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## A New Product for the State Corporation Law Market: Audit Committee Certifications

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A NEW PRODUCT FOR THE STATE CORPORATION LAW MARKET:  
AUDIT COMMITTEE CERTIFICATIONS

[Draft: March 24, 2004]

*Lawrence A. Cunningham*

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A NEW PRODUCT FOR THE STATE CORPORATION LAW MARKET:  
AUDIT COMMITTEE CERTIFICATIONS

*Lawrence A. Cunningham\**

*In the swirling corporate governance reforms led by SOX, the SEC, SROs and PCAOB, states are playing minor roles at best. State absence leaves missing a potentially critical link in the evolving US corporate governance circle. The circle is drawn as follows: state corporation law charges boards of directors with managing corporations and authorizes board committees; SOX charges audit committees with certain tasks, including supervising external auditors; the SEC and SROs require audit committee characteristics like independence and compel disclosure; and PCAOB now requires external auditors to evaluate audit committee effectiveness. This last step could close the circle except that auditors performing this evaluation generate conflicts with state corporation law, conflicts between auditors and audit committees and face other limitations. These conflicts and limitations can be neutralized in an audit committee evaluation exercise conducted by newly-created state agencies staffed with experts in state corporation law such as retired lawyers and judges or academics. These newly-created state agencies could thus square the newly-forming corporate governance circle.*

*The paper presents and evaluates this concept. It reviews the central role audit committees play in corporate governance; considers existing mechanisms that promote committee effectiveness—state fiduciary duties, SEC-SRO disclosure rules, and traditional auditing—noting the limits of each. It considers PCAOB’s new auditing standards requiring auditors to evaluate audit committee effectiveness, showing both the perceived need for such an evaluation and inherent limits on auditor capabilities to render this evaluation effectively. This review leads to state agencies as possible providers of this evaluation and certification. The paper sketches the outlines for creating and running such state agencies. It then assesses the likelihood that this concept would be accepted by various corporate constituents. Likely supporters include users and producers of financial information and the auditing and legal professions. More uncertain is SEC support, given a new model of corporate-governance production in which the SEC uses various instrumentalities, like SROs and PCAOB, to federalize corporate governance. State receptivity depends in part upon and is evaluated according to rival corporation law production models (a race to the top or bottom; interest group; or state versus federal). The paper concludes by lamenting that in the evolving corporate-governance production model, missing links like this one are unlikely to be corrected by state or federal law—unless private-sector agents likely to support such concepts lobby for them.*

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## INTRODUCTION

Audit committees of corporate boards of directors are central to corporate governance for many corporations. Their effectiveness in supervising financial managers and overseeing the financial reporting process is important to promote reliable financial statements. This centrality suggests that it is likewise important for investors and others to have a basis for justifiable confidence in audit committee effectiveness. At present, there is no such mechanism. This Article explains why, considers a way states can provide it and assesses as low the likelihood that states will do so.

State corporation law is designed to produce justifiable investor confidence in board audit committees through a simple structure: shareholders elect boards of directors and state fiduciary duty law requires directors to manage corporations in the best interests of shareholders and the corporation.<sup>1</sup> The business judgment rule reposes governance power in boards to decide whether to use an audit committee, which directors should serve on the audit committee, the scope of its duties and how it should operate.<sup>2</sup>

Perceived failures in the traditional state corporation law approach led Congress to enact federal law mandating a particular approach to audit committees and their role. The federal approach includes mandates under the Sarbanes-Oxley Act (SOX) to staff audit committees with independent directors and to vest them with power to supervise a corporation's external auditors.<sup>3</sup> Other federal requirements impose reporting and disclosure obligations under rules of the Securities and Exchange Commission (the SEC) and its instrumentalities the New York Stock Exchange and the Nasdaq Stock Market (misleadingly dubbed self-regulatory organizations or SROs).<sup>4</sup>

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<sup>1</sup> *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2003).

<sup>2</sup> State corporation law is thus the foundation of corporate governance. It provides that corporations are managed by a board of directors and authorizes, but does not require, the board to act through committees. *E.g.*, DEL. CODE ANN. tit. 8, § 141(c)(2) (2003).

<sup>3</sup> Sarbanes-Oxley Act of 2002, § 301, Pub. L. No. 107-204, 116 Stat. at 776-78; 15 U.S.C. §§ 78c(a)58 & 7201(a)(3). SOX does not require boards of directors to form an audit committee. But without one, the entire board is deemed that committee and is subject to requisite federal laws and regulations. *Id.*

<sup>4</sup> *E.g.*, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.06-07 (Nov. 2003); NASDAQ MARKETPLACE RULES §§ 4200(a)(14)-(15) & 4350(c)-(d) (2003). The SROs are not really self-regulatory but are functional instrumentalities of the SEC. See Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 968-69 (2003); *infra* Part V. Their listing requirements are not really standards but excruciatingly-specific rules. See William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); *infra* note 47.

SOX also created a new audit standard-setting body, the Public Company Accounting Oversight Board (PCAOB), to provide standards governing audits of public companies. In a proposed standard, PCAOB proposed to require external auditors to review audit committee effectiveness.<sup>5</sup> This proposal could be useful, but poses conflicts between auditors and audit committees and is difficult to square with state corporation law.<sup>6</sup> While PCAOB's final standard retracted, in part, it still requires external auditors to consider audit committee effectiveness as part of their overall review of a corporation's internal control over financial reporting.<sup>7</sup>

PCAOB's proposal reveals a hole in the corporate governance system that this admixture of state and federal law creates. Audit committees are central but no one other than boards—and, after the fact, shareholders and courts—has power to oversee them. All SOX does is mandate characteristics and functions; all the SEC and SROs do is mandate characteristics, reports and disclosure. All PCAOB ended up doing—after flagging the issue of audit committee review—is requiring auditors to include an audit committee review as part of the auditor's more general assessment of a company's internal control over financial reporting.

The resulting corporate governance system reveals two major problems that this paper considers. The first is the tension between state and federal law. State corporation law trusts boards of directors to choose the right set of management tools for a corporation. Federal law now provides governmental mandates specifying parameters of the audit function, whether or not a board believes it is necessary. But neither alone is complete and, even when combined, remains incomplete.

While the federal regime specifies audit committee composition and function, it respects federalism limits by not further specifying how that committee's effectiveness is

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<sup>5</sup> PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), A PROPOSED STANDARD CONCERNING AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (Oct. 2003) [hereinafter PCAOB's Proposed Standard].

<sup>6</sup> See Part II, *infra*.

<sup>7</sup> PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (March 9, 2004), ¶¶ 55-59 [hereinafter Auditing Standard No. 2]. [Note: This auditing standard is subject to SEC approval, expected easily given SEC's substantial role in the preparation process.] PCAOB adopted Auditing Standard No. 2 to require external auditors to evaluate the effectiveness of the audit committee's oversight of a corporation's financial reporting and related internal control. This evaluation will be part of the auditor's new task, under SOX, of attesting to managerial assertions concerning the effectiveness of internal control. When Auditing Standard No. 2 was released for public comment as a proposed standard, the proposal appeared to require a separate and complete evaluation.

to be evaluated; while state corporation law provides a framework for this evaluation, it does not provide any mechanism to conduct ongoing review. This missing link creates an opportunity for states to contribute meaningfully to discussions of corporate governance reform SOX prompted.

As Congress, the SEC, SROs and PCAOB—along with hundreds of assorted professionals—have developed a range of policies, proposals and ideas, Delaware and other states have stayed on the sidelines (apart from perceived adjustments in their approach to the common law of fiduciary obligation).<sup>8</sup> States interested in retaining and attracting corporate chartering business, from Delaware to Nevada, have a golden opportunity here: to provide a mechanism for a mandatory or optional audit committee evaluation and effectiveness certification.<sup>9</sup>

The second problem concerns how to monitor the monitors. The federally-prescribed audit committee is directed to supervise the external auditor and PCAOB proposed to have the external auditor evaluate the audit committee. While such 360-degree evaluations can work, the proposal is both jarring and difficult to square with state corporation law. It remains jarring and difficult to square with state corporation law even in the more modest form of having auditors review audit committee effectiveness as part of the auditor’s overall review of internal control.

To address these two problems, this Article considers a state-agency based approach to audit committee evaluation.<sup>10</sup> A branch of state government could be vested with power to conduct a periodic evaluation and provide certification; this could be made mandatory or optional. If made optional, corporations could signal to investors a higher level of confidence in the integrity of their audit committees. This signal could be conveyed in how a state’s corporations are denominated. In Delaware, for example, corporations opting out would continue to be called “Delaware corporations;” those opting in would enjoy the boosted designation “certified Delaware corporation.”

The state-agency approach would avoid many of the thorny problems of having auditors evaluate audit committees. It would eliminate conflicts of interest between auditors and audit committees and give responsibility to those possessing requisite

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<sup>8</sup> See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. \_\_\_\_ (forthcoming 2004).

<sup>9</sup> Delaware is the country’s leading state of incorporation for large companies. Some see Nevada as attempting to compete with Delaware. *E.g.*, Dave Berns, *Shareholders win ITT Decision: Will Judge Pro’s Decision Help Nevada Become the “Delaware of the West”?*, 5 NEVADA LAWYER 22 (Dec. 1997).

<sup>10</sup> Other approaches are possible. For example, state corporation law statutes could be amended to require boards of directors periodically to evaluate and certify their audit committees as effective; these amendments could make the exercise mandatory or optional (an opt-out based on a shareholder vote for example).

expertise using objective criteria. It would also create a mechanism furnishing publicly-disclosed affirmative assurance, in contrast to the more opaque, negative assurance that PCAOB's approach would enable auditors to provide when opining on a company's internal control over financial reporting.

The state-agency approach has limits. Some see SOX's partial federalization of corporate governance as rejecting the existing state law system of audit committee oversight of auditors and auditor oversight of audit committees and management. If so, the state agency concept can be criticized as simply a return or reenactment of that weak world. On the other hand, the SOX approach is incomplete, respecting some federalism limits. Accordingly, states retain a significant role in corporate governance and a mechanism such as a state-agency audit committee evaluation function could help them play it—and could even lead to reinvigorating traditional conceptions of fiduciary obligation.

Despite likely appeal of the concept to users and preparers of financial statements documented in Part IV below, the concept is not likely to be adopted by many states (or any) absent substantial encouragement from those constituents. Regulators, including PCAOB and the SEC, may also be less than receptive to the concept. PCAOB projects itself as an additional source of corporate governance. It will have territorial interests in maximizing its regulatory reach. The SEC, which oversees PCAOB, may wish to preserve maximum power in PCAOB as an additional means for its own ability to control corporate governance, as it does using SROs, without direct encroachment on state corporation law.<sup>11</sup>

Apart from uncertain regulatory support, states also may lack incentives to pursue the concept. Predictions of state inclinations regarding this concept depend on adopting one of several rival theories of state corporation law production: states compete with each other in a race to the top or bottom; they compete to benefit interest groups such as lawyers and investment bankers; they compete against the federal government; or they comprise one component of a multi-pronged model involving state, federal and SRO sources.<sup>12</sup>

If the race is to the bottom, states likely will reject the concept, but if to the top or to help interest groups, they might accept it. Under the more complex models, predictions are more difficult. However, it appears that the SEC is developing an elaborate method of creating corporate governance using instrumentalities such as SROs and PCAOB and may prefer using these arms over which it has direct statutory power, rather than states over which it holds only indirect power. States facing even this indirect SEC pressure may be reluctant to innovate corporate governance reforms the SEC would disfavor, even if they are in the best interests of corporations, investors and the public. This is one price of the increasing functional federalization of corporate governance.

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<sup>11</sup> See Thompson, *Collaborative Corporate Governance*, *supra*, note 4, at 968-69.

<sup>12</sup> See Part V, *infra*.

This Article (I) assesses the need for any formal evaluation of audit committee effectiveness in light of existing alternatives providing assurance; (II) reviews PCAOB's standard for auditor evaluation of audit committee effectiveness to show how its limits point directly to creating state mechanisms for this function; (III) sketches the outlines of such a program's design and administration; (IV) draws from public comments made on PCAOB's proposed standard to suggest that a state-agency approach would garner widespread support from investors and managers and from the auditing and legal professions; and (V) concludes by lamenting that despite virtues and probable field support, regulators and states may not support the concept.

## I. NEED AND PARTIAL SOLUTIONS

The audit committee plays a central role in overseeing management, financial reporting and internal control over financial reporting, among other duties. Effective audit committees can be important components of corporate governance, by aiding in deterring, detecting and preventing fraudulent financial reporting and thus protecting investors and other constituents. In addition, investors benefit from an understanding of audit committee roles in general and within particular organizations. Although these propositions are uncontroversial, an unresolved issue is how best to promote understanding and effectiveness. A combination of substantive duties, disclosure rules and independent assurance is desirable—much of which is in place.

### *A. Existing Substantive Duties*

Longstanding principles of state corporation law provide that boards of directors manage the business and affairs of a corporation as fiduciaries.<sup>13</sup> Audit committee members are members of the board of directors. As such, they are obliged to discharge state corporation law's fiduciary duties of loyalty and care, subject to deference under the business judgment rule. Duties include assuring a corporation's compliance with applicable law. Breach of these duties exposes directors to liability to shareholders in private litigation, subject to state law provisions authorizing corporate charters to exculpate them from personal liability in certain cases.<sup>14</sup> These principles provide a measure of discipline on audit committee members in performing their duties. But given the business judgment rule and the prevalence of exculpatory charter provisions, critics regard this arrangement as insufficient.

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<sup>13</sup> *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2003); *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

<sup>14</sup> *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2003) (for money damages for breaches of the duty of care, but not for injunctive relief or for breaches of the duty of loyalty or acts not taken in good faith); ALI-ABA MODEL BUS. CORP. ACT. § 2.02(b)(4)(1990) (similar, but without the limitations for breaches of duty of loyalty or good faith).

### *B. Existing Disclosure Rules*

SRO rules address the disclosure aspect of audit committee functions. These rules require that audit committees have a charter, disclose it publicly, evaluate its own performance, affirm charter compliance and report on these matters to the full board of directors and to the SRO.<sup>15</sup> These rules seek to impose accountability and discipline on audit committees. The charter-and-disclosure components also provide investors and gatekeepers with sources to understand audit committee operations. Whether these requirements are sufficient to assure audit committee effectiveness is not entirely clear. An independent evaluation and certification would provide valuable additional assurances.

### *C. Existing Audit Practice*

Who might provide such assurances? The auditor is a logical choice, in part, because it also needs such an understanding to conduct its primary audit functions. Thus an existing solution is traditional audit practice. Auditors conducting traditional financial statement audits apply tests of internal controls to help plan the scope of their audits. This probing typically includes some dealing with the audit committee. Many financial calamities that brewed during the late 1990s are attributed to internal control failure, however, including within audit committees. These audit failures cast doubt on the reliability of traditional audit practice to provide requisite assurances.

### *D. Audits of Internal Control*

Responding to these audit failures, SOX directed PCAOB to develop auditing standards concerning attestations of managerial assertions of internal control effectiveness.<sup>16</sup> A key feature of the attestation process requires auditors to assess the effectiveness of audit committee oversight concerning internal control over financial reporting. The chief justification for this assessment is the central role that audit committees play in financial reporting.

PCOAB proposed a standard providing for such an auditor assessment of audit committee effectiveness. For reasons considered in the next section, however, PCAOB's final standard (Auditing Standard No. 2) retracted from this full assessment in favor of a partial assessment as a component of the auditor's more general audit of internal control over financial reporting.

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<sup>15</sup> NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.06-07 (Nov. 4, 2003); NASDAQ By-Laws, Art. 9, § 5; NASDAQ MARKETPLACE RULES, §§ 4200(a)(14)-(15) & 4350(c)-(d) (2003).

<sup>16</sup> Sarbanes-Oxley Act of 2002, §§ 404(b) & 103(a)(2)(A); Pub. L. No. 107-204, 116 Stat. at \_\_\_\_.

A significant consequence of the difference between PCAOB's proposed and final standards concerns transparency. As a separate evaluation, the proposed standard appeared designed to produce disclosure concerning an audit committee's effectiveness, to provide a form of positive assurance to users of financial statements. As a mere component of the auditor's overall evaluation of internal control over financial reporting, it becomes opaque, less visible to financial statement users. It is a form of negative assurance: that the auditor did not find the audit committee ineffective.<sup>17</sup>

This difference minimizes some of the difficulties associated with auditors performing this function, including conflicts, expertise and objectivity discussed next. It opens the question of whether audit committee evaluation assignments that auditors are institutionally incapable of performing should be performed by another party.

## II. INHERENT LIMITS OF THE AUDITOR EVALUATION

PCAOB's Auditing Standard No. 2 requires auditors to evaluate audit committee effectiveness in overseeing external financial reporting and internal control over financial reporting. This raises questions concerning the relationship of this exercise to state corporation law's requirement that boards perform this function (a duty SRO listing standards restate). It also creates conflicts between the auditor and the audit committee, which SOX anoints as the auditor's supervisor. PCAOB's proposed standard elicited criticism along these lines;<sup>18</sup> Auditing Standard No. 2 responds by emphasizing that (1) it does not intend to supplant the board's responsibilities; (2) the auditor's evaluation is not separate or distinct but part of its control environment assessment; and (3) conflicts are inevitable. These responses leave open major issues concerning inherent limits of the auditor evaluation exercise and invite considering alternative providers of audit committee evaluation services.

Auditing Standard No. 2 provides that auditors evaluating audit committees assess committee member independence. This raises questions concerning whether auditors possess requisite expertise to make what are essentially legal judgments. PCAOB's proposed standard directed auditors to evaluate audit committee compliance with requirements of SOX, the SEC and SROs; Auditing Standard No. 2 deleted these provisions in response to criticism that they are beyond an auditor's expertise. This raises questions concerning whether these elements are important for evaluating audit committee effectiveness and, if so, also indicates need to consider alternative service providers. Auditing Standard No. 2 specifies a variety of other factors relevant to the evaluation, none of which lends itself to measurement by objective criteria usually used in auditing. This raises both sorts of questions: whether auditors possess requisite

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<sup>17</sup> Auditing Standard No. 2 triggers public disclosure of ineffective audit committee oversight only when this amounts to a "material weakness" in internal control over financial reporting. Auditing Standard No. 2, at ¶ 59. *See infra* note 30.

<sup>18</sup> *See Part IV, infra.*

expertise and whether alternative providers of audit committee evaluations should be sought.

### *A. Conflicts*

Two classes of conflicts arise from having auditors evaluate audit committee effectiveness: (1) legal conflicts between Auditing Standard No. 2 and various laws and (2) structural conflicts between auditors and audit committees and between management and audit committees.

*1. Legal.* — Auditing Standard No. 2's audit committee evaluation provisions can interfere with the allocation of responsibilities established under state corporation law and SOX. Under state law, boards of directors must manage the business and affairs of a corporation; under SOX, audit committees must discharge the board-oversight duty concerning the external auditor's qualifications and performance.

SOX's approach was designed to correct for the conflict between auditors and managers that could be seen as a systemic weakness (auditors became beholden to management and softened their professional skepticism). The evaluation role Auditing Standard No. 2 assigns to auditors puts them in the position of evaluating the audit committee, an organ of the board of directors. This can be seen to reintroduce the conflict in a different guise. It thus may be seen to conflict with the goals of those laws.

The nature of audit committee oversight adds to legal conflicts. Consider the nature of director obligations under state corporation law compared with professional techniques auditors are trained to apply. Directors have fiduciary duties to their corporations and stockholders. They must act in their best interests when discharging statutory responsibilities to manage the business and affairs of a corporation. A well-developed body of common law applies. Doctrines include the duty of loyalty and the duty of care, along with the business judgment rule. These doctrines provide a judicial framework allowing directors leeway to exercise business judgment, while keeping behavior within acceptable boundaries.<sup>19</sup>

In contrast to judicial approaches to supervising directors, auditors use professional skepticism in their tasks, routinely second-guessing management decisions.<sup>20</sup> This approach, when applied to audit committee evaluations, threatens to alter audit committee behavior: from that contemplated under state corporation law with deference to business judgments into a more rule-oriented and constricting arrangement perhaps not

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<sup>19</sup> Commentators disagree concerning whether state corporation law draws the boundaries faithfully to legitimate norms. Despite disagreement, there is no question that the auditor review would apply a fundamentally different approach.

<sup>20</sup> *E.g.*, VINCENT M. O'REILLY, ET AL., MONTGOMERY'S AUDITING (12<sup>th</sup> ed. 1998), at 4.5 (due professional care of auditors requires the auditor to exercise professional skepticism).

in the best interest of a corporation or its shareholders.<sup>21</sup> It could lead to highly disruptive and unnecessary disagreements. Hence Auditing Standard No. 2 is somewhat at odds with state corporation law.<sup>22</sup>

Consider also the different standards of legal obligation owed by directors compared to auditors. When acting through audit committees, these state corporation law fiduciary duties remain applicable to directors. Auditors are not fiduciaries for their clients or client stockholders. At best, law requires auditors to act professionally and not to commit negligence or fraud.<sup>23</sup> They are contract parties, not fiduciaries. Having contract parties supervise fiduciaries turns a traditional legal hierarchy upside-down. It creates an incoherent corporate governance system.

Obligations of directors and auditors under federal securities laws differ as well. Under Section 11 of the Securities Act of 1933,<sup>24</sup> for example, both are entitled to assert due diligence defenses to defeat claims of negligence in discharging their responsibilities.<sup>25</sup> However, directors are responsible for the entire contents of a registration statement and exposed to related liability; auditors are subject to liability only for those portions of the registration statement they are responsible for preparing as experts.<sup>26</sup>

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<sup>21</sup> See generally William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Standards Versus Rents*, 48 VILL. L. REV. 1023 (2003) (assessing limits of SOX-inspired regulatory urge to develop standards-based accounting concepts as opposed to rules-based concepts to constrain managerial and auditor rent-seeking).

<sup>22</sup> SOX interferes with state corporation law on specific subjects. For example, it bans loans to corporate insiders and authorizes federalized derivative lawsuits to recover profits generated in violation of new blackout rules. SOX, §§ 306, 402. But it does not purport to alter state corporation law's charge that directors manage the business and affairs of the corporation or preempt the business judgment rule. Congress may have the prerogative to take these steps; PCAOB does not.

<sup>23</sup> See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (discussing scienter standard and due diligence defense); *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983) (adopting preponderance of evidence standard rather than clear and convincing standard); *SEC v. Arthur Young & Co.*, 590 F.2d 785 (9<sup>th</sup> Cir. 1979) (discussing negligence standard and requirements of pleading fraud with particularity).

<sup>24</sup> 15 U.S.C. § 77(k).

<sup>25</sup> E.g., *Escott v. BarChris Construction Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968) (reviewing and rejecting asserted due diligence defenses under Section 11 made by various corporate officers and directors and the corporation's external auditor).

<sup>26</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207-08 (1976):

Auditing Standard No. 2 grapples with these challenges in limited ways. First, it implores auditors to recognize that boards are responsible for evaluating the performance and effectiveness of audit committees.<sup>27</sup> This is of course an obvious statement of law, fact, and authority that PCAOB cannot change. Second, Auditing Standard No. 2 declares that it “does not suggest” that auditors are responsible for performing a “separate and distinct” audit committee evaluation.<sup>28</sup> Equally important, however, it emphasizes that auditors assess committee effectiveness because of the central role audit committees play in a corporation’s control environment.<sup>29</sup>

These provisions are helpful in minimizing conflicts between Auditing Standard No. 2 and state corporation law; they do not eliminate them. Suppose a board makes a business judgment not to appoint a financial expert to the audit committee (optional under SOX and SRO listing standards and permitted by state corporation law), and makes a legal judgment concerning how and when to disclose this (required by SOX). But suppose the auditor disagrees with both conclusions. What happens?

In a traditional audit of financial statements, similar disagreements are resolved simply: the board’s judgments control. The auditor uses its opinion when planning the scope of its audit—typically one of broader scope than if it concurred in the board’s judgments. In an audit of internal control over financial reporting, however, additional processes follow.

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Section 11 of the 1933 Act unambiguously creates a private right of action for damages when a registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading. . . . [E]xperts such as accountants who have prepared portions of the registration statement are accorded a ‘due diligence’ defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that ‘after reasonable investigation’ he had ‘reasonable ground[s]’ to believe that the statements for which he was responsible were true and there was no omission of a material fact.

<sup>27</sup> Auditing Standard No. 2, ¶ 56; *see also* Auditing Standard No. 2, App. E ¶ E69 (explaining PCAOB’s conclusion that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor’s evaluation of the control environment is not intended to supplant those evaluations).

<sup>28</sup> Auditing Standard No. 2, ¶ 56; *see also* PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 20-21 (explaining the same point).

<sup>29</sup> Auditing Standard No. 2, ¶ 56.

The auditor must come to an opinion on internal control over financial reporting. If it concludes that these judgments amount to an ineffective audit committee, Auditing Standard No. 2 instructs it to consider this, at minimum, a significant deficiency and perhaps a material weakness.<sup>30</sup> These requirements can constrain an auditor to issue an adverse opinion on internal control over financial reporting. In this circumstance, directors will feel pressure to submit to the auditor's opinion rather than exercise their own judgment.

2. *Structural.* — Under SOX § 301 and implementing measures of the SEC and the SROs, listed company audit committees are directly responsible for appointing, compensating, and overseeing the work of the company's external auditors. This investment of power in the audit committee presents a structural conflict with Auditing Standard No. 2's mandate that auditors evaluate audit committee effectiveness.

The body directly responsible for appointing and determining compensation of the auditors, and overseeing their work, is subject, in turn, to that auditors' scrutiny as part of its audit of internal control over financial reporting. A committee so supervising an auditor, charged with evaluating the committee, can be impaired in performing its duties; an auditor charged with evaluating the committee's effectiveness, in its supervisory and other tasks, can be impaired in performing this evaluation and its other work.

The circular approach can violate the independence concept at the foundation of auditing. Auditors are not independent if they act in a managerial capacity. A formal assessment of audit committee effectiveness is a management role, a board responsibility.

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<sup>30</sup> *Id.*, ¶¶ 59 & 140. Auditing Standard No. 2 defines the central concepts as follows:

*A significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Auditing Standard No. 2, ¶ 9.

*A material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Auditing Standard No. 2, ¶ 10.

Even when the evaluation is described as part of the auditor's overall assessment of a corporation's control environment, this raises issues of independence impairment in fact and in appearance. This violates longstanding principles of federal law expressed by the Supreme Court, specific SEC rules, and voluminous professional auditing literature defining generally accepted auditing standards.<sup>31</sup>

Not all such 360-degree reviews are inherently suspect. Many managerial review exercises at major corporations are conducted in precisely this manner. But given the central function of auditors and audit committees in the financial reporting process, any structures that may deter frank assessments should be resisted. Moreover, devices that may tend to weaken an audit committee should be resisted. When auditors are vested with implicit directive power over board audit committees, this dilutes a board's similar power, which may have the effect of diminishing an audit committee's effectiveness.

If an auditor's evaluation of audit committee effectiveness is memorialized in audit opinions, moreover, consideration would be necessary concerning whether management would also have to formally evaluate the audit committee. This multiplies conflicts. A technical case can be made that when audit committees are part of an auditors' formal scope of review, they would likewise be within management's formal scope of review.<sup>32</sup> If so, managers would become obligated to evaluate audit committees. But audit committees are typically charged with evaluating management. So an additional conflict arises where management is reviewing the audit committee and *vice versa*.

A more severe problem arises. If managers must evaluate the audit committee, auditors will seek to rely on management's evaluation in preparing their own evaluation or reevaluation. This adds yet another circularity problem where auditors rely on management. The result is a series of tangled circles studded with conflicts that risk undermining the systemic utility of both auditors and audit committees.

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<sup>31</sup> See SECURITIES AND EXCHANGE COMMISSION, RULE 2-01 OF REGULATION S-X, § 210.2-01 ("Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact *and in appearance*") (emphasis added); see also SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: REVISION OF THE COMMISSION'S AUDITOR INDEPENDENCE RULES, RELEASE NOS. 33-7919 & 34-43602, at notes 38-39 (citing numerous sources that emphasize requirement of the *appearance* of auditor independence, including professional auditing literature and legal precedents like *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984)).

<sup>32</sup> The technical case would run as follows. Under Auditing Standard No. 2, an ineffective audit committee is a significant deficiency. This in turn is a strong indicator of a material weakness in internal control over financial reporting. In such cases, management must review and address the issue to make its own internal control assessment adequate. This would imply that management would have to review the audit committee in order for the auditor to furnish an unqualified control audit opinion.

PCAOB addresses these concerns obliquely. Its key structural response is to emphasize that the auditor’s evaluation of the audit committee is “not a separate evaluation” but part of evaluating the control environment and monitoring components of internal control over financial reporting.<sup>33</sup> It opined that this would partially address the structural conflict and that the part unaddressed is simply inherent in professional auditing.<sup>34</sup>

PCAOB’s release accompanying Auditing Standard No. 2 sought to minimize conflict concerns. It opined that “Normally, the auditor’s interest and the audit committee’s interests will be aligned” in pursuing fair financial statements and effective control and auditing.<sup>35</sup> It characterized the conflict between SOX § 301 and Auditing Standard No. 2 as “theoretical.”<sup>36</sup> PCAOB appealed to auditing custom and investor knowledge, saying “experienced auditors are accustomed to bearing” such conflicts and “that investors expect an auditor to address” them.<sup>37</sup>

Accordingly, PCAOB does not ultimately resolve the conflict, but says instead that it is inevitable, auditors are used to operating with such conflicts, and investors are okay with this. This result creates deep tension with fundamental concepts of auditor independence and the heavy stress SEC regulations and SOX place on auditor independence. Despite its efforts, PCAOB does not adequately respond to these concerns. An additional or alternative mechanism that avoids these fundamental problems thus remains appealing.

### *B. Expertise*

Two additional concerns relate to whether auditors possess requisite expertise to comply with Auditing Standard No. 2’s requirement that they evaluate audit committee effectiveness as part of assessing the control environment. The first is whether auditors possess necessary knowledge concerning the legal concept of independence, which Auditing Standard No. 2 states auditors assess in this evaluation. The second involves audit committee compliance with SOX, SEC and SRO requirements, which PCAOB’s proposed standard required auditors to assess but which Auditing Standard No. 2 deletes. The deletion solves one question and raises another: auditors are not directed to reach

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<sup>33</sup> Auditing Standard No. 2, App. E, ¶ E66.

<sup>34</sup> *Id.* (explaining that emphasizing the context of the auditor’s evaluation would “address, to some extent, the conflict-of-interest concerns” but that the conflict “is, to some extent, inherent in the duties that society expects of auditors.”).

<sup>35</sup> PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 21.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

legal conclusions concerning compliance, but are these conclusions in fact necessary to form opinions concerning audit committee effectiveness?

1. *Independence.* — PCAOB's proposed standard stated that auditors should evaluate committee member independence, along with evaluating the independence of their nomination, selection and action.<sup>38</sup> Auditing Standard No. 2 retains a provision concerning evaluating member independence, but deletes the latter more detailed provisions without explanation. It likewise dropped without explanation a statement to the effect that the more independent the nominating process, the more independent a committee is likely to be.<sup>39</sup>

Identifying PCAOB's reasons for the deletions requires speculation. Reasons may include concerns that assessing the independence of a nomination or selection process or of director action involves judgments concerning corporate governance and law beyond an auditor's expertise.<sup>40</sup> SRO listing standards require boards to determine the independence of each outside director, using specific criteria under those standards supplemented by general principles rooted in state corporation law.<sup>41</sup> Establishing links between the independence of the nomination and selection process and member independence is difficult. It is likewise a matter of corporate governance and legal judgment. Determinations are made with reference to state corporation law, SOX § 301, SEC regulations, and SRO listing standards, all likely beyond an auditor's expertise.<sup>42</sup>

If the reason PCAOB deleted the supplemental requirements concerned expertise and matters of law, it is difficult to justify retaining the factor calling for auditors to

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<sup>38</sup> Proposed Standard, ¶ 58.

<sup>39</sup> *Id.*

<sup>40</sup> Supporting this guess are some comment letters on PCAOB's Proposed Standard, including those provided by some auditing firms, as discussed in Part IV, *infra*.

<sup>41</sup> NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A.02 (Nov. 4, 2003); NASDAQ MARKETPLACE RULES, § 4350 (2003).

<sup>42</sup> Another possible reason for the deletion is that SEC rules also require corporations to disclose nominating committee processes. *See* SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: DISCLOSURE REGARDING NOMINATING COMMITTEE FUNCTIONS AND COMMUNICATIONS BETWEEN SECURITY HOLDERS AND BOARDS OF DIRECTORS, RELEASE NOS. 33-8340 & 34-48825 (Nov. 24, 2003). However, if this justifies deleting nomination-selection process independence from an auditing standard, it suggests PCAOB serves as more than an auditing standard-setter. It is a component of an SEC-directed regulatory regime combining various instruments including disclosure. *See* Part V, *infra*.

evaluate the “independence of the audit committee members from management.”<sup>43</sup> This is likewise a question of law and corporate governance, not auditing.

In fact, the appearance and use of this factor in Auditing Standard No. 2 are driven entirely by legal rules. This is clear from the following note contained in Auditing Standard No. 2, stating that companies whose securities are not listed:

may not be required to have independent directors for their audit committees [and that] the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency.<sup>44</sup>

The purpose of the note is clear and accurate: when not required by listing standards, absence of independent directors is not alone a control deficiency. The negative implication is less clear and possibly wrong: when required by listing standards, absence of directors is alone a control deficiency. Whether this negative implication is correct is a legal question. The issue is whether an audit committee’s role and relative effectiveness varies with exchange listings and related requirements. That, in turn, depends on the purpose and meaning of the relevant requirements, including in this context the independence concept. The purpose and meaning of legal concepts, including the concept of director independence, are questions requiring legal analysis and interpretation.

Relative to auditing, moreover, why should lack of independent directors indicate a control deficiency? The foregoing note implies that the presence or absence of independent directors is not relevant to internal control, much less to an auditor’s assessment of audit committee effectiveness. Rather, for listed companies, the issue is whether they are in compliance with listing standards, not whether that compliance promotes committee effectiveness. The directive that auditors evaluate audit committee member independence is therefore also fundamentally a matter of complying with those listing standards imposing the requirement.

It is not possible to escape the fact that auditor evaluations of these characteristics are therefore legal judgments, not auditing judgments.<sup>45</sup> In any event, these challenges indicate, again, that a search may be warranted to find alternative or additional providers of audit committee evaluation and certification services.<sup>46</sup>

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<sup>43</sup> Auditing Standard No. 2, ¶ 57.

<sup>44</sup> *Id.*

<sup>45</sup> This view strengthens the suggestion noted above (in note 42) that PCAOB is operating as a component in a complex web of federal regulation being directed by the SEC rather than as an independent auditing standard setter. *See* Part V, *infra*.

<sup>46</sup> Another inherent limit appears. When auditors render opinions concerning audit committee effectiveness that involve legal expertise, they risk violating state laws

2. *Compliance.* — Independent audit committee members are required by SRO listing standards. While Auditing Standard No. 2 retains provisions directing auditors to assess this factor, it deleted two other provisions expressly requiring auditors to evaluate compliance with law and regulation, including SRO listing standards. The deleted provisions directed auditors to assess audit committee compliance with the excruciatingly detailed SRO listing standards under SOX § 301 and whether an audit committee included a financial expert (called an audit committee financial expert or ACFE) as contemplated under SOX § 407.<sup>47</sup> Materials accompanying Auditing Standard No. 2 indicated three reasons for these deletions, as follows:

The factors that addressed compliance with listing standards and sections of [SOX] were deleted, because those factors were specifically criticized in comment letters as being either [1] outside the scope of the auditor’s expertise or [2] outside the scope of internal control over financial reporting [and PCAOB believed] that [3] those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee.<sup>48</sup>

Explanation [1] is easy to accept; the other two raise additional issues.

Concerning the first explanation, consider that audit committees must comply with various SRO listing standards and judge applicable best-practice guidelines

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prohibiting the unauthorized practice of law. *Cf. Letter to PCAOB from BDO Seidman, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 136) (advising that when financial statement preparers lack guidance for SOX § 404 compliance they turn to auditors and “It is possible that auditors providing this guidance might be misconstrued as providing legal advice . . .”). Auditors doing so pursuant to Auditing Standard No. 2 generate an additional bundle of clashes. Issues include the relationship between state law governing the legal profession and prohibiting the unauthorized practice of law on the one hand and the exact juridical status of PCAOB on the other. *Compare* Auditing Standard No. 2, ¶ 2 (noting that the standard summarizes legal requirements to provide context and understanding, not to interpret them).

<sup>47</sup> PCAOB Proposed Standard, ¶ 57. SOX § 301 directed the SEC to direct the SROs to adopt various corporate governance standards as listing requirements, which the SROs have done. Resulting listing standards, including for example the New York Stock Exchange’s Section 303.A.00, specify such minutia as audit committees must have at least three members and such procedures as audit committees having charters containing specified details. SROs traditionally described their listed company manuals as containing “listing standards,” accurate in the pre-federalization era and a misnomer now that these manuals are laden with dense, excruciatingly-detailed provisions bearing no resemblance to the concept of “standards.”

<sup>48</sup> Auditing Standard No. 2, App. E, ¶ E68.

established by SROs, the SEC and other engines of corporate governance. Whether a committee complies with SRO listing standards is a legal judgment and whether a board of directors opts to have its audit committee adhere to formally-articulated best practices is a business judgment.

Consider again SOX's provision concerning including an audit committee financial expert (ACFE). Rules permit, but do not require, this feature and provide that a board opting not to include an ACFE disclose reasons. Whether to include an ACFE is essentially a matter of business judgment. Issues include whether that expertise is necessary and whether relevant SEC standards are appropriate for the corporation. Auditors are not in a position to assess this business judgment.

Rules requiring disclosing whether audit committees include an ACFE are essentially legal rules. The remedy for failure to comply is delisting, and possibly other sanctions. These are legal results posing business consequences. They are not elements within the auditor's purview, which is concerned ultimately with fair financial reporting and indirectly with effectiveness of internal control over financial reporting.

PCAOB's second and third justifications for deleting compliance assessment factors are more difficult to understand and interpret. If these are "outside the scope of internal control over financial reporting" and "not significant" to the auditor's evaluation, why were they included in PCAOB's proposed standard? A possible reason is that PCAOB's proposed standard envisioned an auditor evaluation that was "separate and distinct" and encompassed review beyond effectiveness concerning internal control over financial reporting. The review contemplated by Auditing Standard No. 2 is narrower. This explanation may be satisfactory in terms of understanding and applying Auditing Standard No. 2 as an auditing standard.

But PCAOB's explanation is unclear. It bases its conclusion in part on comment letters critical of the concept as *either* beyond an auditor's expertise *or* outside the scope of internal control over financial reporting; it separately states its opinion that these are not significant to the auditor's expected evaluation. It leaves unclear whether PCAOB believes they are outside the scope of internal control over financial reporting and leaves unexplained why they are not significant.<sup>49</sup>

Whatever weight one assigns to the relative significance of compliance as a measure of audit committee effectiveness regarding internal control over financial reporting, what is clear is that PCAOB is directing auditors not to treat this as a factor. Whether auditors will do so or not is another question, since Auditing Standard No. 2's list of factors is not exhaustive. More importantly, if compliance is significant to audit committee effectiveness, in terms of internal control over financial reporting or more

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<sup>49</sup> Opacity in PCAOB's explanation suggests another possible account of its decision to delete these items, echoing points noted above (in notes 42 and 45): that PCAOB is a component of a broader federalized corporate governance regime managed by the SEC. See Part V, *infra*.

generally, this again suggests reasons to consider searching to identify additional or alternative providers of audit committee evaluations.

### *C. Objective Criteria*

Auditing Standard No. 2 mentions numerous other factors bearing on auditor assessment of audit committee effectiveness in overseeing external financial reporting and internal control over financial reporting. Most of these factors, as well as most audit committee activities, are not measurable using objective criteria, a foundation of traditional auditing standards. In fact, many are quite subjective.

One factor Auditing Standard No. 2 mentions is the clarity boards use in articulating the audit committee’s responsibilities and how well managers and committee members understand them.<sup>50</sup> Measuring linguistic clarity is not easy; teachers measure reading comprehension routinely and assign grades based on examinations. It is unclear whether auditors possess objective tools such as examinations—and whether audit committee members and managers would sit for them.<sup>51</sup>

Auditing Standard No. 2 states that auditors assess the audit committee’s involvement and interaction with the external auditor. Apart from this metric’s circularity and conflict-creation, measuring involvement and interaction is highly subjective. PCAOB’s proposed standard spoke of the “level” of these factors, language AS No.2 drops. Though “level” may be no more objectively measurable, at least it hinted at some standard. Auditing Standard No. 2 also deletes illustrations appearing in PCAOB’s proposed standard concerning involvement relating to the auditor’s retention, appointment and compensation. No reason for the deletion is provided.

Auditing Standard No. 2 also states that auditors assess the audit committee’s involvement and interaction with the internal audit team. The same criticism applies. Auditing Standard No. 2 also dropped the proposed standard’s use of the word “level” in this context. Similarly, it deletes illustrations appearing in PCAOB’s proposed standard concerning involvement relating to the audit committee’s line of authority and role in appointing and compensating internal auditors, also without explanation.

In Auditing Standard No. 2, PCOAB deleted a catch-all evaluation metric appearing in its proposed standard: the amount of time a committee devotes to internal

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<sup>50</sup> *Id.* [“the clarity with which the audit committee’s responsibilities are articulated (for example, in the audit committee’s charter) and how well the audit committee and management understand those responsibilities.”].

<sup>51</sup> No doubt many auditors excel in linguistic clarity and most of Auditing Standard No. 2 is written clearly, but consider the definition it provides for “significant deficiency,” *supra* note 30 (quoting definition of significant deficiency from Auditing Standard No. 2, ¶ 9).

control issues and the amount of time members “are able” to devote to committee activity. It likewise does not explain why, perhaps because the metric so obviously ignores quality of time. By definition, efficient committees spend little time with greater effectiveness and inefficient committees spend more time with lesser effectiveness.

Auditing Standard No. 2 also adds factors not contained in PCAOB’s proposed standard: (1) committee interaction with key members of financial management, including the chief officers of finance and accounting; (2) the degree to which difficult questions are raised and pursued with management and the auditor, including as to critical accounting policies and judgmental accounting estimates; and (3) the committee’s responsiveness to issues that an auditor raises. While likely probative of audit committee effectiveness, none of these is measurable using objective criteria that are staples of traditional auditing practice and assurance.

Despite many comment letters on PCAOB’s proposed standard criticizing the absence of objective measurement criteria,<sup>52</sup> Auditing Standard No. 2 does not come to grips with the reality that these factors elude measurement by objective criteria. This does not mean the factors or even subjective testing of them are unimportant or useless. It suggests that traditional auditing tools are not well suited to conducting the evaluation.

#### *D. Liability Risks*

Finally, two issues arise concerning the liability effects of auditor evaluation of audit committees. First, auditors evaluating audit committee effectiveness may expose themselves to liability for violation of professional standards. Suppose an auditor evaluates a corporation’s audit committee as effective. Subsequently a major financial fraud is uncovered within the company. Auditors are likely defendants in lawsuits by shareholders now armed with an additional liability theory.<sup>53</sup> This auditor liability risk may unduly raise the requirements auditors insist that audit committees meet before drawing a favorable assessment. This bias would accentuate conflicts of interest.

Second, auditors evaluating audit committee effectiveness may expose audit committee members to liability for violation of fiduciary obligations. Suppose an auditor evaluates a corporation’s audit committee as ineffective. Whether or not fraud exists within the corporation, shareholders are now armed with a theory of liability against those directors.<sup>54</sup> This audit committee liability risk may unduly lower the requirements

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<sup>52</sup> See Part IV, *infra*.

<sup>53</sup> In a separate paper, I discuss and analyze liability risks that auditors face under Auditing Standard No. 2. See Lawrence A. Cunningham, *Auditing’s New Early Warning System: Theory, Practice and Auditor Liability Risk under PCAOB Auditing Standard No. 2* (draft manuscript on file with the author and planned for release on [www.ssrn.com](http://www.ssrn.com)).

<sup>54</sup> Director-liability risk is real for any Delaware corporation lacking charter provisions exculpating directors from personal liability for money damages due to breaches of the

auditors insist that audit committees meet before drawing a favorable assessment. This bias cannot be counted on to offset the bias created by auditor liability risk. Taken together, the conflicts again compound.

#### *E. Summary of Limits and Gaps*

To summarize the limits of auditor evaluation of audit committee effectiveness shown by Auditing Standard No. 2:

- reports are not disclosed unless ineffectiveness constitutes a material weakness;
- evaluations are part of an overall control environment review related to internal control over financial reporting, not a full-scale effectiveness evaluation;
- even this partial and non-public method poses conflicts with state corporation law;
- it creates conflicts between auditors and audit committees;
- auditors must assess legal issues such as independence and cannot assess legal issues such as compliance;
- auditors lack objectively measurable criteria; and
- liability risks of auditors and audit committees can impair optimal evaluation, compounding conflicts.

Within these limits, auditors must nevertheless gain some level of assurance as to audit committee effectiveness. Auditors attesting to the veracity of managerial assertions concerning internal control over financial reporting, and to financial statement assertions, require an understanding of audit committee effectiveness.

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duty of care. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2003) (authorizing such charter provisions). For corporations governed by law based on the Model Business Corporation Act the risk is less meaningful. *See* ALI-ABA MODEL BUS. CORP. ACT § 2.02(b)(4)(1990) (stronger version of the exculpation authorization, containing no reservation for breaches of the duty of loyalty and the limitation concerning intentional conduct lacks a good faith alternative). Even for Delaware corporations boasting such charter provisions, director-liability risk is meaningful because charters do not exculpate for breaches of the duty of loyalty or intentional conduct. Lack of independence required by SROs as interpreted by auditors can indicate the former and disagreement with auditors required to evaluate audit committee effectiveness could indicate the latter. Risks include litigation uncertainty arising from judicial treatment of charter exculpations as affirmative defenses, putting the burdens of pleading and proof on directors as to good faith and absence of duty of loyalty breaches. *See Emerald Partners v. Berlin*. 787 A.2d 85 (Del. 2001).

The issues are (1) whether the gap between what auditors can do and the ideal can be filled using additional providers of audit committee effectiveness evaluations and/or (2) whether alternative providers should be sought for the entire exercise, both to provide assurance to financial statement users and for auditors to rely upon.<sup>55</sup> Accordingly, it is fruitful to consider other parties to supplement or substitute in this exercise to overcome these inherent limits of auditor evaluations of audit committee effectiveness.

### III. STATE AGENCIES

To recapitulate the framework of the evolving corporate governance regime: state law provides that boards, including through audit committees, manage corporations; SOX directs that audit committees oversee auditors, but otherwise imposes no substantive duties on or regulatory oversight of audit committees; SROs provide disclosure rules related to audit committee responsibilities and performance;<sup>56</sup> PCAOB provides a partial, limited and non-transparent auditor evaluation of audit committee effectiveness in overseeing financial reporting and internal control over financial reporting.

In this evolving circle of corporate governance, one arc remains to be included: a mechanism for a full, public audit committee evaluation by a party other than the board of directors. While not obviously necessary,<sup>57</sup> the arc is missing from the circle chiefly due to federalism concerns: SOX and the other federal engines (SEC, SROs, PCAOB) have not filled it. Congress could. For example, it could direct that audit committees be evaluated and certified, perhaps by the SEC, PCAOB, or the United States General Accounting Office (GAO).<sup>58</sup>

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<sup>55</sup> See Auditing Standard No. 2, ¶¶ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audit when such other work is competent and objective).

<sup>56</sup> SRO listing “standards” specify in excruciating detail how boards of directors are obliged to supervise and evaluate audit committee performance, though the basic standard is at heart a principle of state corporation law.

<sup>57</sup> See Part I, *supra*. The issue recalls the famous exchange between Senator Alben Barkley and the auditor Colonel Carter during hearings on the original federal securities acts:

Senator Barkley: “You audit the controller?”

Mr. Carter: “Yes, the public accountant audits the controller’s account.”

Senator Barkley: “Who audits you?”

Mr. Carter: “Our conscience.”

See Gary John Previts & Barbara Dubis Merino, *A History of Accountancy in the United States: The Cultural Significance of Accounting* (1998), at 457 n. 98.

<sup>58</sup> A historical parallel supports both identifying and rejecting the GAO alternative: early drafts of the federal securities laws from the 1930s provided that public company audits would be performed by the GAO. In 1945, Congress established the Division of

This is neither likely nor wise. It is unlikely because when Congress enacted SOX, it expended its firepower, acted under the heated light of public fury, and through the combination bought all related political rewards. It is unwise because though SOX itself essentially merely codifies best practices, those charged with implementing its provisions have so heavily extended the tentacles of corporate governance that more federal hands on the scale would throw the system even further out of balance than the gales following SOX so far have done.

Private suppliers could be tapped. A corporation could engage a separate external auditing firm for this function. This would ameliorate conflicts, but not expertise problems. Or a corporation could retain an outside law firm. This would solve expertise problems. But lawyers' interest in other work would pose conflict issues. Specialty firms are unlikely to emerge as major sophisticated providers, given that the service would likely produce low profit margins. Higher-quality providers measured by higher opportunity costs would likely not participate. For all three such alternative providers, moreover, liability risks would be significant. Unless they priced their services at premiums equivalent to functional insurers, this market would unlikely become vibrant or useful to the public capital markets.<sup>59</sup>

Other candidates include rating agencies. They escape or neutralize some problems but pose an additional significant issue. Certifications will appeal to corporations when they lower their cost of capital (by an amount greater than the agency's fee). Rating agencies provide a service that strongly influences the cost of capital. Accordingly, selling these services to rated clients poses a conflict. Involving rating agencies in internal evaluations of audit committees could also impair the rating agency's objectivity and independence when providing credit rating services. Finally, the fact that rating agencies have not emerged to offer this service suggests a low likelihood that they will do so.

#### *A. Inherent Appeal, and Some Limits*

States can fill the gap. This section outlines how a state agency would overcome or neutralize all of the inherent limits associated with an auditor evaluation of audit committee effectiveness. Highlights include: it would be public in terms of disclosure, complete, conflict-free, assess legal and compliance issues, be performed using criteria

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Corporate Audits within the GAO and mandated that it audit all government corporations. Resulting laws dramatically increased the GAO's workload. The GAO continues to play an important watchdog function over public company auditors. See Previts & Merino, *A History of Accountancy in the United States*, *supra* note 57, at 330-31, 403 & 410.

<sup>59</sup> For the case supporting using insurance markets to address financial fraud risks, see Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Revisited*, 8 STAN. J. L. & BUS. 39, 48-61 (2002).

with which relevant experts are familiar, and eliminate liability risks posed by auditor evaluations. The following explains each point.

The first two advantages are nearly self-evident. First, state agencies could provide public evaluations of audit committee effectiveness. Corporations could disclose the certifications as part of their public securities filings. Second, the service could examine overall committee effectiveness, not just concerning areas related to external financial reporting and internal control over financial reporting.

States may be superior to auditors and other private actors because they are free of conflicts these face. Limiting conflicts is inherent in the concept of a state-chartered agency conducting the certification exercise. Both conflicts Auditing Standard No. 2 poses are neutralized: there is no conflict between the state and its corporation law and no conflict between a state agency and boards of directors, audit committees, corporate management or auditors. This would diminish the circumstances in which disagreements arise, limiting them to situations in which major concerns about effectiveness exist, not quarrels over business or legal judgments.<sup>60</sup>

An equally significant advantage is that states have at their disposal the expertise and requisite criteria to apply. Experts in state corporation law would draw on the reservoir of fiduciary concepts. These require independence (a duty of loyalty concept) and competence, including a measure of financial expertise (duty of care concepts). They encompass the particulars specified in SEC and SRO rules emanating from these bedrock concepts, as well as compliance with law.

Critics hold different interpretations concerning the teeth of modern fiduciary duty law, especially as articulated and applied by the Delaware Supreme Court.<sup>61</sup> Traditional fiduciary duty law had teeth. Current state law applications may be seen as lax. State agency affirmations of audit committee effectiveness based on adherence to weak state law principles would not mean very much.

These points suggest possible virtues of a state-agency approach to audit committee evaluations. Certification could help reinvigorate traditional fiduciary

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<sup>60</sup> Conflicts could arise depending on how the state agency were funded, a point discussed in the next section.

<sup>61</sup> As one example among many split views on Delaware Supreme Court opinions, consider continuing critical appraisals of its landmark decision holding directors personally liable for breach of the duty of care in *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985): some call it a “legal disaster” while others champion it as the “apogee” of judicial excellence. Compare, e.g., Fred S. McCheseny, *A Bird in the Hand and Liability in the Bush: Why Van Gorkum Still Rankles, Probably*, 96 NW. L. REV. 631 (2002) with Charles M. Elson & Robert B. Thompson, *Van Gorkum’s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. L. REV. 579 (2002).

obligation. If so, state agencies reviewing the relationship of their laws to audit committee effectiveness could facilitate development of state law more congruent with standards necessary to make audit committees effective. This could not only invigorate competition among states for optimal governance arrangements, but an internal competition within states towards the same end.<sup>62</sup> In addition, state corporation law's fiduciary obligations, including independence and competence (loyalty and care), are standards-based. This provides an attractive alternative to the dense rule-bound approach that invariably emanates from federal sources, including SROs, as well as from accounting and auditing standard setters, including PCAOB.<sup>63</sup>

A major upside to a state agency approach to audit committee evaluation is liability risk limitation. State agencies attesting to audit committee effectiveness can be designed to enjoy the benefits of sovereign immunity, for both the agency and its employees. An agency's certification would not expose it to liability in the event of subsequent financial frauds at the corporation. The result is to eliminate liability risks from the tasks of the agency and the audit committee.

Nor should agency certifications carry any legal significance in subsequent litigation concerning a company, its board of directors, audit committee or shareholders. Positive certifications should not be available to insulate boards or committees from liability and negative certifications should not provide a basis to support shareholder claims of director breach of fiduciary duty or other liability. In each case, however, courts could admit related evidence when deemed appropriate under judicial notice concepts.<sup>64</sup> These provisions would likewise eliminate liability risks from the tasks of the agency and the audit committee.

A final advantage to the state agency approach is that the agency could also experiment with a variety of designations. These can include a pass-fail assessment to more refined gradations. A refined scale would offer more valuable information to the user community and provide superior feedback to audit committees on their effectiveness.<sup>65</sup>

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<sup>62</sup> Probabilities here depend on which of several rival theories of corporation law production one holds, discussed in Part V, *infra*.

<sup>63</sup> See Chandler & Strine, *The New Federalism of the American Corporate Governance System*, *supra* note 4; see also *supra* note 47.

<sup>64</sup> So using judicial notice concepts would enable judges to draw upon knowledge developed by the state agency as to what constitutes effective audit committees. This could enhance the quality of fiduciary duty law judges articulate, without turning the device itself into a liability-determining mechanism.

<sup>65</sup> PCAOB expresses a more modest goal, necessary by virtue of inherent limits on what auditors can do in the exercise. See Auditing Standard No. 2, App. E, ¶ E67 (the goal is not to “grade the effectiveness of the audit committee along a scale” but to detect any audit committee ineffectiveness for purposes of the auditor’s overall control evaluation).

The advantage of a graded scale, on the other hand, implicates complex measurement challenges. State agencies interested in providing graded evaluations would need to develop adequate criteria by which to provide them. This raises a related and broader question they would need to answer: what constitutes audit committee effectiveness. This can vary with contexts, corporations and committees. Officials would need to recognize this informed by an appreciation of fiduciary law principles embracing this reality.<sup>66</sup> Officials would also need to understand that the audit committee is an element of the overall corporate governance system of which board-effectiveness is likewise a key element. Evaluating and certifying this broad functionality may be difficult.

Finally, there may be areas where auditors are in a better position than state agency officials to evaluate aspects of audit committee effectiveness. These may relate to technical aspects concerning internal control over financial reporting. State agency officials would need to develop an understanding of these areas or themselves rely upon auditors for assistance in their evaluation. Whether one or the other of such evaluations is adequate would require investigation; if each contributes unique expertise both may be necessary and each would rely upon the other to complete respective assignments.<sup>67</sup> Advantages to the state agency approach remain in affording this additional assurance auditors cannot provide.

### *B. Implementation*

From the states' viewpoint, a key attraction of a state-agency audit committee evaluation program is to create and/or leverage a brand name. Whether one agrees or disagrees with the structure and content of state corporation law or particular cases, states command legal expertise, especially as to concepts of independence, loyalty, competence and governance. Delaware has a brand name that attracts corporate chartering business to the state; Nevada appears interested in creating one; the larger states with more in-state corporations and a rich corporate law tradition also boast a brand name in the corporate world, including California and New York.

States adopting the concept would signal interest in developing the gold standard in corporate governance. The signal is superior to any similar signals the judiciary could offer through enhanced fiduciary enforcement, for example, since judges only resolve cases and controversies after-the-fact, not general corporate governance matters *ex ante*. Exploiting this opportunity by creating a state agency to provide audit committee

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<sup>66</sup> For “ten rules for really effective audit committees” offered by a corporate lawyer, see John F. Olson, *How to Make Audit Committees More Effective*, 54 BUS. LAW. 1097, 1106-12 (1999).

<sup>67</sup> *Cf.* Auditing Standard No. 2, ¶¶ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audit when such other work is competent and objective).

evaluations and certifications entails facing design and administration issues, the outlines of which are sketched as follows.

*Organization and Authorization.* The agency could be created as part of an existing arm of state government or a newly-created agency.<sup>68</sup> It could be part of the executive or legislative branches of state government, but should be separate from the judicial branches (to protect against the use of agency certifications in subsequent litigation). To enjoy sovereign immunity, the agency should be created as part of the state, rather than any political sub-division. The agency could be created either by act of the governor or through particular legislation.<sup>69</sup> Ideally, the agency would be designed to maximize insulation from political pressures.

*Staffing and Training.* Relevant experts within a state include active and retired lawyers, judges and academics. These experts could be appointed to the agency in the same manner as other state officials or judges. Or alternative appointment mechanisms could be devised, such as the governor appointing officials directly with or without approval of the state legislature. Some experts may opt for this role rather than going on the bench. Limited additional training would be necessary (as to internal control over financial reporting perhaps), though members would undoubtedly continue to maintain their expertise through formal and informal educational pursuits such as reading relevant literature and attending relevant conferences. States could also experiment with outsourcing portions of the exercises using professional organizations that match experts with assignments.<sup>70</sup>

*Certifications and Designations.* Corporation codes could be amended to require or make optional a periodic audit committee evaluation and public certification. A range of certifications could result depending on the scope of the related evaluation, from simple compliance to overall effectiveness. Corporations could disclose the certifications in any forum they wished, including as part of their public securities filings.

*Optional Approach Suggested.* Whether to make it optional or mandatory requires deliberation. While this choice should be left to individual states, there is a strong case

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<sup>68</sup> In Delaware, this task could be assigned to the existing Division of Corporations within the Department of State, or a newly-created corporations auditing office.

<sup>69</sup> In Delaware, the process of amending the state corporation law is straightforward, managed virtually entirely by the Corporation Law Section of the Delaware State Bar Association. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885 (1990).

<sup>70</sup> E.g., GEMinfo.org & Round Table Group ([www.roundtablegroup.com](http://www.roundtablegroup.com)). This approach may be valuable to address the start-up costs associated with developing new agencies. It would also provide resources to the state agency when demand for services periodically spikes, as it may at the program's outset and during periods of unusually high investor anxiety.

for the optional approach given absence of a compelling systemic need for the certification.<sup>71</sup> If optional, corporations would decide on frequency; if mandatory, states would specify whether it should be done annually, bi-annually, tri-annually, or perhaps at different frequencies for corporations of different size, complexity and financial-reporting track records.<sup>72</sup> If made optional, two categories of domestic corporations could be designated, one for those opting in and one for those opting out. In Delaware, for example, corporations could describe themselves as a “Delaware corporation” for those opting out; and a “certified Delaware corporation” for those opting in.

*Extending to Out-of-State Corporations.* States could offer this service for locally-chartered corporations and could even offer it for corporations chartered elsewhere. So extending the service offers the advantage of enhancing competition among states, with the partial disadvantage of requiring experts in one state’s corporation law to become expert in another (there is so little variation across states that this should be of limited significance). If offering the service to out-of-state corporations, these could be authorized to use the designation in a similar way to in-state corporations. A California corporation opting for the Delaware certification, for example, could describe itself as a “Delaware-certified California corporation.”<sup>73</sup>

*Self-Funding.* The agency could generate funds from those corporations using its certification service. Pricing of services could be proportional to SOX’s public company accounting support fee, given work required and information being generated and conveyed. It would certainly be a small fraction of those fees and likewise a small fraction of ongoing audit costs (especially now that they have risen significantly).<sup>74</sup> Pricing could be in part a function of the agency’s expenses. The largest agency expenses would likely be for salaries and office space. Travel expenses could be charged to corporations using the service.

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<sup>71</sup> See Part I, *supra*.

<sup>72</sup> Unlike the SEC or SROs, states also could offer this product to all corporations, not just those with registered and/or listed securities. Appeal for widespread use is suggested by proliferation of SOX-type governance practices among various non-SEC registrants (a phenomenon known as “Sarbinization”). *E.g.*, Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, [WWW.SSRN.COM](http://WWW.SSRN.COM) (March 11, 2004).

<sup>73</sup> Some may find such designations confusing, at first. But nearly all complex novelties are confusing, at first. *E.g.*, ALVIN TOFFLER, *FUTURE SHOCK* (1970).

<sup>74</sup> See FINANCIAL EXECUTIVES INSTITUTE SURVEY ON SARBANES-OXLEY SECTION 404 IMPLEMENTATION (Jan. 2004) [survey of 321 companies of various sizes shows that under SOX (a) on average annual costs rise \$1,322,200 (\$590,100 for internal control audits and \$732,100 for new systems) and (b) for companies with revenues exceeding \$5 billion, average annual costs rise \$6.2 million (\$4.7 million for new internal control audits, \$1.5 million for new systems)].

*Supplemental Budgets.* The agency need not be self-sustaining from service fees it generates. A portion of the state budget funded by corporation franchise fees could be allocated to underwrite the agency's budget. This would be a prudent budgetary measure to the extent the certification becomes a signal of a states' interest in the most effective audit committees and corporate governance generally. States offering the service to domestic and foreign corporations could offer a discount for domestic corporations, a device to lure additional chartering business to the state and offset such supplemental budgeting.

*Funding Conflicts.* A potential conflict arises when corporations pay a state to provide this service, however, on grounds of regulatory capture. There is no complete way around such conflicts. A way to minimize it in this context is to provide shareholders a voice in making the decision whether to use the service. After all, the service would be primarily for their benefit. Alternative tools to facilitate shareholder voice on the subject include state law voting mechanisms such as charter opt-ins or opt-outs and/or federal proxy mechanisms providing for more pro-active shareholder proposals on the subject.

*Other Factors.* This is not an exhaustive catalogue of relevant features of a state agency audit committee evaluation function. It outlines key features. States would be entitled and encouraged to experiment with variations on these and other features. The possibility of variations on these themes and particular models would induce competition among the states. Corporations, acting through their boards of directors and audit committees, would consider which programs, if any, offer the best product in terms of signaling credibility to the market and towards minimizing the corporation's cost of capital.<sup>75</sup>

#### IV. ANTICIPATING SUPPORTING CONSENSUS FROM THE FIELD

Comments offered publicly on PCAOB's Proposed Standard provide a strong basis for inferring that the state-agency approach would garner substantial support from a wide variety of constituencies, including users, producers and professionals.<sup>76</sup>

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<sup>75</sup> For data on the relationship between certain corporate governance features and ratings—and hence the cost of capital—see Hollis S. Ashbaugh, Daniel W. Collins & Ryan Z. Lafond, *The Effects of Corporate Governance on Firms' Credit Ratings*, SSRN.com (March 2004). The researchers find that credit ratings are unaffected by audit committee member independence, are positively related to board independence and negatively related to CEO power over the board. Audit committee certifications would provide more refined information to rate credit quality and possibly improve credit ratings and reduce the cost of capital.

<sup>76</sup> PCAOB recorded 194 comment letters on its proposed standard leading to Auditing Standard No. 2, all available using PCAOB's Web site, [www.pcaobus.org](http://www.pcaobus.org) (click

### A. Users and Producers

Several comments on behalf of investors and other financial statement users supported PCAOB's proposed standard in concept, though recognizing the difficulty auditors face in discharging the assignment.<sup>77</sup> They emphasized the need for an *independent* review, which excludes auditors. Suggestions included that boards of directors hire specialists from another CPA firm or from a non-CPA firm.<sup>78</sup>

Not all investor groups supported PCAOB's Proposed Standard.<sup>79</sup> The California State Teachers' Retirement System emphasized conflicts, limited auditor competencies and existing sources of supervision and information. Even it, however, concluded by suggesting that "PCAOB may want to review the charters and opine on the audit committee's diligence in mitigating risks to the public."<sup>80</sup>

A residual user concern focused on the importance of auditors understanding audit committee effectiveness. Absent such testing, one said, it would be "wrong and misleading to investors" for an auditor to report that it has assessed effectiveness of internal control over financial reporting without assessing the audit committee.<sup>81</sup> This can be solved, however, by providing an independent and competent review upon which auditors can rely.

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Rulemaking to link to PCAOB Docket, number 8). Aside from a handful of polemical screeds, the letters are thoughtful analyses providing numerous perspectives, some 60 of which are cited in the following discussion by letter number in the PCAOB docket.

<sup>77</sup> These included the Commonwealth of Virginia; CalPERS; the AFL-CIO; Ohio Retirement Systems; and Glass, Lewis & Co.

<sup>78</sup> Despite these qualifications, PCAOB asserted in explanations accompanying Auditing Standard No. 2 that "investors supported the provision." Auditing Standard No. 2, App. E, ¶ E63.

<sup>79</sup> This is contrary to PCAOB's assertion in explanations accompanying Auditing Standard No. 2 that "investors supported the provision." *Id.*

<sup>80</sup> *Comment Letter to PCAOB from California State Teachers' Retirement System* (PCAOB Rulemaking Docket No. 8, Letter No. 58).

<sup>81</sup> *Comment Letter to PCAOB from Glass, Lewis & Co., LLC* (PCAOB Rulemaking Docket No. 8, Letter No. 184). Glass Lewis is an independent proxy and financial research firm that provides research to institutional investors. *Id.* Its letter is signed by Lynn E. Turner, former SEC Chief Accountant.

Issuer comment letters nearly unanimously recognized the need for effective audit committees, while generally opposing having auditors perform the evaluation.<sup>82</sup> Only a few issuer comment letters supported using the auditor to perform this task, noting conflicts.<sup>83</sup> Another hinted at the state agency possibility: that the evaluation be done “on a periodic basis by a party other than the external auditor.”<sup>84</sup>

The vast majority of issuers opposing PCAOB’s proposed standard’s auditor evaluation of the audit committee cited SOX § 301 as conflicting with Auditing Standard No. 2<sup>85</sup> (some of these also cited conflicts with SRO rules requiring boards to conduct

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<sup>82</sup> Collective expressions of corporate America’s opinions sounded themes similar to those particular corporations offered and summarized here. *E.g.*, *Comment Letter to PCAOB from Business Roundtable* (PCAOB Rulemaking Docket No. 8, Letter No. 181) (concept is “particularly inappropriate” given SOX § 301 and SRO listing standards). Business Roundtable is an association of chief executive officers of corporations with a combined work-force of more than 10 million US employees and \$3.7 trillion in annual revenues. *Id.*

<sup>83</sup> *Comment Letters to PCAOB from United Technologies Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 46); *Chittendon Corp.* (PCAOB Rulemaking Docket No. 8, Letter No. 34); *Kimball International* (PCAOB Letter Nos. 2 & 38); and *Crowe Chizek and Company, LLC* (PCAOB Rulemaking Docket No. 8, Letter No. 168).

<sup>84</sup> *Comment Letter to PCAOB from Texas Instruments Incorporated* (PCAOB Rulemaking Docket No. 8, Letter No. 114).

<sup>85</sup> *E.g.*, *Comment Letters to PCAOB from BP plc* (PCAOB Rulemaking Docket No. 8, Letter No. 47); *Pfizer Inc.* (PCAOB Rulemaking Docket No. 8, Letter No. 69); *Eli Lilly and Company* (PCAOB Rulemaking Docket No. 8, Letter No. 75); *Boise Cascade Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 81); *Commercial Federal Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 87); *Empire District* (PCAOB Rulemaking Docket No. 8, Letter No. 97); *Southern Union Company* (PCAOB Rulemaking Docket No. 8, Letter No. 98); *EnCana Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 111); *Texas Instruments Incorporated* (PCAOB Rulemaking Docket No. 8, Letter No. 114); *E. I. duPont de Nemours and Company* (PCAOB Rulemaking Docket No. 8, Letter No. 115); *Edison Electric Institute* (PCAOB Rulemaking Docket No. 8, Letter No. 117); *Cummins Inc.* (PCAOB Rulemaking Docket No. 8, Letter No. 123); *Irwin Financial Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 125); *EMS companies (Solecdtron, Flextronics, Celestica and Sanmina-SCI)* (PCAOB Rulemaking Docket No. 8, Letter No. 130); *Sun Life Financial Inc.* (PCAOB Rulemaking Docket No. 8, Letter No. 134); *Jefferson Wells International* (PCAOB Rulemaking Docket No. 8, Letter No. 135); *Bank of America* (PCAOB Rulemaking Docket No. 8, Letter No. 145); *Computer Sciences Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 151); *Motorola, Inc.* (PCAOB Rulemaking Docket No. 8, Letter No. 154); and *BellSouth Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 162).

audit committee evaluations).<sup>86</sup> Many emphasized that audit committee effectiveness is a board of directors' responsibility,<sup>87</sup> questioned whether auditors possess requisite expertise, and noted that SROs are addressing the subject. Issuer comment letters that suggested tying the need to the board of directors returns the question to state doorsteps. On balance, therefore, the issuer community would likely support the state agency concept. If made optional, some would likely opt for it.

Few directors offered comments on PCAOB's proposed standard; those commenting said little concerning specifics of auditor evaluation of audit committee effectiveness. In general, however, one could expect directors to prefer a state agency approach rooted in common law principles. There is nothing new in these concepts. They are also standards-based and include the business judgment rule. This contrasts with the auditor's professional skepticism that would lead to second-guessing and PCAOB's heavily rule-based approach that suffocates business judgment.<sup>88</sup> While not possible to predict every director's opinion, it seems reasonable to expect that a critical mass would support it.<sup>89</sup>

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<sup>86</sup> *E.g., Comment Letters to PCAOB from Commercial Federal Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 87); *E. I. duPont de Nemours and Company* (PCAOB Rulemaking Docket No. 8, Letter No. 115); and *Bank of America* (PCAOB Rulemaking Docket No. 8, Letter No. 145).

<sup>87</sup> *E.g., Comment Letters to PCAOB from GlaxoSmithKline Services Unlimited* (PCAOB Rulemaking Docket No. 8, Letter No. 62); *EnCana Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 111); and *Yellow Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 146).

<sup>88</sup> Numerous comment letters criticized PCAOB proposal as exceedingly dense and rule-bound. *E.g., Comment Letters to PCAOB from Association of the Bar of the City of New York* (PCAOB Rulemaking Docket No. 8, Letter No. 68) ("overly rigid, technical rules," and encouraging "more principles-based and less rigid" approach); *Institute of Chartered Accountants in England and Wales* (PCAOB Rulemaking Docket No. 8, Letter No. 102) ("gives the impression of trying to achieve, and having an overall expectation of, 'perfection'", and evincing a "stifling bureaucracy"); *Irwin Financial Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 125) ("overly prescriptive and rigid"); *ATT Corp.* (PCAOB Rulemaking Docket No. 8, Letter No. 85) ("overly prescriptive"); *Boise Cascade Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 81) ("too prescriptive and detailed"); *Manufacturers' Alliance/MAPI* (PCAOB Rulemaking Docket No. 8, Letter No. 99) ("Unnecessarily prescriptive"); and *Prof. Dennis R. Beresford* (PCAOB Rulemaking Docket No. 8, Letter No. 21) ("overkill").

<sup>89</sup> Comments from consultants to boards furnish support. One proposed to overcome inherent limitations of auditor evaluations by suggesting that audit committee evaluation be done by a "third party approved by shareholders, in a separate evaluation. *Comment Letter to PCAOB from Value Alliance and Corporate Governance Alliance* (PCAOB Rulemaking Docket No. 8, Letter No. 127).

## *B. The Auditing Profession*

Auditing's Big Four firms<sup>90</sup> generally opposed PCAOB's proposed standard requiring auditor evaluations of audit committees, but not because it lacks a certain appeal.<sup>91</sup> Deloitte and PWC sympathized, in principle, but held deep reservations as to implementation; KPMG and E&Y made the practical objections more explicit. All accepted that audit committee effectiveness is an important component of the control environment, but only a component and therefore not warranting separate auditor evaluation. PWC emphasized that the board of directors is responsible for audit committee effectiveness; E&Y observed that internal control should function without audit committee involvement; and Deloitte recognized that many see the audit committee as outside the scope of internal control over financial reporting.

Deloitte and KPMG both expressed concern about evaluation capabilities given that auditors lack full, complete, unfettered access to audit committee members, meetings and information. E&Y identified the following areas where it believes auditors are capable of evaluation using objective criteria: clarity of responsibility articulation; assessing the committee's management approach to designing, implementing, and monitoring internal control over financial reporting; and whether it reacts to management's failure to respond to deficiencies. KMPG disagreed concerning whether auditors have these and other capabilities, noting in particular that it is not clear how auditors would assess member understanding of duties or the significance of time devoted.

All the Big Four singled out areas clearly beyond their capabilities or competence. Leading this list are those involving legal determinations like independence and listing standard compliance. Deloitte characterized testing compliance with listing standards under SOX § 301 as testing for compliance with laws/regulations, outside the scope of internal control over financial reporting. It also indicated the lack of auditor capability in evaluating whether the audit committee nominating process was independent. KPMG opined that compliance with listing standards under SOX § 301 or concerning ACFE

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<sup>90</sup> The firms and the number of their letters in PCAOB's comment-letter docket are Deloitte & Touche LLP (71); Ernst & Young LLP (E&Y) (144); KPMG LLP (91); and PriceWaterhouseCoopers LLP (PWC) (82).

<sup>91</sup> This view is contrary to PCAOB's assertion in explanations accompanying Auditing Standard No. 2 that auditors "were generally supportive" although they sought clarity that the evaluation was "not a separate and distinct evaluation" but "one element" of the auditor's overall understanding and that auditors would have difficulty given lack of total access. Auditing Standard No. 2, App. E, ¶ E64.

under SOX § 407 are legal interpretations and regulatory compliance outside the scope of reliable financial reporting.<sup>92</sup>

Auditing's three mid-sized firms<sup>93</sup> offered opinions similar to the Big Four. BDO Seidman also emphasized that because corporate governance—not just the audit committee—is a critical component of the control environment, board effectiveness is critical. It also cautioned against having auditors provide implicit assurance on audit committee effectiveness.<sup>94</sup> Grant Thornton added that effective audit committees are not necessary to effective internal control over financial reporting and effective oversight is not sufficient for effective internal control over financial reporting. McGladrey & Pullen expressed greater optimism, opining that legal compliance matters aside, auditors possess objectivity and technical competence to judge audit committee effectiveness, but wanted the duty limited to “consideration of observable information and behavior.”

The AICPA substantially replicated comments of the Big Four.<sup>95</sup> An Illinois group was divided, though even supporters noted that auditors face a “difficult task” in evaluation, including as to legal and regulatory compliance.<sup>96</sup> A Texas group favored it, admitting that the audit committee's power over the auditor may deter objective assessment, but noting that ineffective audit committees can cause significant problems.<sup>97</sup> A New York group noted conflicts and competency issues, but again paving the way toward a state approach concluded that this task should be performed by the board of

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<sup>92</sup> Deloitte and KPMG both suggested that if the concept is retained, then management's report would also need to assess audit committee effectiveness. Deloitte cited for support SOX § 407's requirement that boards determine whether to have an ACFE and listing standards that require boards to perform annual audit committee assessments. KPMG concurred (as did the mid-sized auditing firm, McGladrey & Pullen, LLP), adding that auditors should be permitted to rely upon management's assessment in preparing their own evaluation. The Big Four also all agreed that the listed factors need refinement.

<sup>93</sup> The firms and the number of their letters in PCAOB's comment-letter docket are BDO Seidman, LLP (136); Grant Thornton LLP (101); and McGladrey & Pullen, LLP (142).

<sup>94</sup> BDO Seidman was the only major accounting firm to cite SOX § 301's directive as driving a conflict between the audit committee and the auditor and hindering communication, the dominant points offered by nearly every issuer comment letter and many others. *See supra* note 85 and accompanying text.

<sup>95</sup> *Comment Letter to PCAOB from American Institute of Certified Public Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 105).

<sup>96</sup> *Comment Letter to PCAOB from Audit and Assurance Services Committee of the Illinois CPA Society* (PCAOB Rulemaking Docket No. 8, Letter No. 103).

<sup>97</sup> *Comment Letter to PCAOB from Texas Society of Certified Public Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 78).

directors, the SEC or “some other body that is not in the employ of the audit committee.”<sup>98</sup> One professional auditors’ group believed the proposal is appropriate, but required more guidance;<sup>99</sup> another took the opposite position, urging its deletion.<sup>100</sup> The latter cited the litany of factors posing inherent limits, all of which would be neutralized by the state agency concept.

International associations of accountants expressed reservations, drawing on learning that likewise points towards a state solution. The largest group of international accountants observed that it is a difficult question: in theory, auditors cannot perform this task; in practice, someone must perform it; and on balance, the optimal solution is to require auditors to perform an evaluation linked narrowly to their assessment of the overall control environment.<sup>101</sup> A UK accountancy group noted that the UK Combined Code on Corporate Governance requires boards to conduct performance evaluations of audit committees.<sup>102</sup> A European group emphasized the need to address the conflict, not shrink from it, suggesting using a threats-safeguards approach similar to that of the IFAC Ethics Code which would involve requesting an “independent colleague (review partner) to assist.”<sup>103</sup>

Among accounting academics, the leading group, the American Accounting Association (AAA), opined: “one radical and perhaps cost-prohibitive suggestion is to require a second audit firm to perform the audit committee assessment on a less frequent basis (e.g., every 3-5 years).” As noted at the beginning of this Part, this would solve the problem of independence, but not of expertise. It indicates, however, a willingness that should lead the AAA to support the state agency approach—a willingness likewise

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<sup>98</sup> *Comment Letter to PCAOB from New York State Society of Certified Public Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 140).

<sup>99</sup> *Comment Letter to PCAOB from National State Auditors Association* (PCAOB Rulemaking Docket No. 8, Letter No. 113).

<sup>100</sup> *Comment Letter to PCAOB from Institute of Internal Auditors* (PCAOB Rulemaking Docket No. 8, Letter No. 112).

<sup>101</sup> *Comment Letter to PCAOB from Association of Chartered Certified Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 88). The Association of Chartered Certified Accountants boasts that it is the world’s largest professional association of accountants. *Id.*

<sup>102</sup> *Comment Letter to PCAOB from Institute of Chartered Accountants in England and Wales* (PCAOB Rulemaking Docket No. 8, Letter No. 102).

<sup>103</sup> *Comment Letter to PCAOB from Fédération des Experts Comptables Européens* (PCAOB Rulemaking Docket No. 8, Letter No. 79).

strongly indicated by substantially all the other comment letters the auditing profession provided to the PCAOB on its proposed standard, as summarized above.

### *C. The Legal Profession*

The American Bar Association (ABA) concluded that PCAOB's proposed standard was "not consistent with" SOX § 301<sup>104</sup> and "appear[ed] flawed and circular." Beyond these general fatal flaws, the ABA identified three more negotiable flaws: many requirements are beyond an auditor's expertise or are better handled by others; are not measurable by objective criteria; or require legal judgments.

The Association of the Bar of the City New York reported similar objections to PCAOB's proposed standard, and also objected on the grounds that the listed evaluation factors "would require a much greater degree of involvement by the auditors in the internal operation of the audit committee" and observation requiring skills beyond auditor expertise, including knowledge of listing standards and interpretations.<sup>105</sup> The New York State Bar Association expressed similar concerns, citing both independence-impairment when auditors perform this essentially managerial function and questioned whether auditors are in a good position to carry out the duties.<sup>106</sup>

No other bar association commented on PCAOB's proposed standard, though an informed guess suggests that most would concur with the views expressed by the ABA and the two New York associations. On the other hand, certain bar associations might have more specific concerns, including for example the Delaware State Bar Association, whose expertise in corporation law and corporate governance may equip and incline it to provide more detailed insights. In any event, if the comments these bar associations provided are representative, it is reasonable to infer that the legal profession as a body would support the state agency concept.

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<sup>104</sup> *Comment Letter to PCAOB from American Bar Association, Section of Business Law* (PCAOB Rulemaking Docket No. 8, Letter No. 185).

<sup>105</sup> *Comment Letter to PCAOB from Association of the Bar of the City of New York, Committee on Financial Reporting* (PCAOB Rulemaking Docket No. 8, Letter No. 68).

<sup>106</sup> *Comment Letter to PCAOB from New York State Bar Association, Business Law Section, Committee on Securities Regulation* (PCAOB Rulemaking Docket No. 8, Letter No. 180). The American Society of Corporate Secretaries echoed the points, also emphasizing how the SROs are addressing the questions. *Comment Letter to PCAOB from American Society of Corporate Secretaries, PCAOB Sub-Committee of the ASCS Securities Law Committee* (PCAOB Rulemaking Docket No. 8, Letter No. 106).

## V. ANTICIPATING REGULATORY HESITATION

Despite predicting likely support for the state agency concept from users and preparers of financial statements and from the auditing and legal professions, it is uncertain whether regulators or states would support it. These predictions can be informed by evaluating the overall prevailing framework of corporate governance and alternative models of how its components are produced. The current array is dominantly federal, with states residing in the background, a relationship that tends to support predicting federal regulatory hesitation and state reluctance or indifference. But there may be hope.

### *A. Federal*

Generations of corporate law scholars have debated whether state corporation law is a product of horizontal competition among the states and, if so, whether the competitive output showed a race to the top, to the bottom or to somewhere else.<sup>107</sup> As the intellectual and empirical debate stalemates on this horizontal competition among states, an alternative sees a vertical competition between federal securities regulation and state corporate law, with the federal hand dominant but still limited.<sup>108</sup> In this story, SROs either (a) fill a gap between federal and state corporate governance sources or (b) operate as an extension of the federal regulatory hand into territory better reached through superficially-private means or where federal courts would not allow federal administrative agencies to venture.<sup>109</sup>

Recent debates concerning SROs resemble the hoary corporate law debate in asking whether competition among SROs, plus foreign securities exchanges, are running

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<sup>107</sup> Debate dates to the 1930s, led by Justice Brandeis and Professors Berle and Means, continued through the 1970s in a noted exchange between SEC Chairman Cary and Judge Winter, and endured through the 1990s and today with scores of articles devoted to numerous aspects of the subject. For representative positions, see ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATION LAW* (1993) (top); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992) (bottom); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (lawyer and investment banker interest groups); William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L. REV. 401 (1994).

<sup>108</sup> *E.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 488 (2003); Jones, *Rethinking Corporate Federalism*, *supra* note 8.

<sup>109</sup> *See* Thompson, *Collaborative Corporate Governance*, *supra* note 4.

a horizontal race of their own, and whether this is to the top or bottom.<sup>110</sup> Similar debate concerns competition among other regulatory bodies, such as accounting standard-setters like the Financial Accounting Standards Board (FASB) versus the International Accounting Standards Board (IASB).

With PCAOB's creation a similar conversation is likely concerning its obvious competitors such as the International Auditing Standards Board. To the extent PCAOB also engages in standard-setting that affects corporate governance, however, a new conception of horizontal competition emerges: PCAOB can compete with states and SROs. PCAOB's product market is less clear than Delaware's (charters for franchise fees) or the SROs (listings for listing fees). But power to set the agenda and to control the processes of standard-setting may be intrinsically valuable, and despite SOX's effort to insulate PCAOB from the auditing profession, rents may remain available that PCAOB could have a major role in allocating.<sup>111</sup>

In the case of evaluating audit committees, which body should set the agenda and specify required elements: the SEC, SROs, PCAOB or states? The SEC may fear direct efforts to do this would extend beyond the power Congress granted it in SOX (or, more precisely, that a federal court might accept this argument);<sup>112</sup> it may recognize that using SROs would be impracticable given their distance from the operational activities of audit committees; by default or design, PCAOB fills the bill.

Some evidence from the evolution of PCAOB's proposed standard into Auditing Standard No. 2 suggests that PCAOB is operating as a component of a more general federal-based corporate governance system.<sup>113</sup> Whether the SEC would want the states to do this is unclear. Some evidence suggests that federal regulators disfavor competition among SROs;<sup>114</sup> if so, they may likewise object to horizontal competition by states against these SEC instrumentalities.

Indulging a naïve perspective, however, if federal regulators were acting in the best interests of the nation, they would welcome the state agency approach to audit committee certification as well. Congress, the SEC and the SROs exhibited some federalism restraint in their provisions concerning audit committees: all reposed

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<sup>110</sup> E.g., John C. Coffee, Jr., *Racing Toward the Top? The Impact of Cross-Listings and Stock Market Competition on Corporate Governance*, 102 COLUM. L. REV. 1757 (2002).

<sup>111</sup> See Bratton, *Rules Versus Standards Versus Rents*, *supra* note 21.

<sup>112</sup> E.g., *Business Roundtable v. SEC*, 905 F.2d 406 (D.D.C. 1990).

<sup>113</sup> See *supra* notes 42, 45 and 49 (discussing Auditing Standard No. 2's deletion of factors appearing in PCAOB's Proposed Standard concerning independence of audit committee nomination and selection process and compliance while retaining factor of member independence).

<sup>114</sup> See Thompson, *Collaborative Corporate Governance*, *supra* note 4.

substantial power in boards to review effectiveness and imposed disclosure requirements. PCAOB offers enhanced review by auditors, but is clearly aware of inherent limitations. None of these groups offers the solution best suited to the task.

Returning to federal regulators' self-interest, assigning this function to states would relieve these regulators of the particular associated burdens, while leaving them in a position to monitor the concept in action. The SEC operates using a restricted budget, after all, and must appeal to Congress to secure funding for its activities. When facing budget constraints, the SEC may prefer additional funds to support its enforcement activities rather than to develop or support new initiatives such as audit committee certification.

Permitting states a meaningful role in corporate governance offers the SEC another advantage. When systems fail and public protests ensue, federal regulators can point to the states for laxity in fiduciary standards or other weaknesses. The states are thus also useful to Congress as scapegoats for scandal. So Congress may be willing to encourage the SEC to support a state-agency approach to audit committee certifications.

In fact, this view may explain what are otherwise SOX's half-measures. That is, why not preempt state corporation law for public companies, subjecting directors and audit committees to federal corporation law standards and review? Though complex political and legal explanations arise, a simple and plausible explanation is this: maybe the half-steps reflect knowledge that no regulatory regime is capable of preventing fraudulent shenanigans and regulatory laxity like that of the late 1990s and early 2000s.

Leaving the state hole enables the federal apparatus to point to state laxity when the next wave of corporate malfeasance is revealed. If federalization of corporate governance were made complete today, then when the next scandal appears there would be no one but the federal apparatus to blame. Under this view, states as a whole have an incentive to participate in reshaping corporate governance with the same visibility and commitment the federal engines have exhibited. Whether individual states have requisite incentives is considered next.

### *B. States*

Estimating the likelihood that particular states would pursue the state-agency audit committee certification product depends on a theory of state corporation law production. The traditional models—race to the bottom or top or an interest group model—offer ready predictions. If a race to the bottom best explains state corporation law production, states are unlikely to support the concept to the extent it imposes discipline and transparency on management. If a race to the top or an interest group model, then states are likely to embrace the concept. They would embrace the concept under the race to the top to the extent it lowers the cost of capital by reducing agency costs and serves the interests of capital markets and investors. They would embrace it under the interest group theory to the extent it produces additional revenue for states and

their lawyers, keeping services in the legal profession and out of the auditing and accounting professions.

Predictions of state inclination are more difficult if one embraces the two variations on the model, which appear increasingly more capacious and accurate descriptions of the observed federalization of corporate governance production. Under the vertical competition model, states only act when pressured and the federal machinery can nearly always directly or indirectly preempt them. The only way to prevent this is to fall into line; the state-agency concept would constitute an innovation rather than a capitulation. Under the disguised-federalization model, states may have a role, but may lack incentives to play it. A limited incentive is to genuinely compete with the federal apparatus in standard-setting leadership, but the federal hand is so powerful that this would require unusual political fortitude.

Within some states, such political skill might exist. States are not necessarily monolithic. They are political institutions populated by people holding differing views. Within a state, some lawyers and judges may favor the concept while others oppose it. Supporters could recognize that using a state agency along with the judiciary could cause a friendly internal competition as the state's standard-bearer. If the state agency achieved a degree of national recognition as a thought and practice leader in good corporate governance, within the boundaries afforded by state corporation law, this could incrementally induce superior judicial decision-making as well. States could compete with the federal apparatus in a real vertical competition amounting to a race to the top—when next season's scandals hit states could blame the federal machinery.

## CONCLUSION

Auditing Standard No. 2's emphasis on audit committee effectiveness returns federal law's ambitions for audit committees to the foundation, to state corporation law from which directors get their power and duties. The federal return to state corporation law leaves an incomplete and possibly incoherent corporate governance system. The incompleteness is epitomized by the federal emphasis on audit committee effectiveness and the lack of a mechanism—state, federal or private—to provide requisite assurance.

The example and analysis underscores the limits of half-measures. If the federal approach leaves open such an obvious hole in the framework, then it is just as deficient as the state corporation law it purports to correct. Either the federal regime must be complete and fully preempt state corporation law or states must be given incentives and space to participate in developing corporate governance. Congressional reticence against complete preemption of state corporation law suggests need to give states space, incentives and support to contribute meaningfully to improving corporate governance.

State-agency audit committee certifications provide a vehicle for state contributions. The concept would form a logical part of a complex—and unplanned—regulatory model of corporate governance production. It would embrace an emerging horizontal competition among different types of competitors, invigorate vertical

competition between state and federal producers, reinvigorate interstate competition and ignite intrastate competition. Getting these processes rolling would require only a single state to move first. Getting a state to move would probably require lobbying by the private-sector leaders likely to be supportive, including financial statement users and preparers as well as the auditing and legal professions.