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The University of Tennessee – Knoxville

The Issuer-Pays Model:
“Big Four” Auditors and Credit Rating Agencies
Share a Common Conflict

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Chancellor’s Honors Program: Thesis Project

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Abstract:

The financial crisis our world experienced in 2008 exposed the need for reform and regulation in many industries and groups. Two of those highlighted groups, credit rating agencies and public audit firms, share a common issuer-pays business model. This model of earning revenue leads to an observable conflict of interest between these independent industries and the parties who provide their income.

The purpose of this project is to analyze the conflict of interest imposed on credit rating agencies and the “Big Four” public audit firms by the issuer-pays business model. This paper begins by recapping the major developments in the history of both the credit rating and auditing industries, dating back to the inception of both services. Secondly, this paper examines the issuer-pays model and the conflict of interest the model presents to rating agencies and “Big Four” audit firms. Notable examples of the issuer-pays model influencing malpractice in the years leading up to the 2008 financial crisis, are presented. Finally, potential alternatives to the issuer-pays model are discussed. This paper concludes by suggesting that the issuer-pays model is not a sufficient model to satisfy the needs of investors, and that a new replacement to the model is necessary for the credit rating and audit industries.

Introduction:

The world’s most recent economic crisis left a devastating trail of destruction behind, particularly in the United States. Ben Bernanke, the former Chairman of the Federal Reserve, referred to the event as the worst financial crisis in global history, including the Great Depression (Egan). Countless people, including influential government officials and those tasked with

monitoring the market, were caught off-guard by the crisis. Many were quick to point fingers and place blame on the parties who had a part in causing this economic crash. Credit rating agencies and “Big Four” audit firms were two camps that shouldered much of this blame (Norris).

Interestingly enough, both of these industries happen to share the same method of acquiring revenue, which is often referred to as the issuer-pays model. Whether or not the blame received by these parties is warranted is open to debate, but it is clear that the actions of both rating agencies and “Big Four” audit firms leading up to the 2008 financial crisis were heavily influenced by the issuer-pays business model.

Background on the Credit Rating Industry:

A credit rating agency is a potential source of information for market participants, namely investors, who are attempting to ascertain the creditworthiness of borrowers (White, “Brief” 1). These agencies assign ratings, or opinions, to issuers of debt based on their ability to make timely interest payments and the likelihood of default. For example, Standard & Poor’s, a leading credit rating agency, describes their ratings as an “opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time” (Understanding). Essentially, a credit rating is an opinion on an issuers’ credit risk. The rating scale used can vary, but the most commonly used scale assesses ratings on a letter basis. The highest quality credit is assigned a AAA rating, the next best rating is a AA rating, then A, then BBB, BB, B, and so on until a rating of D is assigned in cases of default (Purda 3).

Credit rating agencies can trace their roots all the way back to 1909. In that year, John Moody published the first available bond ratings, which were centered entirely on railroad bonds

(White, “Markets” 211). By the year 1924, Poor’s Publishing Company, Standard Statistics Company, and the Fitch Publishing Company had joined Moody’s in the credit rating industry (White, “Brief” 1). These four rating agencies made their revenues by selling thick bond rating manuals to bond investors. This method of sales is known as the investor-pay business model, as public investors were paying agencies to learn about the credit quality of the bonds they were interested in investing their money in (1). The credit rating industry was solidified as a market necessity in 1936, when the Office of the Comptroller of the Currency prohibited banks from investing in “speculative investment securities”, or bonds rated BB or lower in modern day terms (1). This forced the banks to pay credit rating agencies for their ratings before they could invest in bonds.

The credit rating industry remained steady under the investor-pay model up until the 1970’s, when the industry was forced to address the “public good” nature of their ratings. As technology advanced and the use of the photocopier became popular, investors began to freely distribute their ratings from person to person (Deb and Murphy 1). In order to combat this issue, the credit rating industry shifted from the investor-pay model to the issuer-pay model. This meant that most credit rating agencies would now be compensated by the issuers of the debt, as opposed to the public investors (Purda 4).

Another problem the credit rating industry faced in the 1970s was the ability of a low-quality rating agency to enter the market, potentially driving down the prices issuers paid for their ratings. This issue was alleviated in 1975 when the Securities and Exchange Commission (SEC) introduced the designation of Nationally Recognized Statistical Ratings Organizations (NRSROs) (Purda 5). Moody’s, Fitch, and the newly merged Standard & Poor’s (S&P), were immediately grandfathered into the category. The SEC further ruled that only ratings from

NRSROs were valid for the determination of broker-dealers' capital requirements (White, "Markets" 214). The SEC never established criteria for what constitutes an agency as an NRSRO, but NRSRO status became a significant barrier of entry into the market. As of 2003, there were only four NRSROs, and by 2010 that count had only grown to ten (Purda 5).

According to SEC.gov, there are still just ten agencies recognized as NRSROs as of 2016. Of those ten, the "Big Three" of Standard & Poor's, Moody's, and Fitch have long dominated the world of investment, with S&P and Moody's being well larger and more powerful than Fitch (Deb and Murphy 2). In a 2007 survey among American and European investment managers conducted by Cantor, Gwilym, and Thomas, approximately 70% of fund managers indicated that ratings from S&P and/or Moody's were explicitly referred to in their investment guidelines (5). One can confidently presume that Fitch made up a large majority of the other proportion. As of 2015, the "Big Three" controlled nearly 95% of the credit ratings market (CFR.org). The ratings handed down from these three credit rating agencies have a clear impact on investor perceptions, in turn impacting the global market.

Background on the Audit Industry and "Big Four" Audit Firms:

The "Big Four" public accounting firms and most other public accounting firms provide auditing services for all public companies and some private companies. An audit is the examination of the financial report of an organization by someone independent of that organization ("What"). According to PwC.com, the purpose of an audit is to form a view on whether the information presented in the financial report, taken as a whole, reflects the financial position of the organization at a given date. However, an audit wasn't always in terms of financial reporting.

The history of an audit can be traced back to ancient checking activities in the ancient civilizations of China, Greece, and Egypt (Teck-Heang and Ali 2). These checking activities, which were essentially detailed verification of individual transactions, were observed throughout the world until the 1840s when modern auditing techniques emerged (3). With the advent of the UK industrial revolution in the mid-nineteenth century, factories and large machinery production created high needs for capital. However, the market share during this period was unregulated and highly speculative, causing high financial failures coupled with limited liability (3). This established the need for the auditing profession. From this time up until the early 1900s, auditing was mainly concerned with ensuring the correctness of accounts and detecting frauds and errors (7).

The accounting profession emerged in the United States in the late 19th century when the American Association of Public Accountants, presently known as the American Institute of Certified Public Accountants (AICPA), was founded in 1887 (Zeff 190). Nine years later, in 1896, the profession of accounting was accredited in the United States when New York State passed a law to recognize the qualification of Certified Public Accountants (CPAs) (190). The accounting profession and the audit industry began to take shape over the years as more and more companies voluntarily chose to have their financial statements audited (191). The use of independent auditors remained voluntary until the years following the Great Depression. The Securities Act of 1933 and the Securities Exchange Act of 1934, signed by President Franklin D. Roosevelt, together established the Securities and Exchange Commission (SEC) and required all publicly traded firms to have their financial statements audited by independent CPAs (Zeff 192). By the end of the 1950s, the “Big Eight” public accounting firms had been established and widely recognized with offices in every major U.S. city, several smaller U.S. cities, and

numerous major cities abroad (Wootten and Wolk). During this time, materiality and sampling techniques began to emerge as the focus of auditing shifted from fraud detection and prevention to assessing the truth and fairness of companies' financial statements (Teck-Heang and Ali 4).

By the 1970s, mostly all of the "Big Eight" accounting firms were established as large international partnerships (Wootten and Wolk). These firms experienced tremendous growth in the decade. "Big Eight" firm Arthur Andersen & Co. saw its operating revenues more than triple from 1970 to 1979 (Wootten and Wolk). At the end of the 1980s, the "Big Eight" was compressed into the "Big Six" when two 1989 mega-mergers created Ernst & Young and Deloitte & Touche (Zeff 203). By 2002, the "Big Six" had further condensed into the "Big Four", as a 1998 merger formed PricewaterhouseCoopers and Arthur Andersen & Co. dissolved due to their connection with a large accounting scandal at Enron in 2002 (Giroux 70-71).

The profession of auditing has seen several changes, alterations, and reforms throughout the years that have lead to the current state of the profession. Today, auditors are not only expected to assess the credibility of financial statements, but also to provide value-added services such as reporting on irregularities, internal control, and identifying business risks (Teck-Heang and Ali 7). At the completion of the audit, the firms are expected to prepare audit reports detailing their opinion on a company's financials in order to bridge the gap of information asymmetry between the company's management and shareholders. The "Big Four" accounting firms remain the same now as they were fourteen years prior in 2002. Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, and KPMG have truly earned their title of the "Big Four", as they currently audit over 98% of all assets of Fortune 500 companies (Francis and Michas). The services provided and opinions assessed by these firms are widely trusted throughout the world of investing.

The Issuer-Pays Model and the Conflict of Interest:

The audit and credit rating agencies have both followed unique, yet similar paths to reach their present statuses in the modern investment world. Both industries have seen alterations and reform throughout the years. Both professions exist to add legitimacy to claims made by issuers and assess a publicly available opinion on the overall condition of an entity. Investors around the world rely heavily on the information provided by both professions, and trust the objectiveness of their conclusions. But perhaps the most eye-opening parallel between the credit rating and auditing industries is whom they accept their fees and revenues from. Both the “Big Three” credit rating agencies and the “Big Four” audit firms follow the issuer-pays business model.

The issuer-pays model, sometimes referred to as the client-pays model, is a business model in which an audit firm or rating agency’s principal revenue stream is received from the issuers whose products they rate or assess an opinion on (Xia and Strobel 1). By observing the issuer-pays business model, a glaring conflict of interest is introduced for credit rating agencies and “Big Four” public audit firms. The audit and credit rating industries are both intended to be premised on independence and objectivity (Neuman 921). However, as Lynn Stout, a professor of corporate and securities law at the University of California-Los Angeles puts it, “When the people being watched get to choose their watchdog, they're not going to choose the toughest animal around” (Rapoport).

As previously discussed, issuer-pays model is used by most credit rating agencies, as they accept fees from debt issuers to rate their credit quality. Rating agencies are pressured, like any other for-profit companies, to focus their efforts on pleasing and retaining their paying clients (Neuman 934). After all, the fees earned by credit rating agencies from bond issuers make up approximately 90-95% of their annual revenues (Roberts 2). Therefore, because of these

pressures to retain clients and earn revenues, a conflict of interest is born. Some even argue that the issuer-pays model renders credit rating agencies incapable of providing truly independent and objective information about the risks associated with debt instruments and issuers (Hodge).

To illustrate the effects of the conflict of interest on credit rating agencies, an independent study conducted in 2012 compared ratings from an issuer-pays model rating agency (S&P) and a subscriber-pays model agency (EJR). Findings from the study indicated that the conflict of interest associated with the issuer-pays model lead to a significant amount of ratings inflation (Xia and Strobel 3). This practice of ratings inflation was most notably observed during the mid-2000s.

The credit rating industry and the issuer-pays model faced widespread scrutiny following the financial crisis of 2008. From the early 2000s to 2007, the problems with the issuer-pays model became apparent when rating agencies were tasked with calculating appropriate, reliable ratings on securities backed by mortgages, including subprime mortgages (White, “Markets” 220). These complex mortgage-back securities provided substantially larger profit margins for issuers, and the rating agencies had essentially no prior experience with rating them (221). Armed with that leverage, investment banks issuing these mortgage-backed securities now had an even more powerful threat to influence favorable ratings from the rating agencies, as they could simply take their securitization business to a competitor agency (221). Facing the fear of losing business and the considerable financial pressure to assess ratings that issuers wanted, the rating agencies issued wildly optimistic ratings for mortgage-backed securities, only to later be forced to downgrade these securities as losses became apparent (221). As of June 2009, Standard & Poor’s had downgraded 90% of collateralized debt obligations backed by mortgages that they originally rated AAA between 2005 and 2007 (221).

To further illustrate the shockingly poor performance of the credit rating industry during the crisis, major rating agencies still had high, “investment grade” ratings on Lehman Brothers’ commercial paper on the September 2008 morning that Lehman Brothers was forced to file for bankruptcy (White, “Markets” 218). It was now clear to investors the dangerous conflict of interest that the issuer-pays model presents to the credit rating industry. A CFA Institute member opinion poll conducted in July of 2008 showed that 11% of respondents had witnessed a credit rating agency adjust its rating in response to pressure from an investor or issuer (Hodge). Of those respondents, 68% believed the decision to adjust the rating was fueled by the promise of future business, or a fear that the issuer would take their business to a competitor (Hodge). Investors and the general public had finally seen the dangers of the issuer-pays model in the credit rating industry, but it was too little, too late.

Unfortunately, it took a global economic crisis to demonstrate the negative effects of the issuer-pays model in the credit rating industry. In 2008, the Securities and Exchange Commission passed multiple regulations in hopes of improving rating agency independence, but none of these addressed compensation and many felt the regulations would not play a part in a successful solution to rating agencies’ conflicts of interest (Neuman 939). Some investor groups looked to hold the rating agencies accountable for their actions leading up to the financial crisis by taking legal action. Pension funds that had invested \$5 billion in the mortgage-backed securities of now-bankrupt Thornburg Mortgage went after the rating agencies, claiming they ignored underlying risks in the securities and issued top ratings (Hoffman). The case against the agencies was later dismissed, as the funds could not provide evidence that the agencies had knowledge of the falsity of their ratings (Hoffman). This failed attempt to hold a credit rating

agency responsible for acting on their conflict of interest further highlighted the drawbacks of the issuer-pays model.

Like credit rating agencies, the public audit industry and the “Big Four” audit firms also operate under an issuer-pays, or client-pays, business model. The audit firms are paid large fees to audit the financial statements of all public and some private companies to provide an independent opinion on their financial integrity. In 2015, public companies paid an average of \$1.5 million in audit fees to independent auditors (Cohn). In terms of the “Big Four” audit firms, PricewaterhouseCoopers lead the group with \$15.2 billion in 2015 global audit revenues (Butcher). These notably large fees paid to “Big Four” audit firms have the ability to “silence” auditors and present a clear conflict of interest between the firm and the entity under audit (Sikka).

Unlike the credit rating industry, the public was not late to notice the conflict of interest due to compensation in the audit industry. A 1991 independent study concluded that there was a measurable correlation between the size of audit fees and the perceptions of auditors’ ability to resist management pressure (Gul 169). However, little was done in terms of regulation and reform to address this issue and other issues of auditor independence. The issuer-pay model hit a head in the early 2000s, as the audit industry came under fire when several large international corporations were exposed for furnishing deceptive financial statements, employing irregular accounting practices, and committing acts of fraud (Neuman 929). These were well-established brand name companies like WorldCom, Enron, and Tyco that ruined financial portfolios, pensions, and left thousands unemployed (929). The fallout of these major corporations caused investors to lose their faith and trust in the audit industry, as the auditors failed to inform the public of the deceptive and fraudulent accounting activities, and instead issued “clean” audit

opinions (929). Arthur Andersen, a then “Big Five” audit firm tasked with auditing Enron, did not survive the scandal (Wiggins, Bennett, and Metrick 5).

Following the major accounting scandals in the early 2000s, Congress was forced to address the lack of auditor independence quickly. In 2002, the Sarbanes-Oxley Act was passed in order to establish strict standards for auditor independence and limit auditors’ financial dependence on their audit clients (Neuman 931). This act forbid audit firms from providing many non-audit services to their audit clients, and prohibited auditors from having any direct business or financial relationships with the entities under audit (931-932). The Sarbanes-Oxley Act also attempted to limit the conflict of interest from the issuer-pays model by prohibiting audit firms from accepting contingent fees or commissions from their clients (932).

Although the Sarbanes-Oxley Act made efforts towards ensuring auditor independence and restoring the public faith in audit firms, the restrictions have proven to be insufficient in eliminating the conflict of interest issue altogether. Most notably, audit firms still continue to earn their revenues on the issuer-pays business model. The “Big Four” auditors and the issuer-pays conflict of interest came under fire again during the financial crisis of 2008. Numerous large investment banks and debt issuers were forced to file for bankruptcy, despite the fact that all of the entities had received unqualified, clean audit reports from “Big Four” accounting firms (Sikka). Perhaps the most notable investment banking collapse of the crisis was Lehman Brothers, who paid \$150 million in audit fees to Ernst & Young between 2001 and 2008 (Wiggins, Bennett, and Metrick 6). Lehman Brothers bankers created a scheme in 2001 called Repo 105 that allowed the bank to temporarily remove significant amounts of bad debts from their financial statements to appear much more financially healthy than they actually were (Chatterjee). Each year Ernst & Young issued Lehman Brothers a clean audit report, certifying

the bank's statements represented a true and accurate picture of their financial state. When Lehman Brothers filed for bankruptcy in 2008, the state of New York investigated the auditing practices of Ernst & Young and eventually filed a lawsuit against the firm in 2010 (Chatterjee). Although they initially defended their auditing practices, Ernst & Young eventually agreed to pay \$10 million to settle the suit (Chatterjee).

The "Big Four" audit firms clearly still face difficulties remaining independent and avoiding the conflict of interest presented by the issuer-pays model. The firms, and particularly the lead audit partners, often develop strong relational ties with their clients. If their client is a large corporation or bank, like Lehman Brothers, the prospect of losing that client's revenues is often not acceptable, as the firm develops a strong financial incentive to keep the client happy (Wiggins, Bennett, and Metrick 6). Many may argue that if the audit firms are allowed to continue to operate on the issuer-pays business model, it is only a matter of time before the next "Lehman Brothers" scandal.

Alternatives to the Issuer-Pays Model:

Despite the exposure of malpractice in the credit rating and "Big Four" audit industries during the 2000s, there has yet to be a change to the issuer-pays business model in either industry. The conflict of interest presented by the issuer-pays model is still omnipresent for rating agencies and "Big Four" audit firms, alike. However, several alternative business models for both industries have been presented and discussed. Most notably, the Securities and Exchange Commission conducted a study on the issuer-pays model in December of 2012, as required by the Dodd-Frank Act (Frankel).

The most notable proposed alternative to the issuer-pays model in the credit rating industry is the formerly used investor-pays, or subscriber-pays model. This model is still observed by some smaller rating agencies, today. Under the investor-pays model, the individual investors pay credit rating agencies fees in order to obtain ratings on potential debt investments (Securities and Exchange Commission 16). This model is an effective way of aligning the incentives of rating agencies and investors, and eliminating the conflict of interest between the agencies and debt issuers (Deb and Murphy 11). However, the investor-pays model presents a new potential conflict of interest between the investors and the rating agencies. An investor may have a financial interest in a particular credit rating, and in turn exert pressure on a credit rating agency to provide a credit rating that results in a favorable outcome for the investor (Securities and Exchange Commission 16).

Another alternative to the issuer-pays model is what is often referred to as the investor-owned credit rating model. Under the investor-owned credit rating model, sophisticated investors would create their own credit ratings, and debt issuers would be required to obtain ratings from credit rating agencies and the investors (Securities and Exchange Commission 62). The credit rating agencies would continue to be paid fees by issuers, but the issuers would also pay market-dictated fees to the investors for their ratings (63). The hope with this model is that investor ratings will produce more accurate credit assessments due to their personal stake in the industry (Bongaerts 21). However, critics of the investor-owned credit rating model argue that the model creates new conflicts of interest and is not feasible due to the reliance on investor cooperation (Securities and Exchange Commission 63).

There are several additional alternative models to the issuer-pays model that have been researched and proposed in recent years for credit rating agencies. A potential contingent fees

model would compensate rating agencies based on the accuracy of their ratings (Bongaerts 23). Another proposed model, the Franken Rule, would have issuers pay into a market-fund, and then have an elected committee disperse those fees to the credit rating agencies (23). The Securities and Exchange Commission's study on the issuer-pays model lists numerous other alternatives, including but not limited to: the stand-alone model, the designation model, and the user-pay model (64-68). Although all of these models could possibly be implemented, no model is free from criticism and barriers of implementation.

Unlike the credit rating industry, the list of alternatives to the issuer-pays model in the audit industry is not extensive. Although one could argue the benefits to an investor-pays model in the auditing industry, such a model is not feasible due to the nature of financial reporting. All publicly traded companies are required to have their financial statements audited by independent certified public accountants (Zeff 192). Not only would investors struggle to pay the large fees warranted by the "Big Four" audit firms, but they could also refuse to pay the fees and the model would be forced to retreat back to the issuer-pays model. However, there have been a few suggestions in recent years to begin talks of auditor compensation reform.

In March of 2012, a PCAOB Investor Advisory Group made a presentation in which they recognized the pitfalls of the issuer-pays model in the audit industry and made two alternative model suggestions. The first suggestion was one in which the mutual, pension, and endowment funds owning the majority of the stock in public companies would organize together to take greater fiscal responsibility in retaining the audit firms (PCAOB Investor Advisory Group). However, the more radical of the two suggestions proposed a system of financial insurance. Under this approach, financial statement issuers would be required to purchase financial statement insurance protecting their investors from financial reporting misrepresentations

(PCAOB Investor Advisory Group). The benefits of this model are seen at the issuer and auditor level, both creating a more accurate financial environment for investors. The financial statement issuers would work to ensure that their statements are free from misstatements in order to receive lower insurance premiums, while the auditors would be motivated to avoid incorrect assessments in fear of losing numerous clients (PCAOB Investor Advisory Group).

Conclusion:

As observed throughout the accounting scandals of the 2000s and the 2008 financial crisis, the issuer-pays business model presents a blatant conflict of interest for both credit rating agencies and “Big Four” audit firms. As Reuters contributor Alison Frankel puts it, “Fallout from the financial crisis has shown time and again that when money is at stake, investors cannot rely on systems contingent upon the honor of financial institutions” (Frankel). Although the model has existed in both industries for a substantial period of time, the sustained use of the issuer-pays model will likely continue to result in discreditable acts committed by both professions. Credit rating agencies will continue to be influenced to provide favorable ratings to avoid losing business, while “Big Four” auditors will always possess the ability to express clean audit opinions on materially misstated financials in exchange for larger fees. The public investors of the world economy deserve to have their confidence in credit ratings and financial statements restored, and that starts with abandoning the issuer-pays business model and implementing a new model for both the credit rating and audit industries.

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