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Book Review of Gatekeepers: The Professions and Corporate Governance by John C. Coffee, Jr.

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Book review

Gatekeepers: The Professions and Corporate Governance, J.C. Coffee Jr. Oxford University Press, Oxford, UK (2006). vii plus 389pp., £18.99, ISBN: 0-19-928809-7, 978-0-19-928809-0

In Gatekeepers, a commanding book of policy scholarship for an academic and professional audience, Columbia University's John Coffee diagnoses corporate scandals, assesses reforms and prescribes further corrections. The book scrutinizes auditors most extensively, and also thoroughly examines underwriters, attorneys, analysts and rating firms. These professions are vital in corporate governance, for "all boards of directors are prisoners of their gatekeepers," Coffee says, and no board "can outperform its professional advisors."

Gatekeeper effectiveness is influenced by the role that reputation plays in valuing professional services. Many suggest that auditors place a premium on honesty to win favor from external audiences, especially investors. Although essential, Coffee also explores how auditors must develop reputations, projected toward managers, for exercising professional skepticism when evaluating financial statement assertions. That trait is compromised when auditors cross-sell consulting services to clients or otherwise become beholden to management.

After cross-selling consulting services became an important revenue stream for audit firms during the 1990s, firms decided that each partner "should be compensated as much as a salesman as an auditor." This practice changed audit firm culture, undermining "the core values of the professional firm" in favor of "primarily commercial interests." To correct resulting auditing laxity and restore its traditional professional culture, US law now limits auditor cross-selling of consulting work to audit clients. These restrictions reinvigorate auditing's historical watchdog function.

Until recently, managers supervised auditors and auditors may have responded to their preferences, reducing audit quality. US reforms changed the relationship by vesting board audit committees with power over auditors. Other reforms may be better in theory, such as random assignment of auditors to particular engagements or using financial statement insurance, but these face practical hurdles. Coffee notes that an ideal governance structure is not easily identified and audit committee supervision of auditors may be the best available.

Auditor incentives to invest in reputation may remain low, however, for only a handful of firms are capable of auditing the vast majority of the world's largest companies. With limited competition, it may not pay for firms to develop reputations for exercising professional skepticism or providing rigorous audits. There appears to be no solution to this problem of concentration, short of the radical and unlikely prospect of breaking the firms up into a larger number of smaller units.

As a result of these limitations on incentives, legal liability threats are necessary to promote gatekeeper effectiveness, Coffee explains. But they pose a Catch-22. Without a credible liability threat, gatekeepers are tempted to acquiesce in managerial preferences; with it, they demand detailed rules and insist upon narrow duties. Coffee argues that regulatory reform must address this conundrum.

Excessive litigation risk is one explanation for the greater detail in US GAAP compared with other accounting systems, including IFRS. This is because "rules give the accountant a safe harbor, whereas discretion invites lawsuits." Coffee does not opine on whether rules or principles are superior in accounting, except to note that the choice affects the scope of discretion. He refocuses debate by asking the more fundamental question: to whom is discretion given? Whatever form standards take, current accounting practice gives discretion in choosing conventions to managers. Coffee would vest discretion in auditors.

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Yet this prescription faces a related obstacle: litigation fears also explain why auditors resist responsibility for assessing the appropriateness of chosen accounting conventions, insisting that management has this responsibility. Auditor duties are limited to testing year-to-year consistency without opining on the selection of applicable conventions. Coffee notes that the "true and fair view" principle has long been law, but that the profession diminishes its significance by emphasizing compliance with US GAAP instead. "True regulatory reform must re-introduce an obligation" of reasonableness on auditors, Coffee contends.

Reformers urge auditors to recognize a responsibility to detect material fraud, but the profession fears exposure to increased litigation by doing so. The profession emphasizes the role of internal controls in disrupting fraud and agrees to conduct tests and give opinions on control effectiveness. This auditor reticence appears in securities underwriting, where auditors avoid replying to underwriters' inquiries about fraud when preparing offerings. The standoff between underwriters and accountants is "disappointing," Coffee says, lamenting that the auditing profession is "refusing to discuss the prospect for fraud …with other gatekeepers."

Increasing auditor discretion and leverage with their clients are the primary policy prescriptions that Coffee offers to promote auditor effectiveness. He acknowledges that the profession will resist expanding its obligations, whether to assess reasonableness or search for fraud. Overcoming the resistance requires "internalizing norms" of oversight that may be hard to generate absent requisite incentives. Coffee notes that concern for reputation and fear of litigation, both amplified by recent scandals and reforms, may help. Moreover, cultural change may be under way.

Still, auditors probably lack sufficient incentives related to enhanced reputation to perform optimally. And litigation's deterrence may not induce ideal performance. It is prudent to instill the necessary professional values into the younger generation of accountants now being trained in universities. However, incentives ultimately hinge on the profession's internal culture and, due to the cross-selling of recent generations, it may take many years for the required cultural change to crystallize.

Perhaps participants can draw on lessons from the cross-selling experience to supply incentives. By rewarding auditors with lucrative consulting work, managers impaired auditors' willingness to second guess managerial judgments. Coffee says: "the carrot works better than the stick, precisely because the threat to take the carrot away was more credible." Following this logic, auditors may need to be paid bonuses for fraud detection and reasonableness opinions. The challenge, then, is to find money to subsidize these incentives. Underwriters and other gatekeepers could chip in by paying their proportionate share for these services.

The book mostly analyzes US practice, but includes an illuminating comparative chapter. This highlights Europe, where countries have less litigation than the US and use accounting systems that tend to rely relatively more on principles than rules. Coffee explains that the types of accounting frauds observed in different countries are related to the concentration of corporate ownership. In locales characterized by concentrated ownership, incentives motivate fraud artists to manipulate the balance sheet and funnel assets to controlling persons. In those with dispersed ownership, incentives push them to manipulate the income statement and award earnings-based compensation to insiders, especially by using stock options.

Such insights may help to explain the varying form of accounting standards in different cultures today. They also point up the more daunting challenges of designing reliable corporate governance systems amid globalization. That appears to be a book for another day, however. The immediate priority is to fix enduring problems in the US gatekeeper regime. This book addresses that need with clarity, scholarly thoroughness and policy astuteness.

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