

The Future Role of Auditors as Financial Gatekeepers

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Overarching Question

Are regulatory and legal forces post-SOX undermining the continued value and viability of large external audit firms as financial gatekeepers?

Risk Management Framework

- Auditor perspective
- Audit regulator perspective
 - SOX mandated a shift from self-regulation to government regulation of auditors of SEC registrants
 - SOX established the Public Company Accounting Oversight Board (PCAOB)
 - Independent body, although subject to SEC oversight
 - Funded by support fees assessed to SEC registrants and registered audit firms

PCAOB

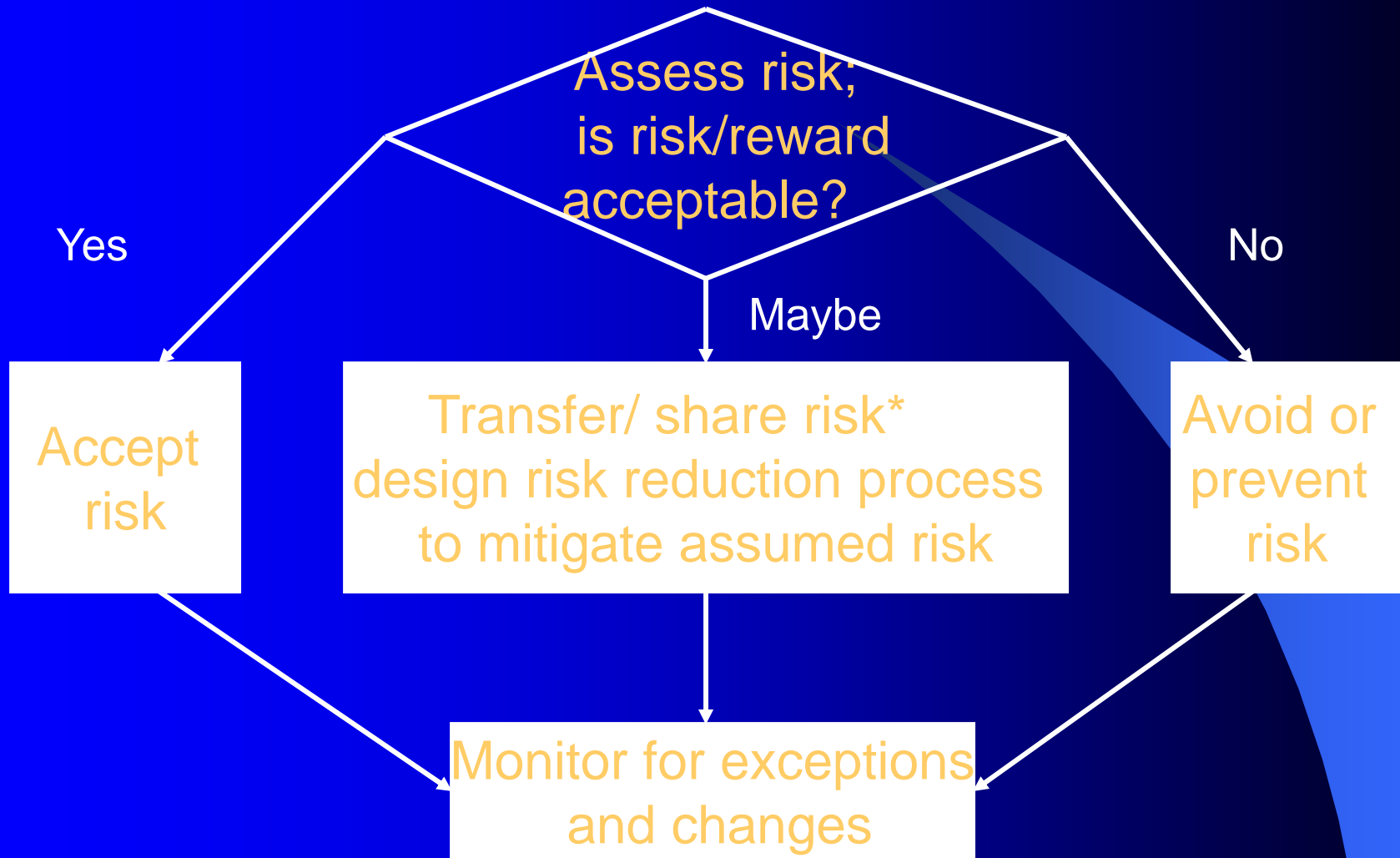
- Responsibilities

- Promulgates rules (auditing, quality control, ethics, and independence)
- Monitors and inspects for compliance
- Investigates and sanctions audit firms and auditors
 - Represents a new, additional source of discipline

- Selected Issues

- Lack of accounting and auditing expertise
 - Lawyer/SEC dominated Board and staff
- General exclusion and disempowerment of practicing auditors
- No SOX requirement to consider costs/benefits of regulation
- Lack of transparency

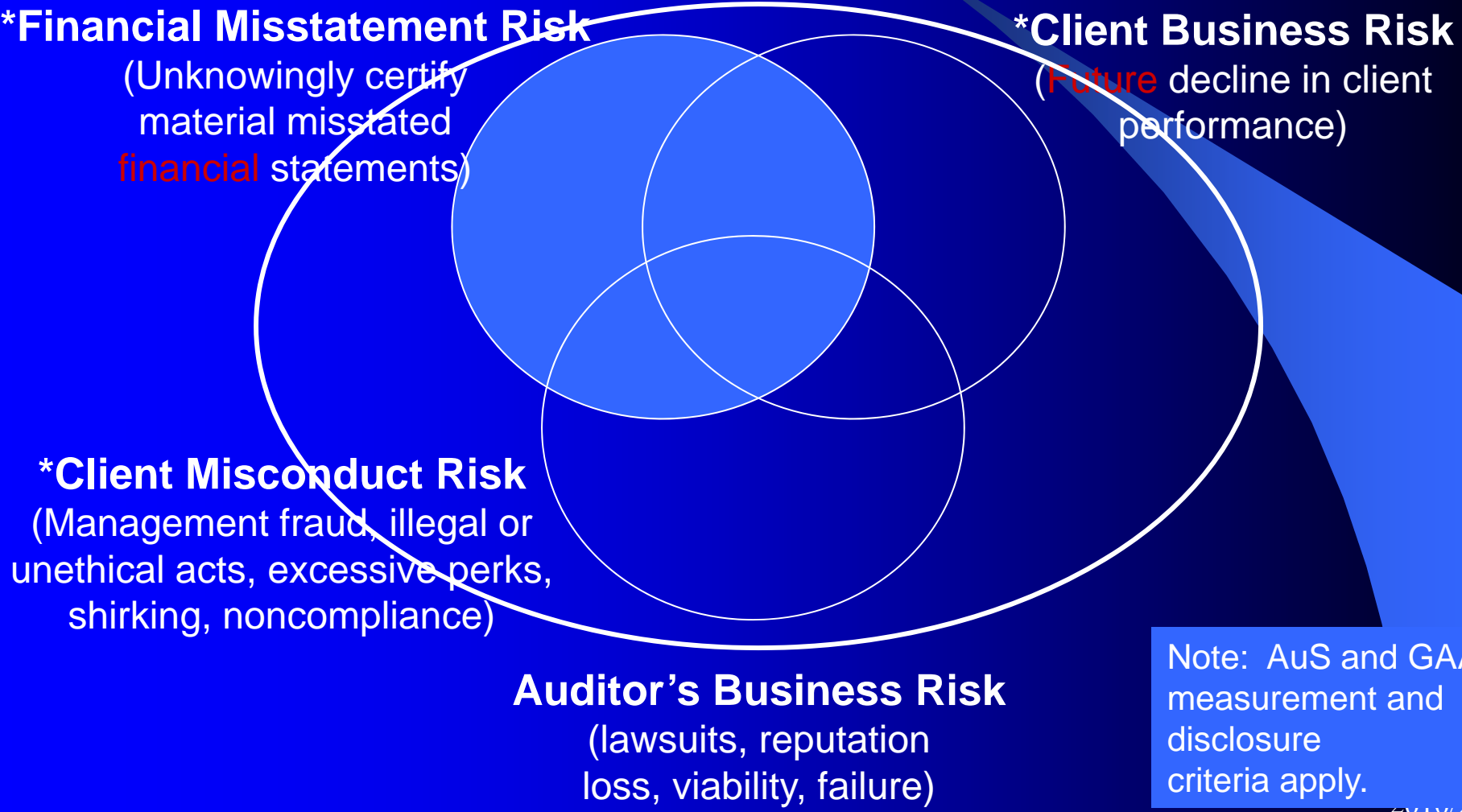
Figure 1
Risk Assessment and Control



*General examples: hedging, derivatives, insurance, contracting, pricing, joint ventures, alliances

Figure 2

Auditor Business Risk and *Engagement Risk



Note: AuS and GAAP measurement and disclosure criteria apply.

Litigation Over Alleged Audit Failures

- In accounting and auditing cases, the legal system does not effectively
 - Assess the role of auditor performance versus other factors and circumstances (i.e., assess the merits)
 - Determine the worth of claims (i.e., relate the merits to auditor sanctions)
- Trial is not a viable option for auditor defendants on mega cases claiming multi-billion dollar damages
 - This also drives-up settlements
- Uninsured (uninsurable) current (future) mega cases undermine the stability of the largest audit firms
 - Fraudulent financial reporting characterizes these cases

In Summary

- Auditor regulation and legal liability are important mechanisms for mitigating (detering) audit failures (and for compensating financial statement users for losses caused by any such failures)
- Even so, the current regulatory and legal systems transfer significant risks to audit firms, which the firms likely cannot bear because of regulatory, legal, and market constraints on audit firm risk management activities

A Proposed Solution: An Audit Master's Office

- Under the PCAOB umbrella
 - Avoids the need for legislative action to establish
 - Establish by PCAOB action with SEC approval
 - Provides access to all necessary confidential data with appropriate legal protection
- But independent of the PCAOB from the standpoint of supervision and control
 - Intended to give it the appropriate objectivity and incentives to evaluate the audit regulator

Audit Master's Office: Purpose

- Determine whether there was an audit failure for allegations from auditor litigation and regulatory actions involving auditors on SEC registrants
 - That is, assess auditor compliance with accounting and auditing standards
- Determine the contributions, if any, to the audit failure by
 - Auditor performance
 - Audit firm quality control systems and methodologies
 - Audit-related standards (auditing, quality control, independence, professional conduct, etc.)
 - Other regulatory processes (e.g., PCAOB inspections and risk assessments)
 - Accounting standards
 - Client actions and circumstances

Audit Master's Office: Use of Assessments

- Available to the PCAOB to use in the regulatory process to improve standards, inspections, etc.
- Available to an audit firm to use in the legal process
 - Voluntary
 - To avoid violating PCAOB confidentiality requirements imposed by SOX
 - Represent “friend of the court” advice on the merits and worth of plaintiffs’ claims
 - Based on considering the facts and circumstances of the cases and how they compare with a body of prior cases
 - Negative signal if not provided

Audit Master's Office

- Precedents
 - From outside accounting and auditing: The National Transportation Safety Board
 - From prior auditor self-regulation: Modifies and extends the QCIC process under the Public Oversight Board
- Represents an incremental change within the existing structure that is feasible