, 42 (2008) (considering the effect of auditor tenure on auditor performance and discussing two competing effects—“the ‘learning curve’ effect” and “the ‘loss of independence’ effect”). One would expect that the beneficial learning effects would be especially strong in the first few years of the tenure while the harmful effects of prolonged tenure would become especially strong down the road. Indeed, at least one study found that auditor performance is weaker in the beginning of its tenure but also in cases of extended auditor-client relationships. See Mark Schelker, Auditors and Corporate Governance: Evidence from the Public Sector (CREMA Working Parker Series, Paper No. 2008-05, 2008), available at http://ssrn.com/abstract=959392 (testing auditor performance in mandated auditor rotation cases in the public sector and suggesting that mandatory audit rotation is advisable for public firms as well).

195. See GAO, POTENTIAL EFFECTS, supra note 191, at 13–14, 33–48 (describing minority views of institutional investors that supported audit firm rotation).

196. A common rationale for resistance to audit firm rotation are that “the additional financial costs and the loss of organizational knowledge associated with audit firm rotation, as well as the current reforms being implemented, may negate any benefits of rotating auditors.” J. Whitley, Audit Firm Rotation Not Yet Required, INTERNAL AUDITOR, Feb. 2003, available at http://findarticles.com/p/articles/mi_m4153/is_1_61/ai_n6152494/.

197. Some of the current audit-client relationships are amazingly long, and both parties involved are quite proud of this connection. See, e.g., General Motors Co., Proxy Statement (Form DEF 14A), at 24 (Apr. 21, 2001), available at http://www.sec.gov/Archives/edgar/data/40730/000089016301000190/0000890163-01-000190-0001.txt. (“Deloitte & Touche LLP
The Introduction to this Article proposed a plan allowing a maximum tenure of three years, during which the audit firm (or audit partner) defers a certain fraction of its compensation until it signs and certifies the last auditing report. Following such final certification, the auditor (or the relevant partner) would receive shares in the firm of a value equivalent to the amount of deferred compensation based on the market value of those shares at the time of issuance. Thus, if the price per share on the day after the release of the last audited report by the issuer is $30 and the deferred compensation is $30 million, then the auditor (or the partner) would receive one million shares. Those shares would then be restricted and could be sold only after a holding period long enough for any financial irregularities to emerge yet short enough that the auditor would not assume an unreasonable risk.

This example illustrates the third element of the proposed plan, namely, the conversion of the deferred compensation into restricted shares in the corporate client following auditor rotation. Conversion following rotation and the holding period requirement place the auditor in a long position for a substantial period of time, thus creating incentive for the auditor to reveal any information that artificially inflates share value before conversion and to do all it can to prevent postponement of bad news until the period following conversion. This effect would be magnified by compensating the succeeding auditor under the same scheme; the new auditor would therefore be similarly motivated to reveal any problematic matter left behind by the previous auditor.

An important exception to the regular operation of the proposed plan is an Enron-like scenario in which the firm collapses and the value of the shares drop to practically zero. In such an endgame scenario, the incentive plan set forth in this Article would arguably backfire since the auditor would lose all her compensation if she revealed the status of the firm. To remedy this, if the corporation experiences bankruptcy, delisting from the stock exchange, deregistration by the SEC, or other major failures so designated in the trust agreement, then the trustee would release the deferred compensation to the audit firm as a cash payment, preventing the perverse incentive of the endgame scenario mentioned above.

Aside from these rare occurrences, however, the auditor would become a shareholder of the firm following the termination of its services. A holding period for the shares is, of course, vital because it means that the auditor bears a risk that information it did not force the firm to reveal will slip out and harm its

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has audited the Corporation’s books annually since 1918.”). Note that a widespread usage of the advocated scheme would mean that many more clients would be up for grabs. Hence, the fear of losing clients as a result of the proposed scheme is not truly warranted.

198. A three-year term of service for an audit firm is not unique. In a survey of 4720 U.S. public audit firms, 680 of the firms had provided services three years or less. Gul, Jaggi & Krishan, supra note 154, at 31 tbl.2. The median audit tenure for the entire sample was seven years. Id. at 16.
compensation. The downside of the holding period is that it exposes the auditor to the risk of fluctuations in firm value unrelated to misreporting. Under the proposed compensation scheme, prior to the holding period and throughout the auditor’s term of service, the auditor does not shoulder the risk of market fluctuations in the firm’s value. Because the auditor receives its deferred compensation in shares based on their market price following termination of its service to the corporation, previous stock price variations do not affect the overall value of the auditor compensation package ($30 million in the above example). The number of shares the auditor receives will be set with this goal in mind, and it will thus receive fewer shares if the price per share increases and more shares if the price per share drops. This means that the auditor bears no investment risk during the period it works for the firm, but must still be alert to any misreporting that could artificially inflate the value of the shares and could then backfire when it can sell its shares.

Only during the holding period, which comes after the auditor finishes its services to the firm, does it become subject to the risk of fluctuation in firm value and to market risk in general. It is important to note, however, that the holding period under the proposed scheme could be shorter than the typical period during which employees are required to hold on to equity-based remuneration, since the latter is intended to both retain employees and encourage prolonged employee effort. The holding period in this case is required merely to ensure that information concealed during the period that the auditor worked for the firm is given enough time to leak out. Moreover, a shorter holding period leads to less risk-exposure and, consequently, makes the scheme less expensive (relative to employee stock-based compensation) for the corporation and, indirectly, its shareholders.

Finally, the proposed arrangement produces not only an incentive for the auditor to fight against artificial inflation of share prices, but also an incentive to artificially deflate share prices. The auditor, however, does not work in a vacuum. Rather, it negotiates and scrutinizes reports that are prepared by corporate executives motivated by equity-based compensation. Two sophisticated parties acquainted with the true state of the corporation and the appropriate accounting treatment would have opposing interests. The managers would benefit from artificially inflated stock prices while the auditor would benefit from just the opposite. This appears to be a level playing field, unlike the current imbalance with interested executives on one side and independent auditors on the other. Auditors do not determine the future direction of the

199. Scholars commonly argue that options are “golden handcuffs,” which help firms preserve their workforce and prevent attrition. Options undoubtedly do have this quality, as they usually vest gradually, normally over a four-year period, which makes it worthwhile for workers to maintain their positions at the firm. See Hannes, supra note 188, at 1429.

200. For a discussion on equity-based compensation, see supra Part I.A. For a discussion of audit-client negotiations, see supra Part III.A. See also Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53 (2003).
firms they audit; they are involved only in the firm’s disclosure process. Securities law prohibits directors and officers from short sales of the company’s securities,\(^{201}\) a restriction that stems from the fear of corporate executives being incentivized to harm the value of the firm they run. Auditors, however, do not run the company, and thus, their incentive to block disclosure of information that will artificially inflate firm value will not have similar consequences if acted upon.

The proposed compensation scheme raises additional issues that must be considered. Prior to any discussion of this issue, however, it is necessary to consider the safe harbor rule mentioned earlier. For in the current absence of such a safe harbor, the proposed plan is simply illegal, and any attempt to adopt it would be futile.

**C. The Need for a Safe Harbor Rule**

Current securities law, which requires auditor independence, bars the possibility of adopting an auditor compensation regime of the type suggested by this Article.\(^{202}\) This bar should be lifted because the proposed scheme supports the purpose of securities regulation by enhancing the auditor’s performance as gatekeeper. Auditor independence is a tool meant to preserve the auditor’s integrity and should therefore not exclude the scheme which is meant to detach auditor incentives from perverse managerial incentives.\(^{203}\)

The auditor independence regulation sets forth a general standard of independence and then specifies a variety of applications of the general standard.\(^{204}\) Both the general standard and, even more so, the specific applications prohibit the compensation scheme proposed here. The general standard states that the SEC will not recognize an accountant as maintaining independence if the SEC “would conclude that the accountant is not . . . capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement.”\(^{205}\) Objectivity can be impaired because the auditor and its client have either mutual or conflicting interests.\(^{206}\)

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201. Securities Exchange Act of 1934, § 16(c), 15 U.S.C. § 78p(c) (2006) (“It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal: (1) does not own the security sold . . . .”). See HAZEN, supra note 137, at 65–68 (discussing the short-sale prohibition).


203. The purpose of the independence regulation is outlined in the Preliminary Note to § 210.2-01. Id. § 210.2-01(1) (“Rule 210.2-01 is designed to ensure that the auditors are qualified and independent of their audit clients both in fact and in appearance.”).

204. Id. § 210.2-01 (“This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section.”) (emphasis added).

205. Id. § 210.2-01(b).

206. Id. § 210.2-01(2) (“In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service” compromises auditor
Deferring a portion of the auditor’s compensation and instituting a
commitment to purchase restricted shares in the audited client corporation
could be interpreted as violating the objectivity requirement. Note, however,
that the proposed remuneration scheme creates a conflict primarily between the
audit client management and the auditor. Moreover, the conflict that arises is a
constructive one because it counterbalances the problematic incentives
produced by the typical executive compensation schemes. Indeed, this conflict
is the crux of this Article and its scheme.

Debating the interpretation of the general standard may be unnecessary,
however, because the specific prohibitions set by the independence requirement
also prevent the adoption of the advocated arrangement. The auditor payment
scheme appears to violate at least three of the specific conditions for auditor
independence prescribed by regulations. First, the rule states that auditor
independence is prejudiced when there is “[a]ny loan . . . to or from an audit
client.” 207 The deferred pay component of the scheme could be construed as a
loan to the audit client, thus undermining auditor independence. The rationale
behind precluding such loans is that they generate an auditor interest in the
client’s financial stability. In the proposed scheme however, the deferred
compensation is held by a trustee, so the financial stability of the client is not
an important concern for auditors participating in the scheme. 208 Second, the
rule provides that any investment, including “stocks, bonds, notes, options, or
other securities,” in the audit client constitutes a violation of auditor
independence. 209 Although the proposed compensation plan allows the auditor
to hold shares of the audit client only once it has ceased to provide audit
services, the prohibition in the regulation is also formulated broadly enough to
encompass a commitment to purchase shares in the audit client. 210 Finally, the
auditor independence rule bars payment of contingent fees. 211 This prohibition
might also forbid the advocated compensation arrangement because the
proposed compensation scheme ties the actual auditor fee to future contingencies relating to the client.

Inevitably then, the proposed gatekeeper compensation plan requires the
SEC to promulgate a safe harbor rule applicable in this context. 212 A safe
harbor rule sets forth conditions under which the Commission will presume that

207. Id. § 210.2-01(c)(1)(ii)(A).
208. See supra note 33 and accompanying text.
210. Id. § 210.2-01(c)(1) (“An accountant is not independent if, at any point during the
audit and professional engagement period, the accountant has a direct financial interest . . . in the
accountant’s audit client . . . .”).
211. Id. § 210.2-01(c)(5) (“An accountant is not independent if, at any point during the
audit and professional engagement period, the accountant provides any service or product to an
audit client for a contingent fee or a commission, or receives a contingent fee or commission from
an audit client.”).
212. For a general discussion of safe harbor rules, see HAZEN, supra note 137, at 47.
the law has been complied with. Tailoring the auditor compensation plan to accord with the terms of a safe harbor rule would ensure immunity from SEC prosecution for any deviation from the auditor independence requirement. In accordance with the principles of the proposed scheme noted in Part III.A, the safe harbor rule should specify the features of the plan that would be guaranteed SEC clearance. The particular details of each compensation arrangement, as well as the initial decision of whether to adopt it, should be left to the private parties involved.

The safe harbor could also prevent issuers from using the compensation scheme as a smoke-screen, when they actually have no intention of providing their auditors with powerful incentives to counter fraud and misreporting. For instance, the safe harbor should forbid auditors from hedging their exposure to the risk involved in holding on to the client firm’s shares throughout the holding period. Managers must also be prevented from timing their equity grants to circumvent the purpose of the proposed scheme.

D. Further Discussion of the Proposed Scheme

This Part discusses the proper ways of encouraging adoption of the compensation plan, advises the relevant board committees on how to avoid certain shortcomings of the plan, and explains the advantages of the plan as compared to a high-profile alternative reform proposal.

While the main purpose of the safe harbor rule called for above is to legitimize, enable, and ensure integrity in the use of the proposed compensation plan, regulators should also consider granting firms that do choose to adopt it certain exemptions from Sarbanes-Oxley.

There are at least three reasons to consider such exemptions. First, the Sarbanes-Oxley Act entails considerable costs, especially in its dubious section 404 containing an extensive and expensive requirement for assessment of internal controls. If improved auditor incentives, such as those generated by the proposed compensation scheme, can serve as a cheaper alternative to any of these measures, then it would be worthwhile to consider relinquishing some of the more expensive mechanisms. Second, exemptions can serve as an incentive for firms to adopt the scheme before it becomes a prevalent practice. The

213. Examples of safe harbor provisions include Rule 147 (exempting certain interstate offerings), Rule 175 (exempting forward looking statements), Rule 144 (exempting secondary market transaction from registration), Rule 10b-18 (stating that the announcement of a firm’s intention to repurchase shares serves as a safe harbor against Rule 10b-5 allegations); and a recent safe harbor created in Rule 14d-10(d)(2) (stating that approval of independent directors for compensation arrangements exempts such arrangements from the best-price rule in tender offers). See 17 C.F.R. §§ 230.144, 230.147, 230.175, 230.506 (2009).

214. For instance, the rule may require that the auditor not short-sell any shares of the client during the holding period.

215. Further analysis in the next Part elaborates on and accounts for this possibility.

216. See supra Part II.B.
literature on network externalities shows that issuers are generally wary of adopting novel legal arrangements until they become widespread.\textsuperscript{217} However, that acceptance should be encouraged because there are certain advantages to the plan that will not materialize until the scheme is widely applied. Once many audit clients have adopted the model, auditors could diversify away much of the risk it imposes by taking on a number of different clients with similar plans. Furthermore, audit firms will feel less apprehensive about losing a client that offers such a compensation plan when many firms will use similar schemes with other audit firms eventually making them available as potential clients upon culmination of the tenure periods.

Third, existing shareholders may become a hurdle to the adoption of the new scheme because they have sub-optimal incentives to adopt a compensation plan that improves the accuracy of share prices. Existing shareholders sometimes benefit from inflated share prices at the expense of creditors and future shareholders.\textsuperscript{218} However, shareholders' low incentives to adopt the scheme could be counterbalanced by offering them exemptions from expensive regulation.\textsuperscript{219} Accordingly, regulators may see fit to add additional exemptions from other SEC rules, which would make adopting the arrangement more attractive to issuers, at least until it becomes prevalent amongst firms.

In addition to these regulatory inducements, market forces could also encourage companies to adopt the proposed plan. To begin with, institutional shareholders and banks hold large stakes of equity and debt and are therefore vulnerable to misreporting and inaccurate share prices.\textsuperscript{220} Given that the proposed gatekeeper compensation plan could ameliorate the problem, these powerful market players should use their influence to support adoption of the

\textsuperscript{217} See Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (or "the Economics of Boilerplate"), 83 Va. L. Rev. 713 (1997) (discussing the effect of network externalities on innovation and optimization of corporate contracts); Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757 (1995) (suggesting that legal products may be network products that provide much of their benefits only when they are widespread); see also Sharon Hannes, Corporate Stagnation: Discussion and Reform Proposal, 30 J. Corp. L. 51 (2005).

\textsuperscript{218} See supra Part II.C.

\textsuperscript{219} Recall also the managerial power theory that argues that managers control the mechanisms that set their pay and thus avoid optimal incentives to improve performance. See Berchuk & Fried, supra note 15, at 159–89. This power can spill over to the mechanisms that set auditor pay as well.

\textsuperscript{220} Despite corporate scholars’ almost exclusive focus on shareholders and institutional investors, recent studies have shown that banks play a monitoring role that improves corporate governance. See, e.g., Joanna M. Shepherd, Frederick Tung & Albert H. Yoon, What Else Matters for Corporate Governance?: The Case of Bank Monitoring, 88 B.U. L. Rev. 991 (2008) (finding evidence that banks serve a monitoring role that improves firm value); Elif Sisli, Monitoring By Affiliated Bankers on Board of Directors: Evidence from Corporate Financing Outcomes (Nov. 15, 2006) (unpublished manuscript, available at http://ssrn.com/abstract=973973) (showing that banker-directors whose banks have outstanding loans perform an important monitoring role on a company’s board of directors).
advocated plan. The same holds true for third-party proxy advisors like the RiskMetrics Group (formerly ISS: Institutional Shareholders Services). Because good corporate governance is a priority for advisors, they can use their leverage to advocate for the proposed plan. For example, advisors could show greater leniency towards certain managerial-sponsored proposals when their adoption will be accompanied by the adoption of the mechanism proposed in this Article.

Internal corporate bodies, especially board of directors audit committees, will also play a crucial role in the decision whether to adopt the proposed plan. The independent directors on such committees must understand that, as outsiders, they have limited insight into the intricacies of the auditor-client negotiations. Therefore, their oversight role should concentrate on creating the right incentives for the auditor in its relationship with the corporation and its financial officers. In my view, the proposed plan can be used to calibrate such incentives. Each audit committee should decide whether the plan is suited to its corporation and, accordingly, adjust the plan to fit the firm’s particular characteristics (including the compensation structure of its executives).

Moreover, the audit committee, together with the compensation committee, will have an important role to play in overcoming certain difficulties inherent in the proposed plan. The timing of managerial stock-option grants and their realization must not undermine the auditor compensation plan. For instance, if managers receive the stock option grant soon after the firm’s current auditor (compensated as advocated in this Article) issues its final audit report and exercise their options before the next auditor issues its final audit report, they could get away with inflating share prices in the interim period between the two reports. This, of course, runs counter to the objectives of the proposed gatekeeper compensation plan and should be prevented.

The audit committee would have yet another important function in preventing auditors from trying to build a reputation of not working diligently, despite receiving equity-based compensation. If auditors were to be hired

221. Evidence suggests that corporate fraud occurs often in firms with much leverage, indicating that banks and other creditors are the frequent victims of disclosure manipulation. See, e.g., Patricia M. Dechow et al., Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 CONTEMP. ACCT. RES. 1, 21 (1996).

222. Proxy advisory firms provide services to investors in connection with shareholder voting. These firms, which typically operate on a subscription basis, research proxy issues, issue voting recommendations, and assist institutional investors in formulating voting guidelines. For a discussion of proxy advisors role and its influence on the shareholder franchise (typically institutional shareholders), see e.g. Stephen J. Choi, Jill E. Fisch & Marcel Kahan, Director Elections and the Role of Proxy Advisors, 82 S. CAL. L. REV. 649, 657 (2009) (“With the growing importance of the shareholder franchise, the influence of proxy advisors has received increased attention. ISS, in particular . . . being able to sway up to 30 percent of the vote in any particular proxy contest.”); William J. Holstein, Is ISS Too Powerful? And Whose Interests Does It Serve?, BNET: THE CORNER OFFICE, Feb. 7, 2008, http://blogs.bnet.com/ceo/?p=1100&tag=content;col1.
directly by the firm’s managers (who may fancy auditors with such reputation) such a scenario could result and would pose a significant threat to the objectives underlying the arrangement set forth in this Article.

Importantly, the advocated compensation scheme does not overcome the rare problem of auditor corruption. A corrupt auditor could simply accept a side payment that would eliminate any favorable incentive generated by the compensation plan. Most auditors, however, are far from corrupt and would never accept such a side payment or knowingly cooperate with dishonest managers. Nonetheless, the underlying rationale of the proposed plan rests on the notion that even honest auditors are human beings and their incentives should be calibrated to support the goal of accurate financial reporting.

Before concluding the discussion, it seems imperative to compare the advantages of this Article’s reform proposal with an alternative reform proposal aimed at improving auditors’ performance as gatekeepers. One major proposal suggests enhancing auditor exposure to legal liability. Simply put, the Supreme Court’s current interpretation of the securities regulation leaves little opportunity for public shareholders to sue auditors for failing in their duties.

Accordingly, it has been suggested that either the judicial interpretation or the

223. See Coffee, Gatekeeper Reform, supra note 4, at 345 (recognizing the problems caused by corrupt managers while tellingly not arguing that auditors are also corrupt); Max H. Bazerman, Research in Action: The Impossibility of Auditor Independence, in ORGANIZATIONAL BEHAVIOR (L.K. Stoh, et al., eds., 2002) (suggesting that the fundamental problem with auditors is not corruption but psychological bias resulting from various self-serving biases).

224. As discussed supra Part III.B, this type of incentive-based compensation is currently prohibited by law. One could wonder why such compensation for auditors did not evolve prior to the imposition of this prohibitive regulation. I do not believe, however, that this is a fair question. Incentive-based compensation, which is currently the norm in many branches of the economy, is a relatively new phenomenon. See Lemieux, Macleod & Parent, supra note 173. Therefore, the inability to adopt incentive-based compensation has only recently become relevant.

225. See infra Part II.A.

226. Other relevant reforms that I do not discuss here are those aimed at minimizing the adverse side-effects of management equity compensation. See Jesse M. Fried, Hands-Off Options, 61 VANDERBILT L. REV. 453 (2008) (suggesting a new design for option grants that overcome the manipulation incentive as well as managers’ ability to abuse inside information). The most obvious downside to this type of reform, which my proposal does not suffer from, is the impairment to the compensation committee’s discretion and flexibility in setting executive pay.

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regulation itself should be amended to increase auditors’ potential liability. Liability and incentive compensation are two mechanisms that, under certain circumstances, can achieve similar results, although the costs and methods are quite different. For brevity’s sake, I will not delve into these significant differences and will only flesh out the unique advantages of the compensation plan proposed here that are not shared by an enhanced liability approach.

As noted earlier, the cases of fraud and financial restatements that have been exposed constitute only the tip of the iceberg. Often, fraud and accounting mistakes are unobservable and particularly difficult to prove in the courtroom. Business and financial climates change quickly, and economy-wide or business-specific downturns can wash away the traces of imprecise disclosures involving fraud. In other instances, accounting sugar-coating and whitewashing fall within the scope of legitimate accounting discretion and therefore never generate legal liability even when the legal standard favors plaintiffs. The cost to the economy of the consequent inflated and inaccurate share prices is enormous.

The unique benefits of the incentive compensation scheme are most pronounced where other mechanisms, including legal liability and reputation, fail. Even behind the closed doors of the auditor-client negotiations, where both sides possess private information that can never be verified in court, the auditor will have an incentive to avoid inflated earnings, which would ultimately impact future share prices. Even if no indications of fraud or accounting error can be proven, share prices would drop and cause the auditor to share the losses borne by future shareholders. Put differently, the same reasoning that justifies equity-based compensation for corporate executives also justifies equity-based compensation (of the type suggested in this Article) for auditors. Both arrangements generate performance incentives even when no one is watching.

Finally, I wish to address two concerns that the proposed scheme raises. First, recall that under the plan, equity compensation is provided to the auditor based on the market price of the firm’s shares following the auditor’s certification of the final financial statement. Thus, for the period of years in which an auditor is employed by a particular corporation (three in the above example), share prices do not directly affect the auditor incentives. Does this mean, however, that the plan creates no incentives for the auditor until the auditor starts working on the final audit? If this were the case, then we should not anticipate any improvement in the accuracy of disclosure and share prices until the last year of the auditor’s tenure. But while it is possible that the

228. See, e.g., Coffee, supra note 30, at 309 (“A more relevant public policy agenda should also: (1) increase the legal threat to deter acquiescence in managerial fraud . . . .”). For an international comparison of the current trends in auditor liability claims see Jagdish Pathak, Liability of Auditors: A Growing Concern, 4 J. CPA J. AUDIT PRAC. 7 (2007).
229. See, e.g., Kahan, supra note 41; Jensen, supra note 16; Shleifer & Vishney, supra note 41.
compensation scheme would cause the auditor to put extra emphasis on the final audit the plan still generates beneficial incentives throughout the tenure period. Financial representations are based on the auditor’s long-term interpretation of the accounting standards and its accounting policy given the specific circumstances of the client. An auditor must, therefore, be alert to any misreporting from the very beginning of its relationship with the client. Otherwise it would be hard pressed, in the audit-client negotiations, to maintain the status quo disclosure policy.

Second, the plan features a holding period during which the auditor is required to hold the shares of its client at least until the next auditor issues its first audit report. This feature is especially important because it means the auditor bears the risk that any hidden problem with the financial statements during its tenure period will at some point impact the share-prices during the holding period, when it is no longer in charge of certification. The longer the holding period, the higher the chances that hidden problems will surface and affect share prices. This notwithstanding, however, prolonged holding periods should be avoided to minimize the delay in payment to the auditor and the unrelated market risk created by an excessively long holding period. Importantly, the limited holding period does not mean that the auditor does not have to worry about errors in its audit that normally would not surface during a short holding period. The reason is that the next auditor, assuming it is offered a similar compensation structure, will have to do its utmost to uncover problems that the previous auditor failed to expose. Otherwise, the new auditor would have to bear the risk of the firm’s share prices being adversely affected during the holding period of its own compensation scheme.230 With this in mind, the first auditor will also be induced to fend against all financial misrepresentations, including those that may emerge after the holding period.

CONCLUSION

This Article has argued that the inability to observe audit quality justifies drafting an incentive contract that current law does not allow for. The Article has considered the costs and benefits of one such possible incentive scheme. Under the compensation plan advocated here, auditors would commit to becoming future shareholders of the corporation after they have concluded their tenure. And as future shareholders, they should seek to guard against financial misrepresentations that artificially and temporally inflate the value of the shares they would purchase from the client. Over time, share prices will incorporate any adverse information that was not properly disclosed in the financial statements. Thus, the compensation arrangement automatically holds the auditor accountable for any misrepresentations that are made. The same unique benefits that have led to the widespread adoption of executive incentive

230. The same holds true for all subsequent auditors.
compensation, therefore, support with equal force the implementation of auditor incentive compensation.

This Article did not argue that the proposed plan is suitable for all firms, but its clear advantages should cause the regulator to allow and support it. Mid-cap and large-cap firms with stable performance and large auditors (mostly Big 4 audit firms) seem most suited to this plan. And once the regulator would be willing to accept the proposed scheme, major market players, such as institutional investors, lenders, and proxy advisors, that are interested in the integrity of share prices and good corporate governance should help persuade firms and their auditors to adopt plans suited to their particular needs.

Before concluding, I wish to stress that the proposed auditor fee structure is only one elaborated example of the suggested concept of gatekeeper incentive pay. As the title of this Article suggests my mission is more ambitious; my intention is to provoke a debate about gatekeeper compensation at large. While auditors are important gatekeepers, they are certainly not the only ones to hold this capacity in the public capital markets. At least two other candidates for my compensation scheme—outside legal counsel and credit rating agencies automatically come to mind.

Without any intent to exhaust the discussion on this subject, it seems from the outset that the type of pay advocated by this article does not fit the first group but may be customized to fit the latter. This is true although both groups have been identified in the literature and legislation as gatekeepers and, just like auditors, they both receive their pay from their clients which may compromise their role as gatekeepers in the absence of my plan.

Unlike auditors, however, outside legal counsel do not conduct any independent inquiry into their clients. Outside counsel almost always receive all their information from the client. Under these circumstances, an incentive pay structure that is meant to cause lawyers to flush out wrongdoing may be counterproductive. Clients might become reluctant to share information with their attorneys and the role of the lawyer as fiduciary may be jeopardized to a large extent.

This analysis does not necessarily hold true for credit rating agencies. These agents are by no means fiduciaries of their clients. Instead, they perform an independent analysis of their clients’ ability to return their debt. Under these circumstances the incentive scheme advocated herein for auditors may be adapted for rating agencies as well.

Adaptation, however, is far from simple for a few reasons. For one, the current pay scheme of rating agencies is different than auditors. Rating agencies receive the lion’s share of their compensation at the outset when the debt is issued and the initial rating is set. The proposed auditor compensation scheme, however, builds upon constant annual pay. Second, while auditors rotation (which is a requirement of the suggested program) is a concept that was raised in the past and was almost adopted independently of the suggestion
of this article, rating agencies rotation is a new concept that may be hard for the market to digest. Last, the rating agencies market is even more concentrated than the market for audit services and in the absence of competition and alternatives for the clients to choose from the proposed incentive pay scheme would not work well.

Returning to auditor compensation, there is good reason to believe that the need for the auditor fee structure advocated here will soon grow in urgency. Worldwide accounting standards have recently been revolutionized by the introduction of the International Financial Reporting Standards ("IFRS"). The most striking feature of these new standards is that all items in the balance sheet must be marked to market. Instead of the traditional use of historical prices, each firm now has the discretion to evaluate and assess the market value of its assets and liabilities and include this in its disclosure. Under the IFRS, executives, who already have an extensive amount of discretion in financial disclosures, gain even more freedom. Outside the United States, this augmented freedom does not pose a major threat, as foreign public firms tend to have a concentrated ownership structure with a controlling shareholder. Because controlling shareholders seldom sell their holding stakes, they have little reason to engage in financial manipulation (at least not of the type often witnessed in the United States). In contrast, U.S. managers are usually subject to a dispersed ownership structure without any controlling shareholder that monitors their actions and with generous equity compensation schemes that incentivize manipulation. The combination of these features with the IFRS could be catastrophic.

Thus far, the United States has yet to adopt the IFRS, but there has been rapid movement in that direction. On November 15, 2007, the SEC adopted a proposal allowing foreign firms that trade on the U.S. securities market to choose the IFRS instead of the traditional U.S. Generally Accepted Accounting Principles. In addition, the SEC issued a press release that raised the


234. See Coffee, supra note 1, at 204 ("[T]he controlling shareholder seldom, if ever, sells its control block into the public market.").

possibility of allowing all firms to similarly opt for the IFRS in the future. Even if full adoption does not materialize soon, some form of convergence does seem imminent. This implies that U.S. executives will soon have far greater discretion in drafting their firms’ disclosures and, in turn, auditors’ responsibility for defending against abuse will substantially increase. Innovative and well-crafted auditor incentive pay programs of the type advocated for in this Article could play a major part in alleviating these concerns.

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