ROLE OF WATCHDOG INSTITUTIONS IN CORPORATE GOVERNANCE
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No matter what other goods and services a corporation produces, it produces information and sometimes misinformation as well. The efficiency of managers’ funding and corporate control activity turn on their ability to collect, verify, analyze, store, and transmit relevant information. As the spate of recent scandals show, inside agents are often reluctant to share with corporate “watchdogs” and outside investors adverse information about a firm’s performance and loss exposures that financial markets need to price securities accurately.

Using the Golden Rule as a touchstone, this paper argues that flaws in the ethical codes of watchdog professions encourage their members to abet the manufacture of misinformation. In the U.S., the Sarbanes-Oxley Act of 2002 imposes new disclosure obligations on corporate officers and increases penalties they face for misrepresenting material facts. However, absent convincing evidence of malicious or fraudulent intent, auditors still need only affirm that figures reported derive from approved valuation procedures. Professional ethics do not require auditors to use statistical methods to test the quality of the information being certified against independent evidence or to express specific suspicions they may have about sources of bias. This asymmetry in the enforceable obligations of users and producers of accounting services is unhealthy. Within the accounting industry, it makes it possible for an unethical revenue rainmaker to advance more rapidly than an equally talented but conscientious employee. Penalizing scruples distorts the accounting industry’s lobbying strategy by promoting to high positions individuals who prefer to insulate from appropriate sanctions rents they can generate by abetting deceitful behavior. Until the ethical codes of all sectors of the watchdog industry firmly embrace their Golden Rule duties to avoid corrupting forms of compensation and to assure the economic meaningfulness of the income and net-worth figures corporations publish, watchdog professions will find it hard to garner the authority and prestige their members covet.

I. The Golden Rule of Corporate Governance

* This paper compresses and reframes Kane (2004).
While philosophers find it impossible to formulate universal moral principles, common-law theories of corporate contracting impose broad duties of competence, loyalty, and care on all stakeholders. These duties require insiders and outsiders alike to explore the economic perspectives of other stakeholders and to avoid doing net (i.e., insufficiently compensated) harm to any of them.

This is a principle of nonexploitation. It expresses a “Golden Rule of Corporate Governance.” Because it is impossible to build an information and control system capable of truly enforcing due compensation, the rule is only a counsel of perfection. However, it can serve as a touchstone with which to identify weaknesses in the incentive systems under which real-world corporations and watchdog institutions operate.

A firm’s internal incentive system is “evenhanded” or “impartial” if it minimizes temptations for its employees (including so-called independent directors) to engage in inefficient, dishonest, or exploitive behavior. The theory of principal-agent relationships transforms this ethical criterion for fairness into a condition of economic efficiency. The transformation leans on the proposition that in every contract “counterparties have incentives to reduce or control conflicts of interest so as to reduce the losses these conflicts engender [and]…then share the gains” (Jensen, 1994). Costs of principal-agent relationships (“agency costs”) are minimized when information and corporate-governance systems harmonize the marginal benefits and costs that managerial strategies and tactics confer on different stakeholders.

As the Golden Rule stipulates, incentive compatibility is achieved when information flows and enterprise contracts leave all parties unable to gain an advantage from other stakeholders by acting opportunistically. An enterprise whose incentive system offers specific employees an opportunity to pursue personal benefits or short-run advantages at the expense of unwilling or uninformed others may be characterized as “institutionalizing a temptation to do wrong.”

Because insiders have an inherent informational advantage over outside stakeholders, the Golden Rule requires the governance systems empower putatively independent parties to monitor their behavior and reports. Accounting standards and corporate controls are supposed to flag irregularities for close review by inside and outside “watchdogs.” A watchdog’s job is:
“to probe, to uncover, to check, to expose, to unveil, to question, to interrogate . . . to disbelieve, until that which we are being told can be proved to be true.” (Forsyth, 1999).

Watchdogs lower stakeholder coordination costs by designing and enforcing disclosure requirements and by policing managerial behavior. Internally, a firm’s board of directors and auditing team are tasked with developing sound and comprehensive reporting safeguards and detecting deviations from them. Externally, their work is tested by other specialists. These external watchdogs include: outside auditors, stock analysts, credit-rating agencies, standard-setting professional organizations, regulators, government examiners, law-enforcement personnel, and information media (the “press”).

The Golden Rule requires that outside stakeholders and participants in the market for corporate control regularly test watchdog performance. This paper emphasizes that watchdogs face incentive conflicts of their own and that these conflicts are only partially mitigated by reputational concerns and codes of professional ethics that frown on dishonesty.

II. Discouraging and Overcoming Disinformation

Financial information is perfectly true and timely only if it conforms to all of the facts that are knowable at a given time. Markets whose prices reflect all true information and ignore disinformation show what economists call strong-form informational efficiency. Financial disinformation (D) consists of statements whose spurious elements or false implications are shaped for the express purpose of preventing less-informed counterparties from grasping the full-information or “inside” value (Fi) of a particular contract i. By design, disinformation is negatively correlated with unfavorable information that insiders want to hide from outsiders. The goal is to keep adverse elements of private information known only to the disinformers.

Disinformation can account for empirical evidence (summarized by Dimson and Mussavian, 1998) that security returns show weak positive correlation over weekly and monthly horizons, but display slight negative serial correlation over longer horizons. Abstracting from the filtering activity of watchdog institutions, the market value Vi of any contractual obligation or portfolio i differs from its full-information value by a wedge of “outside” value [wi(D)] which disinformation can temporarily engender:

\[ V_i = F_i + w_i(D) . \]
To sustain the wedge of counterfeit value, decaying disinformation must be reinforced and re-energized over time. As long as the bolstering effort is successful, short-horizon returns correlate positively. However, because disinformational effects often collapse with a bang, the correlation reverses over longer periods.

Figure 1 illustrates the information filtering process. Ideally, watchdogs help outside investors to sift corporate disinformation out of their information sets. Unfortunately, in practice, watchdogs sometimes deliberately or inadvertently certify false or misleading statements.

It is reasonable to assume that the marginal cost of acquiring inside information declines as the information ages. Unfavorable information on any party that is uncovered by any contractual counterparty diffuses over time to all other interested parties. The more parties that acquire the information, the larger number of routes through which a still-uninformed outsider can obtain it. Also, the juicier the dirt, the quicker it spreads as rumor on the gossip mill. Recent rumors are captured, investigated, and (if verified) disseminated at a cost by the information specialist. Eventually, previously hidden information becomes common knowledge that almost anyone can verify at virtually zero cost.

Individuals can counter the effects of disinformation in three ways: by directly acquiring incremental information for themselves through reading and research; by relying on professional information specialists for incremental intelligence; and by reaching out for help from law-enforcement officials and legislators when evidence of fraud surfaces. Whenever a contract is initiated or renewed, every party to which the contract assigns an informational risk has an incentive to reassess the situation: to sort through and correct information known to be supplied by incentive-conflicted sources. The strength of this reassessment incentive can be measured by the difference between the marginal benefits of challenging potential disinformation and the marginal costs of the ex ante and ex post effort it takes to mount this challenge.

Incentive support for disinformational activity comes from forms of compensation – such as short-dated stock options – that allow insiders to profit disproportionately from artificially boosting measures of short-term performance. Such contracts tempt insiders to believe that they can realize gains while disinformation remains effective and use a portion of the proceeds to employ high-powered legal assistance to escape formal blame.
Disinformers often put political or economic pressure on information specialists to secure their help in concealing or misrepresenting unfavorable information. Users of information must always allow for the possibility that a particular specialist may be innocently, negligently, or even corruptly making disinformation more credible.

The more transparency an information system displays, the more successfully outside monitoring and penalties for issuing false and inadequate disclosures can mitigate the potential harm that disinformational activity might introduce. Issuers of securities have incentives to release favorable inside information promptly, but to conceal or distort the meaning of adverse events as they occur. This asymmetry implies unfavorable information tends to accumulate before its release, so that [as Bakshi and Madan (1998) find for U.S. equities] sudden large downward movements in asset prices are somewhat more frequent than sudden large asset price increases.

The gross social value of the professional information industry lies in reducing mispricing by discouraging and refuting disinformation. Incentive support for transparency comes principally from the size and uncertain incidence of penalties imposed _ex post_ by market forces and by the legal system if and when deceptive and false statements are found out. The desirability of transparency may be enhanced deliberately by increasing the budgets of governmental watchdogs or accidentally by scandal-driven decreases in the credibility of audited information. Either event reduces the marginal benefit of disinformational activity.

Disclosure standards are formulated and enforced by three layers of external watchdog institutions. The first layer of external watchdogs consists of professional information specialists: auditors, credit and investment analysts, and government officials charged with overseeing existing standards for reporting and disclosure. An intermediate layer consists of the entities—such as the Financial Accounting Standards Board (FASB)—that set the accounting standards that the first layer of institutions enforces. In the U.S., FASB-approved standards are called “Generally Accepted Accounting Principles (GAAP).” A third layer consists of information media whose employees—besides paraphrasing accounting reports—occasionally investigate the work of the first layer of watchdogs. In combination with academia and investigative arms of government, information media generate feedback to the standard-setters. They publicize defects in accounting standards and provide a forum within which to discuss ways of closing or narrowing loopholes that are deemed to violate cultural standards.
In most countries, refutational checks on disinformational activity are produced by overlapping private and governmental entities. There are two reasons for this. First private efforts to strengthen truth-telling incentives benefit parties that cannot easily be made to pay information suppliers for producing them. Producers of external benefits can seldom collect fair compensation without invoking the enforcement and dispute-resolution powers of the state. The existence of uncompensated externalities in watchdog activities make it hard for private information agents to deploy the optimal amount of monitoring resources. Second, joint responsibility makes it harder for corrupt managers to buy their way out of informational discipline. In view of these considerations, the Golden Rule suggests that neither governmental nor private cooperative entities should dominate the process of developing and enforcing disclosure standards.

For financial firms in the U.S., joint public-private regulation is in fact the norm. Federal and state agencies importantly supplement private accounting and credit-rating watchdogs in formulating and enforcing disclosure standards. These agencies seek to cover the costs of their activities through fees, taxes, fines, and civil lawsuits.

III. Ethical Standards for Information Production

The dilemma of private and public governance is that, at the margin and over short periods, it is often mutually profitable for corporate managers and their immediate watchdogs to hide adverse information. Given the size of corporate frauds being observed, the Golden Rule tells us that outside stakeholders deserve more complete accountability than can be fashioned from the accounting standards that auditors currently enforce and the resulting gaps in the information flows outsiders receive.

To determine whether a private or government enterprise is run honestly, outside stakeholders need accurate and timely information both about the adverse effects of the tactics and strategies that those in authority adopt and about their motives for adopting these procedures. Incomplete revelation must be expected (Bloomfield, 2002). Even ethical managers may have legitimate reasons to conceal important aspects of what they are doing.

Concealment may be labelled unethical (but not necessarily immoral) if it violates shared norms to which the subculture of a particular society, profession, or firm has firmly committed.
itself. Such norms express communal preferences and generate explicit and implicit ethical standards that constrain and redirect individual behavior. In ethically well-ordered cultures, actions by managers and watchdogs that greatly damage unknowing others bring personal “shame” and external disrepute onto those who perform them. Such societies reinforce their norms by subjecting particularly offensive behaviors to explicit and implicit governmental and commercial sanctions. However, when preserving one’s honor and reputation is a major goal, most individuals prefer to operate well away from bright-line legal boundaries of right and wrong.

Tolerating gaps in reporting and governance standards puts great pressure on managers’ character by giving them cover for acts that can harm any of the following stakeholders:

- stockholders
- creditors *qua* creditors
- customers generally
- guarantors
- taxpayers
- employees
- the economy.

This cover would be less worrisome if Securities and Exchange Commission, Federal trade Commission, National Association of Securities Dealers, and Federal Deposit Insurance Corporation investigations did not regularly determine that corporate managers, securities professionals, and bankers do in fact harm some of these others.

**Deviations of Ethical Subcultures from the Golden Rule**

Individuals develop their character and commit to personal values in overlapping cultural contexts. One of these contexts is the ethical subculture established by their profession, industry, or firm. The particular institutions that generate and promulgate ethical standards adapt to changes that related subcultures undergo over time. Around the world, parents, schools, churches, professional societies, news media, entertainment industries, and justice systems send distressingly mixed messages about what particular ethical limits the conscience of a business or governmental policymaker should respect. While societywide processes of standard-setting typically promote altruistic values—such as compassion, truth-telling, promise-keeping, and fair play—that condemn opportunistic behaviors, subcultures often countenance self-interested conduct that conflicts sharply with the goals of society as a whole. For example, in the nexus between investment banking and equity research or between mutual-fund management and
employees’ personal trades, corporate controls may fail to condemn behavior that exploits trust and market liquidity built up by honest others.

Hard-to-resolve conflicts exist between limits set by principled and practical standards of behavior. These conflicts allow a corporate manager or information agent to define its duties self-interestedly by drawing opportunistically from conflicting systems of business and governmental ethical standards (Jacobs, 1992).

It is convenient to label the duties implied by abstract or principled standards as ethics one and the often-looser obligations imposed by practical standards that hold sway in subcultures as ethics two. Ethics one are hypothetical rules and values that --in a given society-- you and I would prefer that others would accept as governing right and wrong when they are faced with a given conflict in interest. Ethics two are the rules and values that we would accept as constraining ourselves if we would actually be presented with the same situation. This distinction may also be framed as “rules for others” and “rules for ourselves.” The Golden Rule acknowledges this duality and advises us to do unto others as we would have them do unto us. The rule—which plays a role in most major religions and cultures (Bruton, 2004)—defines a right conscience as one that would make managers’ “ethics two” rules identical with those of their “ethics one.”

As a guide to forming a right conscience in working life, the reciprocity criterion dictated by the Golden Rule tells individuals how to resolve incentive conflict. The Golden Rule offers a way to make principled choices of behaviors from diverse ethical guidelines. Although the standard for determining a clean conscience is permitted to be idiosyncratic, the Rule’s adherents have no reason to fear informational transparency. The Rule requires individuals to admit mistakes quickly, to compensate individuals for the harm caused, and to make a firm purpose of amendment. However, to gather incentive force, it must be supplemented by a substantial fear of private dishonor, public shame, or divine retribution. As and when these fears lose potency, civil and criminal laws and penalties must be designed to take their place.

IV. Dialectics of the Sarbanes-Oxley Act

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1 Formally, the Rule inserts a rational estimate of the welfare of counterparties on an equal basis into each individual’s own objective function.
Representative governments may be conceived as arenas in which lobbyists for diverse interests battle endlessly with one another. Every important battle ends in a temporary and loophole-ridden peace treaty. To understand the latest treaty and why it must eventually break down, one must understand the weaknesses that undermined the treaty it replaces. One must also appreciate the changing objectives, strategies, and relative strength of the different lobbies.

It is no accident that, in the modern U.S., incentive conflict in information production is controlled imperfectly. A strong lobby prefers loophole-ridden codes of watchdog ethics and a poorly enforced system of structural checks and balances (Zeff, 2002). In each election cycle, this lobby defends these codes against a counterlobby desiring stricter liability laws and tougher disclosure standards.

Flawed accounting standards and unresolved incentive conflicts expose the wealth of trustful users of corporate information to precipitous losses. When sizeable weaknesses in the nation’s system for vetting corporate disinformation have been concealed for a long while, their sudden revelation is bound to shake the confidence that investors and the press have in the reliability of financial reports and ethical codes. This decline in confidence raises the compensation that investors demand for bearing valuation and performance risk and embarrasses standard-setting institutions. By triggering these unpleasant phenomena, a series of outsized accounting and ethical scandals can—as indeed they did in the wake of the Enron, WorldCom, Parmalat, et. al. scandals of 2002-2004—kick off an urgent dialectical process of worldwide accounting and regulatory adjustment.

Analysts agree that aggressive interpretation of GAAP rules and government reluctance to ferret out and challenge unsupportable interpretations contributed to a decline in the reliability of corporate reporting in recent years. Cox (2003) and Crockett, Harris, Mishkin, and White (2003) explain how the growing importance of income from nonaudit services to accounting firms may have helped dishonest managers to persuade outside auditors to go along with questionable accounting decisions. Benston (2003) sees the gradual acceptance by the SEC and FASB of elements of projection-based fair-value accounting as particularly dangerous, in that this acceptance expanded managerial opportunities to cook their books in ways that permit outside auditors to wash their hands of their duty of objective verification. However, rather than abandon fair-value methods, it seems preferable to require that projections not be used unless auditors can adequately defend them by appropriate statistical methods.
The Sarbanes-Oxley Act of 2002 toughens restrictions on preferential loans and insider trading and strikes at the determinants of corporate incentives to block or delay the release of adverse information identified in Section II. Although a few of its provisions became effective immediately, many were routed through the Security and Exchange Commission (SEC) for followup team-building and rulemaking consistent with the purposes of the Act.

The Act may be conceived as a weapon that, if used expertly, would puncture the pipeline of disinformation in three places. The first prong took effect almost immediately. It increases the reputational and legal penalties that top managers, outside lawyers, directors, and auditors may expect to face if they are ultimately shown to have condoned or engaged willfully, knowingly, or carelessly in deceptive accounting. The second prong seeks to empower and incent internal watchdogs—directors and external auditors—to challenge untruths contained in tricky or aggressive accounting claims. The third prong shifts formal control of auditing standards at publicly trading companies from industry self-regulators to the SEC-appointed Public Company Accounting Oversight Board (PCAOB). Given pressure for Regulatory Capture, this prong promises to need continual sharpening.

Accountants and managers seeking to preserve loopholes in reporting and governance controls exerted political and economic counterpressure on the post-enactment rulemaking process. Their counterpressure sought to undermine the effectiveness of the standards, penalties, and enforcement procedures the SEC finally installed, especially with respect auditor independence, attorney conduct, and off-balance-sheet transactions. One line of pressure focused on preserving the industry-controlled FASB’s responsibility for reporting standards, allowing this body to gently transform rather than to eliminate the reporting loopholes and incentive conflicts whose final shapes were still in play. A second line of pressure exerted a right to cull proposed appointments to the group (the PCAOB) that the Act charged with improving the auditing process.

The Act’s first and second prongs focus on the initial procreators of financial disinformation and place important Golden Rule obligations on corporate insiders. The first prong obliges public companies to disclose material changes in financial condition or operations in “real time” (section 409). In addition, a public company’s principal executive and financial

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2 Detailed analyses of the Act’s many provisions are available on the internet. (See e.g., Fried, Frank, et al. (2003) and Squire, Sanders, and Dempsey (2003).
officers must certify the material accuracy of the periodic financial reports their corporations
issue [section 302 and 401(a)]. Senior officials guilty of knowing or willful miscertification
would face large fines and a substantial prison sentence. Reinforced by whistleblower
protections and an increase in the SEC’s budget for investigating questionable reporting, this
prong promises to improve the accuracy of fair-value accounting by making top managers
answerable for knowingly supplying deceptive projections of future earnings or loss exposures.
The second prong requires corporations to describe their internal controls and to disclose
whether they promulgate a code of ethics for senior officers. It also introduces a series of
structural checks and balances designed to increase the effective independence and financial
competence of corporate boards of directors and their information-handling subcommittees.

The third prong calls for writing new auditing standards and delegates the task to the
PCAOB. The politics of selecting and influencing PCAOB members recalls Groucho Marx’s
acid characterization of politics as the “art of looking for trouble, finding it, misdiagnosing it,
and then misapplying the wrong remedies.” Lobbyists are bound to pressure the PCAOB to do
things: (1) to adopt as much as possible of the code of Generally Accepted Auditing Standards
(GAAS) previously established by the accounting industry, and (2) to avoid criticizing the ways
that Generally Accepted Accounting Principles (GAAP) established by FASB limit the
effectiveness of GAAS. Moreover, it will seem expedient to do these things, even though safe-
harbor defenses inherent in GAAP and GAAS lie at the root of the most-outrageous corporate
scandals of recent history.

Conforming to these principles and standards is by no means the same thing as conveying
transparency to outside stakeholders. Requiring auditors to certify merely that a corporation’s
reports conform with GAAP sidesteps the Golden Rule issue of investigating and certifying
whether the way the principles and standards are applied in particular reports truly and fairly
reflects economic reality (see Wolnizer, 1987). Until and unless the PCAOB refocuses the
auditing process on authenticating the economic meaningfulness of income and net-worth
calculations, the bluntness of this prong will reduce the penetrating power of the other two.

Across the chain of information production, the Sarbanes-Oxley Act and SEC rulemaking
have imposed vastly stronger Golden Rule obligations on investment analysts and corporate
insiders than on the accounting profession. Top corporate officials are now obliged to report
material events promptly and fully. Management must provide information that it believes is
necessary for an understanding of its off-balance-sheet arrangements and must quantitatively reconcile presentations of so-called “pro forma” information with comparable measures prepared according to GAAP. Attorneys representing public companies must report evidence of material violations of laws or duties to a firm’s CEO, chief legal officer, or board. Mutual-fund managers must publicly disclose how they vote their proxies. Investment analysts must certify that opinions they express in research reports accurately reflect their personal views and must disclose any specific payments that may have influenced their research. Because the informational benefits and costs of these provisions were not specifically estimated and weighed quantitatively by the SEC, as data on their compliance burdens accumulate, one must expect these issues to be revisited in subsequent rounds of lobbying by spokespersons for each class of obliged party.

V. Asymmetric Ethical Treatment of the Accounting Industry

Around the world, accounting professionals have traditionally softened the edges of accounting and litigation reform legislation (Zeff, 2002). Despite evidence of favoritism toward the accounting industry strong enough to force his resignation soon after the Sarbanes-Oxley Act was passed, former SEC chairman Harvey Pitt managed to stay in office as a lame duck long enough to oversee the precedent-setting first stages of the post-enactment rulemaking process. As a result, an opportunity to reshape the government’s response to investor dissatisfaction with inherited accounting standards and disclosure incentives was routed back through regulatory channels to the incentive-conflicted foxes whose willingness to mismanage the henhouse was the ultimate target of the exercise.

This experience shows that one of the weakest links in the chain of corporate governance and information control is an all-too-partisan SEC. SEC weakness reflects the strength of the accounting lobby. This lobby’s ability to exert political pressure traces ultimately to the rents that members of this highly concentrated industry can obtain by cleverly helping troubled firms and even rogue managers to conceal adverse information from outside stakeholders.

Roberts, Dwyer, And Sweeney (2003) disaggregate the profession’s clout into three parts: the size of the lobbying staff it maintains in Washington, DC; its capacity to generate information and research with which to build support for its legislative interests; and the financial resources it can contribute to the members of House and Senate committees that have
primary jurisdiction over accounting issues.

For each of the biennial election cycles of 1988-1996, Table 1 presents these authors’ estimates of the size of the campaign contributions channeled through Political Action Committee (PACs) maintained by the American Institute of Certified Public Accountants (AICPA) and the largest accounting firms. Cox (2003, p. 24) reports that the industry went on to spend another $41 million on lobbying activity during 1997-2001. The substantial upward trend these figures reveal suggests that industry clout has grown greatly in recent years.

Table 2 seeks to compare accountants’ clout with that of other financial lobbies. The product of the last two columns measures lobbying strength by dues revenue at industry trade associations. The idea is that funds channeled into lobbying activity each year are likely to come principally from this source. Using this measure, accountants have a political war chest that makes the banking, securities, and insurance industries look poorly armed.

In his 1820 essay “On Government,” James Mill opined: “All of the difficult questions of government relate to the means of restraining those, in whose hands are lodged the powers necessary for the protection of all, from making bad use of it.” A principal protective mission of the SEC is to safeguard investors and the integrity of U.S. securities markets from corporate disinformation. The Sarbanes-Oxley Act empowers the SEC to make it harder and more dangerous for managers to overstate revenues, understate expenses, and make deceptive use of reserve accounts. However, always and everywhere, the use that an incentive-conflicted regulator makes of its powers is less a matter of principle than of politics.

In 2002-2003, lobbyists’ successes and failures in their first and second bites at the ethical apple can be benchmarked by comparing the SEC’s adjustments of governance and disclosure standards under the Sarbanes-Oxley Act with movements that would be consistent with the Golden Rule. One place to look for Golden Rule improvements is to identify actions taken by international regulatory bodies, by state officials (e.g., in California), and by managers who, without waiting for external standards to be reformulated, conscientiously make reporting and corporate-governance repairs on their own. Individual firms often commit voluntarily to improvements in reporting and ethical standards that go markedly beyond mandates they might rationally expect to emerge from multilateral negotiations. Such commitments include the expensing of options and the provision of strong whistleblower protections. Samuelson’s (1948) Principle of Revealed Preference predicts that, where they are adopted, Golden Rule ethical
constraints reduce agency costs. For example, we might suppose that an organization that was
determined to root out unethical behavior might require its managers to avoid even the
appearance of incentive conflict. To outsiders, this standard would offer informational
transparency and ease of enforcement. However, in fashioning such a rigorous test, one has to
worry about balancing Type I and Type II error. An Appearances test would generate many false
positives. For this reason, even nonopportunistic insiders may be expected to resist the career
turbulence and unwelcome loss of privilege this standard would bring. That few firms enforce so
transparent and unyielding an ethical standard suggests—but does not prove—that it may be
overly scrupulous.

In the absence of data comparing the benefits of Sarbanes-Oxley obligations to outsiders
with the costs they impose on particular information agents, it is illogical for SEC commissioners
to distrust the ethics of corporate insiders, outside financial analysts, and mutual-fund managers
so severely while continuing to rely heavily on professional accountants to behave
conscientiously. Making the top officers of auditing firms responsible for seeing that underlings
use statistical methods to review the overall economic plausibility of the numbers their firms
certify and for explaining how specific payments might have influenced their auditors’ opinions
would impose enforceable obligations parallel to those placed on other parties in the information
chain.

The most suspicious payments are fees auditing firms collect for performing nonaudit
services for audit clients. Table 3 reproduces a table from the American Banker that compares
revenues that the top 25 U.S. banking organizations transmitted to their auditing firm in 2001 for
audit and nonaudit services. In several cases, the auditor’s nonaudit income positively dwarfs its
revenues from audit fees.

Congress understood the need to prevent accounting firms from making so much money
selling nonaudit services to audit clients that they could be persuaded to certify a series of
disinformational reports. For this reason, section 201 of the Act expressly prohibits accounting
firms from performing particular types of services for their audit clients. However, rather than
identifying and narrowing the loopholes inherent in this list, SEC rulemaking widened them.
The SEC authorized outside auditors to perform tax and other nonaudit services not expressly
forbidden by the Act on the basis of Audit Committee policies and procedures for preapproval
rather than requiring the specific and explicit approval of the Audit Committee as envisioned in
the Act. This rule places the burden of assuring that client-auditor arrangements comply with the Act on a public company’s Audit Committee and lets the accounting firm off the hook.

In a further effort to assure formal auditor independence, the Act also calls for firms to rotate their auditors every few years. Final SEC rules on auditor rotation softened the burden of this provision. SEC rules require only that particular categories of audit partners leave a company’s auditing team after five or seven years. However, expressing the SEC’s singular and unjustified confidence in the ability of accounting firms to overcome conflicts of interest, the continuity of the team as a whole is not explicitly constrained.

The asymmetry of SEC rulemaking is illogical on its face. It permits auditing firms to collect laundered bribes from dishonest or desperate managers for knowingly and willingly certifying disinformational reports without squarely exposing themselves to the explicit obligations and penalties that the corporate managers face themselves. To dream up a parallel situation in criminal law, one might imagine a penal code that exempted lookouts and drivers of getaway cars from penalties for participating in armed robbery.

VI. Concluding Comments

Although observers such as the Financial Economists Roundtable (2002) describe the Sarbanes-Oxley Act as a response to a three-way crisis in accounting, auditing, and corporate governance, follow-up rulemaking by the SEC has focused disproportionately on strengthening the corporate Audit-Committee and governance links in the informational chain. The SEC has exempted the self-interested ethical codes of the auditing industry and accounting profession from the actionable obligation to affirm the economic accuracy of audited reports that the Act imposed on the other information producers and might symmetrically have imposed on informational watchdogs as well.

That accountants could preserve such asymmetric privileges underscores how difficult it is for modern governments to address even blatant market failure. Like basketball referees, accountants’ strongest obligation should be to the integrity of the game, not to the players and especially not to the particular teams or leagues that happen to pay their per-game expenses and fees. That the auditing and credit-rating industries have each become so highly concentrated is consistent with Akerlof’s (1970) model of how the rents generated by opportunistic behavior can push principled behavior increasingly out of watchdog markets. It is hard to resist the hypothesis
that scrupulously honest accountants and managers might wish for opportunities to differentiate themselves from less-conscientious colleagues. If so, to reregulate accountants’ incentives in the U.S. may require—not just a first-class PCAOB and a better-funded SEC—but a concerted effort to encourage diversity by fostering new entry into the increasingly global accounting and credit-rating industries.
References


### Table 1

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<td>$474,555</td>
<td>$1,017,010</td>
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<tr>
<td>Total</td>
<td>$1,699,065</td>
<td>$1,935,230</td>
<td>$3,304,140</td>
<td>$4,422,960</td>
<td>$5,929,684</td>
<td>$17,291,079</td>
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</table>

Source: Roberts, Dwyer, and Sweeney (2003), assembled by FECInfo, Inc. from Federal Election Commission reports. Individual CPAs also made personal contributions during each election cycle.

### Table 2

<table>
<thead>
<tr>
<th>Financial Strength of Financial Lobbies as Measured by Trade Groups’ 2000 Revenues</th>
<th>2002 Revenues</th>
<th>% of Revenues Derived from Members Dues</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of Certified Public Accountants</td>
<td>$130.8M</td>
<td>48%</td>
</tr>
<tr>
<td>American Bankers Association</td>
<td>$55.9M</td>
<td>35%</td>
</tr>
<tr>
<td>Credit Union National Association</td>
<td>$44.3M</td>
<td>34%</td>
</tr>
<tr>
<td>Investment Company Institute</td>
<td>$43.9M</td>
<td>80%</td>
</tr>
<tr>
<td>Securities Industry Association</td>
<td>$40.6M</td>
<td>58%</td>
</tr>
<tr>
<td>American Council of Life Insurers</td>
<td>$38.0M</td>
<td>90%</td>
</tr>
<tr>
<td>American Insurance Association</td>
<td>$20.9M</td>
<td>87%</td>
</tr>
<tr>
<td>Independent Community Bankers of America</td>
<td>$17.5M</td>
<td>38%</td>
</tr>
<tr>
<td>America’s Community Bankers</td>
<td>$15.4M</td>
<td>46%</td>
</tr>
<tr>
<td>Independent Insurance Agents and Bankers of America</td>
<td>$14.3M</td>
<td>45%</td>
</tr>
<tr>
<td>Financial Services Roundtable</td>
<td>$9.3M</td>
<td>91%</td>
</tr>
<tr>
<td>Consumer Bankers Association</td>
<td>$5.6M</td>
<td>41%</td>
</tr>
</tbody>
</table>

Source: 8-2-02 American Banker, Compiled from Internal Revenue Service 990 Forms
<table>
<thead>
<tr>
<th>Firm</th>
<th>Audit Fees</th>
<th>Other Fees</th>
<th>Firm</th>
<th>Audit Fees</th>
<th>Other Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>KPMG</td>
<td>$26.1M</td>
<td>Wachovia</td>
<td>E&amp;Y</td>
<td>$2.1M</td>
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<td>J.P. Morgan Chase</td>
<td>PWC</td>
<td>$21.3M</td>
<td>First Union</td>
<td>KPMG</td>
<td>$7.3M</td>
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<tr>
<td>Bank of America</td>
<td>PWC</td>
<td>$13.2M</td>
<td>Golden State</td>
<td>KPMG</td>
<td>$1.9M</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>KPMG</td>
<td>not available</td>
<td>BB&amp;T**</td>
<td>Andersen</td>
<td>$0.7M</td>
</tr>
<tr>
<td>Bank One</td>
<td>KPMG</td>
<td>$4.4M</td>
<td>SouthTrust**</td>
<td>Andersen</td>
<td>$0.5M</td>
</tr>
<tr>
<td>Washington Mutual</td>
<td>Deloitte</td>
<td>$2.9M</td>
<td>Regions</td>
<td>E&amp;Y</td>
<td>$0.7M</td>
</tr>
<tr>
<td>FleetBoston</td>
<td>PWC</td>
<td>$8.6M</td>
<td>Golden West</td>
<td>Deloitte</td>
<td>$0.5M</td>
</tr>
<tr>
<td>SunTrust*</td>
<td>Andersen</td>
<td>$1.5M</td>
<td>Comerica</td>
<td>E&amp;Y</td>
<td>$0.5M</td>
</tr>
<tr>
<td>KeyCorp</td>
<td>E&amp;Y</td>
<td>$1.8M</td>
<td>Fifth Third</td>
<td>Deloitte</td>
<td>$0.7M</td>
</tr>
<tr>
<td>National City</td>
<td>E&amp;Y</td>
<td>$1.9M</td>
<td>AmSouth</td>
<td>E&amp;Y</td>
<td>$0.9M</td>
</tr>
<tr>
<td>U.S. Bankcorp</td>
<td>E&amp;Y</td>
<td>not available</td>
<td>MBNA</td>
<td>E&amp;Y</td>
<td>$1.1M</td>
</tr>
<tr>
<td>Bank of New York</td>
<td>E&amp;Y</td>
<td>$1.3M</td>
<td>State Street</td>
<td>E&amp;Y</td>
<td>$0.7M</td>
</tr>
<tr>
<td>PNC</td>
<td>E&amp;Y</td>
<td>not available</td>
<td>Charter One</td>
<td>Deloitte</td>
<td>$0.4M</td>
</tr>
</tbody>
</table>

From most recent proxy filings. Figures are rounded. *SunTrust said in February it would replace Andersen as auditor. **BB&T and SouthTrust still planned to keep Andersen. +Includes information systems consulting.

Source: 3-13-02 American Banker based on Figures in Bowman's Accounting Report, Atlanta.
Figure One:
Age-Old System for Transmitting and Imperfectly Purifying Data on Corporate Condition and Performance