Maintaining the Value and Viability of Independent Auditors as Gatekeepers Under SOX: An Auditing Master Proposal

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I. Introduction

I am delighted to be part of this conference. It is both timely and necessary to consider the future role of auditors as financial gatekeepers. There have been many reforms over the last few years, of which the most radical is the shift from a self-regulated to a government regulated profession, with the Public Company Accounting Oversight Board (PCAOB) now overseeing auditors of companies registered with the Securities and Exchange Commission (SEC). Still, the scrutiny and criticism of auditors continues, and recent events have renewed the public debate over both the value of external audits and the viability of the largest firms performing these audits.[1, 2] So, assessing the consequences of reforms and considering where the auditing profession might be headed seems essential.

Yet taking stock is not an easy task. Companies and auditors are still adjusting to the requirements of the Sarbanes-Oxley Act of 2002 (SOX). Not all of the Act's provisions have been fully implemented. But this has not prevented a backlash against parts of it, particularly the Section 404 requirement for internal control effectiveness reporting by management and attestation by auditors,[3] over which auditors face growing

[1] Kinney et al. (2005) provide some quantitative evidence on the benefits versus the costs of auditing for a large sample of public companies.

[2] KPMG's problems from their past tax shelter services once again raised the specter that an audit firm could be rendered inoperable from a criminal indictment by the Justice Department. Any such move would further concentrate the market for accounting services and constrain clients' choices among accounting firms for audits and other services. Proposals to break-up or nationalize audit firms, or to convert them to audit-only firms are less speculative in this environment. Certainly the future of privately-owned accounting partnerships (whether LLPs or LLCs) continuing to serve as external auditors for public companies is not assured.

[3] The SEC formed the Committee on Smaller Public Companies primarily to address concerns over SOX and Section 404. The Committee recommended and the SEC approved a delay in the date for non-accelerated filers to comply with Section 404. The new compliance date is for fiscal years ending on or after July 15, 2007.

hostility from corporate America and a public relations nightmare (e.g., see Powell 2005, Smitherman 2005, Wolkoff 2005).[4, 5] Meanwhile, the PCAOB remains a work in progress, companies with significant accounting problems keep surfacing, restatements trend upward,[6] and auditors continue to get sued and investigated, even while they attempt to resolve litigation and regulatory investigations over services they performed pre-SOX.

Recognizing the challenge of my assignment, I decided to address what I consider to be an overarching concern: Are regulatory and legal forces post-SOX undermining the continued value from and viability of large external audit firms as financial gatekeepers? I explore this concern using a risk management framework. I discuss risk management post-SOX from the perspectives of both audit firms and the primary audit regulator – the PCAOB. I identify a number of factors that complicate audit-firm risk-management activities. Essentially, rather than assuming or sharing risks, it appears that the post-SOX

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[4] This backlash is not surprising. In unregulated markets, the voluntary demand for financial statement audits is common, while demand for audits of the effectiveness of internal control is not. Thus, imposing internal control reporting and auditing, and the attendant costs, on *all* public companies as a response to instances where auditors failed to detect fraudulent financial reporting is viewed by many clients to unjustly reward auditors by increasing their revenues and profits at clients' expense.

[5] For research on how private companies often provide audited financial statements, see Leftwich (1983), Strawser (1991), and Blackwell et al. (1998). In addition, using data prior to The Securities Acts of 1933 and 1934, Chow (1982) reports that 79 percent of NYSE and 48 percent of OTC industrial companies listed in the December 31, 1926 issue of *The Wall Street Journal* (with data available) had external audits. On the other hand, McMullen et al. (1996), using 1993 data, document that management of very few companies (n=55) in their overall sample (n=2,221) publicly reported on the effectiveness of internal controls (and only 25 used COSO criteria for doing so); moreover, it appears that few if any of these had auditor attestation on controls.

[6] Interpreting this trend is difficult. Some see it as "bad news" because it indicates that quarterly (reviewed) and annual (audited) financial statements continue to be misstated post-SOX. Others see it as "good news" because it indicates SOX is working and that financial reporting problems are being cleaned-up; that is, management is identifying and remedying financial reporting errors, perhaps with SOX certifications or in implementing Section 404 requirements, and/or gatekeepers (both auditors and audit committees) are getting tough post-SOX. Still others see it as "no news" because the upward trend is driven by restatements over accounting technicalities (a recent example is lease accounting) and a tightening of materiality (Logue 2005).

regulatory regime is transferring additional risks to audit firms. This has created new uncertainties for auditors, which now include PCAOB criticism for over auditing, while the critical risk of fraudulent financial reporting continues.

Major instances of fraudulent financial reporting typically create the impetus for regulatory reform under a fire-alarm approach to regulation (see Kinney forthcoming),[7] and enacting SOX in response to Enron and Worldcom represents the latest example. How much, if at all, SOX has mitigated the risk of fraudulent financial reporting (pre- and/or post-audit) by changing the behavior of management, boards and audit committees, auditors, regulators, users, and others is an open question. But regardless of whether SOX has reduced it, the risk of fraudulent financial reporting most certainly has not been eliminated.

Audit firms can bear some, but not all of the risk of fraudulent financial reporting. Even the largest audit firms remain vulnerable when fraudulent financial reporting actually occurs on large clients with high market caps and/or significant amounts of debt, and when it disguises fundamental problems with the viability of these companies. These circumstances can result in investor losses in the billions of dollars. Yet, audit firms *cannot* obtain insurance coverage for such large losses, and they are constrained in obtaining funds from alternate sources to otherwise cover a meaningful portion of such losses.[8] Moreover, the current legal system cannot be relied on to effectively sort out

[7] Political scientists describe a fire-alarm approach to regulation as one in which regulators take little action until constituents express complaints, and then regulators respond by "answering the alarm" (McCubbins 1984).

[8] State laws and professional codes of conduct preclude audit firms from operating as basic corporations and otherwise restrict audit firms from having outside investors. Obtaining resources by charging higher fees to some or all existing clients based on predicting future significant or catastrophic but low (albeit non-zero) probability events and the costs that will eventuate from them is complex and complicated by inter-generational allocation issues among partners joining and leaving a partnership.

causal relationships and auditors' responsibilities from limitations of generally accepted accounting principles (GAAP) and other factors (Kinney forthcoming). This makes it difficult to match auditor conduct with appropriate sanctions in resolving private civil litigation and regulatory enforcement actions.

Now that government regulation of auditors, via the PCAOB, has supplanted self-regulation, it is appropriate that the regulators explicitly share fraudulent financial reporting risk with audit firms. To do this, I propose establishing an Auditing Master's Office under the PCAOB umbrella, but independent from the Board and staff. The paper provides some discussion of the rationale for and the role of an Auditing Master's Office.

The paper proceeds with background on external auditors as gatekeepers (section II), followed by a discussion of audit firm risk management (section III), and background on the PCAOB as audit regulator (section IV), along with some commentary to give context to the discussion of risk management from a PCAOB perspective (section V). Next, the paper elaborates on fraudulent financial reporting as a central risk for audit firms (and the PCAOB as audit regulator) using evidence from auditor litigation (section VI), and proposes the Auditing Master's Office to help manage this risk and maintain the value from and viability of external audit firms (section VII).

II. Auditors as Gatekeepers

Financial information is used to plan, control, and evaluate the activities and performance of companies and their managers. But to be useful for decision-making and contracting, the information needs to be relevant and trustworthy. Attestation by external auditors (with expertise in accounting, auditing, systems, and client businesses) helps give the financial information the requisite reliability and credibility, even though management provides the information. Essentially, managers use audited financial statements to inform themselves, to inform others, and to comply with laws and regulations (Kinney 2000).

If auditors fail to detect and disclose material omissions or misstatements in the financial statements, users can seek compensation from auditors, among others, for losses caused by such failures. Some studies (e.g., Dye 1993) describe these as the informational and insurance roles of auditing, whereby attestation reduces information risk and, since investors have recourse against auditors for audit failures, "auditors provide investors with a means to indemnify losses" (Mansi et al. 2004) (also, see Menon and Williams 1994, Baber et al. 1995, and Khurana and Raman 2004).[9] However, as subsequently discussed, the insurance (indemnification) notion is fragile. Auditors cannot be asked or expected to insure financial statement users in trillion-dollar capital markets (Kinney 2005).[10]

Because audited financial information – typically financial statements prepared in accordance with generally accepted accounting principles (GAAP) – is used in contracting, auditors represent one type of gatekeeper. Auditors facilitate or inhibit companies' access to goods, services, debt, and equity for their operating, financing, and investing activities. (This occurs in both free and regulated markets.) While auditors are

[9] Recently the Supreme Court reminded in deciding the Dura Pharmaceuticals case that the purpose of permitting private lawsuits for securities fraud is not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause (Greenhouse 2005).

[10] The Financial Accounting Standards Board (FASB) estimated that public security-holders had $22.8 trillion invested at the end of 2003 (FASB 2005). About half of all SEC registrants have market capitalizations of less than $100 million and these represent about 1 percent of the total market cap; thus, about half of all public companies make up 99 percent of the total market (*Securities Mosaic* 2005).

not the only party that functions as a gatekeeper, auditors are not viewed as bit players in their gatekeeping role (Kinney 2005).

Regulated markets, such as the U.S. public securities market, help emphasize the compliance aspect of auditor gatekeeping given the need for companies to file audited GAAP financial statements with the SEC to comply with the securities acts. The Acts grant independent public or certified accountants exclusive rights to perform audits and give the SEC some regulatory authority over these auditors. SOX extends the SEC's authority over public accounting firms and auditors (largely through the PCAOB). It also extends the mandated scope of auditor attestation to reporting on management's assessment of internal controls over financial reporting,[11, 12] although material weaknesses in internal controls do not preclude SEC registrants from continuing to access the public capital markets.

Unqualified opinions by auditors provide assurances that management-prepared financial statements are free of material misstatements, but auditors' fees for rendering these assurances are paid by client companies.[13] As a result of identifying a management that does not follow GAAP or that commits fraud, an audit firm may lose the client, and

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[11] Since 1993, Section 112 of the Federal Deposit Insurance Corporation Improvement Act has required management of insured depository institutions with total assets of $500 million or more to annually assess and report on whether their internal controls over financial reporting are effective and to provide an independent accountant's *attestation* report on management's assertion. Nonetheless, the American Banking Association told the PCAOB that proposed Auditing Standard No. 2 "goes beyond an attestation to require a full audit, which significantly alters the requirements under SOX and significantly increases the costs to companies" (Hamilton 2004a, p. 1).

[12] In accordance with PCAOB Auditing Standard No. 2, auditors express two different opinions: (1) on management's assessment of the effectiveness of internal controls over financial reporting and (2) on the effectiveness of internal controls over financial reporting.

[13] SOX requires that audit committees assume responsibility for the appointment, compensation, retention, and oversight of the work of the external auditor, including resolution of disagreements between management and the auditor regarding financial reporting.

thus the future fees that otherwise would have been obtained. Audit firms are not compensated privately or publicly for such revelations (Kinney forthcoming).[14] Indeed, investors and creditors often sue the audit firm for not detecting and disclosing fraud sooner. Clients can dismiss their audit firms at will in the U.S. Essentially, only the costs of change and the need for SEC registrants to disclose the existence of and some circumstances around the change constrain clients from dismissing auditors.[15] Confidentially rules and restrictions preclude auditors from disclosing client information or discussing information disclosed by others, which constrains auditors from defending their work. All these factors contribute to some skepticism that auditors have adequate incentives to detect and disclose financial reporting problems.[16, 17]

Yet, there are a number of mechanisms (or countervailing forces) that help incentivize auditors to detect and disclose material misstatements (Nelson forthcoming). Many of these mechanisms are economic-based, and involve cost avoidance, as subsequently described. Even so, it should not be overlooked that countervailing forces also include professional and societal considerations. Some argue that there has been a

[14] Even so, audit firms can design partner and staff compensation arrangements to reward individual auditors for detecting and disclosing non-GAAP financial reporting.

[15] SEC registrants must disclose an end in the relationship with the auditor by filing Form 8K within five business days. The filing must also disclose whether or not the auditor's report for either of the past two years contained an adverse opinion, disclaimer, or qualification. Other reportable events include disagreements, internal control weaknesses, an inability of the auditor to rely on management representations, and an unwillingness of the auditor to be associated with financial statements prepared by management.

[16] Moore et al. (forthcoming) also argue that unconscious bias affects auditor judgments and that auditors' lobbying activities prevent meaningful reform; but see Nelson (forthcoming) for counter-arguments and King (2002) for evidence on how any bias is neutralized in audit team settings because groups create social pressure to conform to group norms.

[17] For evidence on whether the nature and extent of client-auditor relationships (including supplying non-audit services) create conflicts of interest that diminish the quality of audit services or users' perceptions of that quality, see Kinney et al. (2004), Larcker and Richardson (2004), and Myers et al. (2005) and their discussions of extant research.

gradual "deterioration in professional values" over time (Zeff 2003). Nonetheless, "as a professional, [auditors] recognize a responsibility to the public, to the client, and to fellow practitioners, including honorable behavior, even if that means personal sacrifice" (Arens and Loebbecke 1991, p. 75).

In spite of a dearth of positive incentives, audit firms and auditors face negative consequences to be avoided. Audit firms are highly regulated organizations. Audit firms are subject to a myriad of standards and laws on auditing, quality control, independence, and professional conduct, which define a lower bound for auditor actions and performance and require that audit firms maintain systems and processes to ensure compliance. Allegations of noncompliance with a standard or law can result in criminal actions, civil litigation, regulatory enforcement by a variety of federal and state authorities (amongst which are the PCAOB, SEC, and state licensing bodies), and discipline by professional organizations against audit firms and individual auditors. Finally, allegations of an audit failure can diminish the reputation of both the audit firm and the individual auditors involved.

As an aside, audit firms typically have to defend multiple actions on any single alleged audit failure. Thus, auditors can confront *all* types of actions, or typically some subset that include civil lawsuits by numerous different plaintiffs (which may not all be consolidated as class actions) and regulatory investigations, but only rarely criminal investigations.[18] Further, since audits can be international in scope, an alleged audit failure on any one client with global operations can result in all of these types of legal,

[18] In spite of criminal investigations of client personnel and the recent criminal proceedings involving Andersen and KPMG, criminal actions against audit firms or individual auditors are rare.

regulatory, and professional disciplinary activities occurring in both the U.S. and one or more foreign countries.

Together, these mechanisms are intended to deter auditors from accidentally (erroneously) or intentionally compromising their services by attesting to financial statements with material misstatements or omissions. These mechanisms are economic in nature. They impose costs on auditors. Defending against allegations of audit failure, including the diversion of partner and staff time and effort, can be very costly, as can settlements, judgments, and other penalties. Along with deterring audit failures, auditor liability is intended to help compensate users (plaintiffs) for their recoverable losses. It is this purpose that leads academics to attribute an insurance role to auditors. I will return to both of these issues in section VI, after discussing risk management activities from the perspectives of audit firms and the PCAOB as audit regulator.

III. Audit Firm Risk Management

All organizations must manage risk. Audit firms are no exception. Kinney (2000) provides a general framework for considering risk assessment and control activities, as shown in Figure 1. This section briefly overviews this framework before applying it to the specifics of risk management by audit firms.

Insert Figure 1

As shown in Figure 1, the first step is to identify the risk(s) and assess whether the risk/reward relationship is acceptable to the firm. If the answer is yes, the firm accepts the risk; if the answer is (unalterably) no, the firm avoids or prevents the risk. Between these two extremes, the firm’s choices are to transfer the risk, share it, or design risk reduction processes to mitigate it or otherwise improve the risk/reward relationship. In all instances, the firm monitors the risks – whether accepted, transferred, shared, mitigated, avoided, or prevented – for exceptions and changes.

Figure 1 notes a variety of mechanisms that exist to transfer, share, or otherwise improve the risk/reward relationship, including: hedging, derivatives, insurance, contracting, pricing, joint ventures, and alliances. However, laws and professional standards (many of which intend to address concerns over auditor independence) prohibit most all of these mechanisms from being used by audit firms.[19] Moreover, even insurance appears to be unavailable at meaningful levels of coverage for larger audit firms. At least in the current environment, larger audit firms cannot obtain insurance against high-end claims for significant to catastrophic amounts.[20] And, as previously noted, "pricing-out" risks assumed by raising fees to either "more risky" or all existing clients is not a realistic option for audit firms. Thus, audit firms' risk management mechanisms are limited. Still, as subsequently discussed, auditors share a number of risks with the audit regulator, so some forms of risk sharing with the regulator are possible.

But first, the discussion applies the risk management framework illustrated in Figure 1 to audit firms, beginning with the question: What risks do audit firms need to manage? Overall, audit firms must assess and control their *business risk*, which is defined as the risk of lawsuits, regulatory actions, reputation diminishment, declines in

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[19] This includes contracting for alternate dispute resolution or indemnification, which the SEC precludes under most circumstances on public clients. The Federal Financial Institutions Examination Council proposes extending a similar preclusion to financial institutions (*Federal Register* 2005).

[20] This statement is based on private discussions with attorneys and general counsels.

audit firm viability, and audit firm failure from *all* sources, not just audit services.[21] Of course audit services represent a major source of business risk.

Focusing on audit services, auditors need to manage *engagement risk* – the risk of incurring losses from associating with a particular audit client (Huss and Jacobs 1991, AICPA 1992, Kinney 2000). To do this, auditors must assess and control the three elements of engagement risk: (1) *financial misstatement risk* (also called *audit risk*), the risk that the auditor will unknowingly certify that financial statements are free of material misstatement when, in fact, they are materially misstated;[22] (2) c*lient business risk*, the risk of loss to the auditor from declines in client performance, client financial distress, and client failure; and (3) *client misconduct risk*, the risk of loss to the auditor from management fraud, illegal or unethical acts, excessive perks, shirking, and other acts of noncompliance by clients. Figure 2 illustrates these concepts and their inter-relationship, including the intersections among financial misstatement, client business, and client misconduct risks.[23]

Insert Figure 2

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[21] For example, threats to the viability of KPMG involved tax services, and one way to have controlled that risk was not to have developed and sold the aggressive tax shelters at issue.

[22] Misstatement risk encompasses opinions rendered on annual (audited) financial statements, interim (reviewed) financial statements, and management assessments of internal control and their effectiveness. However, arguably post-SOX, misstatement risk may no longer fully subsume internal control risk, given the separate audit of controls under Section 404. To the extent that it does not, this would be an additional risk for auditors (and regulators) to consider.

[23] Figure 2 is not drawn to scale. However, there are a number of studies that provide insights on these inter-relationships (intersections) and their (ex-post) frequencies in the context of auditor litigation (e.g., Palmrose 1987, Carcello and Palmrose 1994, Palmrose 1999) and restatements for non-GAAP accounting (e.g., Palmrose and Scholz 2004).

Exploring the elements of engagement risk, Figure 2 notes that both auditing and accounting (GAAP) standards have a role in the risk of financial misstatements.[24] GAAP provides the measurement and disclosure criteria that define misstatements, but there are additional subtleties to appreciate regarding the role of GAAP. For example, there is growing recognition that accounting standard-setters can promulgate standards that facilitate misstatements (Watts 2003 and 2005),[25] in part, because they are difficult to audit (Carmichael 2004, Palmrose 2005), or are even unauditable (Taub 2005).[26, 27]

While many assume that auditors would not encounter problems if they just did better audits,[28] Figure 2 clarifies that an auditor can do a "perfect" audit (i.e., comply

[24] I use the term auditing standards, while recognizing the complication and potential confusion from having three set of standards in the marketplace: (1) PCAOB audit standards (required by SOX for SEC registrants), (2) generally accepted auditing standards (GAAS) promulgated by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) (for private companies, among others), and (3) from an international perspective, auditing standards as promulgated by the International Auditing and Assurance Standards Board (IAASB). The ASB and IAASB are working together toward convergence, and the IAASB participates as an observer at the PCAOB's Standing Advisory Group (SAG) meetings. However, with three sets of audit standards, auditors must now manage the risk that allegations of audit failure can involve questions of which auditing standards were applied and whether these were the appropriate ones to use (Rosario and Holl 2005).

[25] The interplay between accounting standards and audit quality extends to earnings management. However, in considering earnings management from an auditor perspective, it is important to distinguish between non-GAAP reporting and aggressive reporting within GAAP, because the auditor's responsibilities over each differ. Nelson et al. (2002) provide useful insights on the role of GAAP from the perspective of auditors' experiences with earnings management.

[26] In particular, this issue has arisen as the FASB and International Accounting Standards Board (IASB) move more towards fair market value accounting (Carmichael 2004, Palmrose 2005, Taub 2005, Watts 2005), and away from historical-cost transaction-based accounting, traditional approaches to revenue recognition and expense measurement, and the concept of conservatism (Brown and Palmrose 2005, Watts 2003).

[27] The Panel on Audit Effectiveness (2000), the PCAOB's Chief Auditor (Carmichel 2004), and the Federal Reserve Board (Hamilton 2004b) have all recommended that the FASB consider the auditability of accounting standards before promulgating them. But tensions exist because the FASB considers auditors and the PCAOB as just one of many sources of input into their standard-setting process. Since the SEC must adopt FASB pronouncements before they apply to financial reports issued by public companies, it remains to be seen whether the SEC will continue to adopt FASB accounting standards that involve auditability problems and that may increase the likelihood of misstatements.

[28] Earnings management research, much of which relies on abnormal accruals, has contributed to the notion that auditors fall short in their role as financial gatekeepers. But, while abnormal accruals may reflect a

with auditing standards, or even exceed them) and yet not eliminate misstatement (or engagement) risk. This is because misstatement risk is influenced by, but does not coincide with, client business risk and client misconduct risk. Although increases in client business and misconduct risks increase the risk of misstated financials, clients can also suffer declines in performance, fail, and/or engage in misconduct without having misstated financial statements (or weaknesses in internal control over financial reporting). Yet, in these situations, allegations can be made against auditors and/or auditors can suffer reputation diminishment from being associated with such clients. And recall, as previously noted, it is difficult for users and the legal system to sort out (ex post) the contributions to an alleged audit failure of GAAP, audit-related standards (for auditing, quality control, independence, and professional conduct), auditor performance, regulator performance (see section V), and various client characteristics.

Thus, client business risk and client misconduct risk are among the reasons that client acceptance and retention decisions are important engagement risk (and overall business risk) management activities for auditors. One way for auditors to avoid being sued or criticized over the quality of their work is to avoid clients where this is likely to occur. Further, client business risk and client misconduct risk are among the reasons that auditors cannot just manage misstatement risk (or engagement and business risks) by *only*

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number of factors, including differences in performance or aggressive accounting, few studies actually distinguish between GAAP and non-GAAP reporting. Exceptions include DeChow et al. (1995 and 1996) that document statistically significant associations between non-GAAP reporting (using SEC enforcement actions) and abnormal accruals. Nonetheless, evidence in Bradshaw et al. (2001) demonstrates the limitations of abnormal accrual models for discriminating non-GAAP reporting from an audit perspective. Classifying a time-series of companies on Compustat into ten accrual portfolios (with about 6,700 observations in each) and identifying those with subsequent SEC enforcement actions, Bradshaw et al. find four enforcement actions in the lowest accrual portfolio and 28 in the highest (i.e., non-GAAP reporting rates that vary between .0006 and .004).

doing better audits. Complying with accounting and auditing standards can only partially protect an auditor.

Once the decision is made to accept the client and auditors have assumed engagement risk, they can audit more effectively to mitigate it (and, accordingly, mitigate misstatement risk).[29] Therefore, it is not surprising in 2004-2005, where auditors are being closely monitored and scrutinized, and are providing first-time internal control audits, that they would do more work, tighten materiality (and not waive adjustments of the misstatements detected), request advice and support from specialists within the firm including through consultations before making decisions, and make more conservative judgments and decisions on extant audit engagements. While these activities likely reduce misstatement risk, they also increase audit fees. Clients and the PCAOB have questioned whether these risk mitigation activities are necessary (i.e., whether improved audit quality is worth the cost, or whether an over auditing problem exists). However, assuming these activities are necessary, an important question remains: Are they sufficient, especially to detect collusive and actively hidden fraudulent financial reporting, when management overrides controls?[30] And, this extends the discussion to considering whether the resulting risk/reward trade-off is sufficient to maintain the value and viability of auditing in the post-SOX environment.

[29] An "audit risk" model forms the conceptual underpinnings for financial statement audits. While the propriety of this model is not the focus on this paper, there appears to be no economical alternative to a risk-based approach to auditing. Still, implementation issues do arise naturally and the Panel on Audit Effectiveness (2000) and Kinney (forthcoming) provide some discussion of these issues.

[30] This is another reason, along with the lack of voluntary demand, the Panel on Audit Effectiveness (2000) did *not r*ecommend the SEC require management and auditors to report on the effectiveness of internal controls. Instead, the Panel emphasized the need for greater audit committee involvement with internal control matters. AICPA (2005) provides guidance to audit committees in addressing the ever-present risk of management override of controls – the "Achilles' heel" in preventing fraudulent financial reporting.

To explore these issues requires considering the role of the PCAOB as audit regulator. The next section provides background on the PCAOB to give context to the subsequent discussion of risk management from the perspective of the PCAOB.

IV. The Audit Regulator: The PCAOB

PCAOB Statutory Authority

SOX Section 101 established the PCAOB "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." According to the PCAOB's website, it "has responsibility for improving the quality and transparency in financial reporting and independent audits, advancing corporate responsibility, and furthering the public interest."[31]

SOX gives the PCAOB the authority to register public accounting firms that prepare audit reports for issuers; establish or adopt (or both) auditing, quality control, ethics, independence,[32] and other standards relating to the preparation of audit reports for issuers; conduct inspections of registered public accounting firms; conduct investigations and disciplinary proceedings and impose appropriate sanctions where justified upon

[31] Probing the propriety of this broad statement and reconciling it with SOX is not the focus of this article. For example, some might suggest it intrudes into the FASB's domain. However, a broad statement of responsibility has the advantage of recognizing external auditing as just one of the inputs into the quality of financial reporting and, therefore, it appreciates the complexity of regulating audit-related matters.

[32] The PCAOB has not attempted the monumental, but arguably crucial, task of rationalizing the current rule-oriented approach to and regulation of auditor independence. For example, the independence rules in conjunction with Section 404 requirements have had a chilling effect on auditor/client communications and undermined the ability of clients to obtain accounting-related advice from their external auditors (Lumb 2005c). However, the PCAOB has issued independence rules on tax services and contingent fees (Rules 3521, 3522, and 3523), meanwhile the SEC continues to handle day-to-day inquiries that arise in practice when trying to comply with the complexities of the various auditor independence rules.

registered public accounting firms and associated persons of such firms; perform other duties or functions that the Board or SEC determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services; enforce compliance with SOX, rules of the Board, professional standards, and the securities laws in relation to the preparation and issuance of audit reports, and the obligations and liabilities of accountants thereto; and set the budget and manage the operations of the Board and its staff.

SOX gives the PCAOB statutory authority to make the rules, monitor and inspect for compliance with the rules, and otherwise enforce the rules such as by bringing and deciding disciplinary actions for non-compliance.[33] Unlike self-regulatory standard-setting bodies, which include among their members currently practicing auditors who either implicitly or explicitly weigh the market (or personal) impact of their standards, the PCAOB is not similarly constrained by market considerations (although, political considerations matter, as discussed in section V). Moreover, SOX does not require that the PCAOB consider the costs versus the benefits of its rules and actions (although the Board assures that it voluntarily does so).

Having standard-setting, inspection, and enforcement under one umbrella has the advantage, in theory at least, of allowing for timely feedback between practice and regulator. Thus, it has the potential for more current, seamless, and continuous improvements in standards and performance (by both auditors and regulators), and thereby improving the quality of auditing and financial reporting. However, this cannot

[33] SOX allows the PCAOB to compel testimony and production of documents through the SEC's subpoena powers. SOX also requires the PCAOB to notify the SEC of pending Board investigations involving potential violations of the securities laws and to coordinate its work with that of the SEC's Division of Enforcement as necessary to protect an ongoing SEC investigation (Section 105).

occur without open communication between practicing auditors and regulators.[34] This requires a high level of trust and mutual respect between both groups, which may take some time and experience to develop. Unfortunately, the design and implementation of the PCAOB may impede this development. For example, the general exclusion of practicing auditors from and disempowerment of them in the PCAOB's regulatory activities, and the natural uncertainties that attend regulatory inspections and the risk of enforcement may be among the impediments.

While in concept inspections allow the PCAOB to maintain confidence in the underlying quality of audits, the inspection process really focuses on areas for practice improvement. The public portions of the inspection reports discuss problems, deficiencies, and defects in audits and criticisms of audit firms and the work of their partners and staff. Neither the inspection process nor the public portions of the inspection reports are intended to provide a balanced assessment of the overall effectiveness of the audits of public companies by each of the registered firms.

Another impediment may be the lack of checks and balances with the SOX-designed regulatory structure.[35] The only designated check and balance on the PCAOB is another regulator – the SEC. SOX gives the SEC overall authority over the PCAOB. For example, the SEC appoints Board members, approves the PCAOB's budget, approves all

[34] Still, when communications occur, the PCAOB must agree to resolve practice issues. For example, the SEC's new securities offering reform rules that take effect December 2005 raise issues for SAS No. 72, which applies to comfort letters. Since the "matter is not a high priority on the PCAOB's agenda, the AICPA and a group of industry participants are developing a framework of discussions between underwriters and auditors and will share their white paper with the PCAOB" (Lumb 2005d, p. 3).

[35] The Panel on Audit Effectiveness (2000) recommended a governance structure that provided checks and balances by recognizing important roles for a self-regulatory body(s) (e.g., a more empowered Public Oversight Board and, if it had been supported, Independence Standards Board), the SEC, audit firms, and any other professional standard-setting bodies (e.g., the ASB) and related organizations (e.g., the AICPA).

standards promulgated by the PCAOB before they can take effect, and reviews disciplinary actions of the PCAOB upon application to do so. And, while SOX is silent on the need for the PCAOB to consider costs and benefits, the SEC is required to assess costs and benefits before promulgating rules. Nonetheless, the SEC's regulatory mandate and enforcement orientation, along with some evidence of tensions between auditors and the SEC (see Panel on Audit Effectiveness 2000), demonstrate that the SEC may not always provide an ideal solitary check and balance.

PCAOB Expertise Issues

To provide additional background for considering the PCAOB's risk management activities, recognize the PCAOB is a board of non-experts. SOX specifies that the PCAOB shall consist of five members, only two of which can be or have been certified public accountants.[36] To qualify for appointment to the PCAOB requires being "among prominent individuals of integrity and reputation who have demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures" (Section 101(e.1)).

These provisions are intended to insure that auditors neither dominate nor control the regulatory process. But in doing so, SOX minimizes the involvement on the Board of people with recent, relevant auditing and accounting experience and, therefore, essential

[36] If the chairperson is a CPA, then SOX specifies that he or she *cannot* have been a practicing CPA for at least *five* years prior to Board appointment.

expertise.[37] None of the current Board members has any substantive experience actually doing financial statement audits. It is somewhat ironic that SOX requires greater financial expertise for audit committees (Section 407) than it does for the PCAOB.

The lack of accounting and auditing expertise within the PCAOB is deeper than a non-expert Board. A lack of meaningful experience conducting financial statement audits characterizes most current holders of the 14 major staff positions listed on the PCAOB's website. This may be less important or even unimportant for some staff positions, but not for all.

The PCAOB can help mitigate these expertise problems by including currently practicing auditors in a number of activities. For example, the PCAOB elected to *establish* auditing standards themselves by relying on the Office of the Chief Auditor rather than *delegate* this important task to an outside professional group of auditing experts, like the Auditing Standards Board, as allowed under SOX (Section 103).[38] The Board describes their process for developing standards as an open public one with auditors and the accounting profession as among the sources that can provide input for the PCAOB to consider.

[37] This discussion is not a criticism of any member of the PCAOB or its staff. I believe the Board and staff are extremely dedicated and I have the utmost respect for them. However, the design and implementation of the PCAOB has been subject to very little analysis and debate (for rare exceptions see Wallison (2005) and Kinney (forthcoming)). Given the importance of the change from a self-regulated to a government regulated audit profession, it seems essential to analyze the usefulness and limitations of this form of government regulation. Moreover, the PCAOB's reach extends to foreign auditors of SEC registrants, and anecdotal evidence suggests that the PCAOB is not recognizing self-regulated (rather than government regulated) bodies as satisfactory for oversight and inspection of these auditors.

[38] The Office of the Chief Auditor had 12 employees at the end of 2004 (PCAOB 2004, p. 23). This contrasts with the expertise utilized for audit standard-setting by the ASB. For example, to develop and draft a single standard, ASB Statement on Auditing Standard (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (October 2002), the 14 members of the ASB utilized a core group of more than 17 additional people to serve on a task force and a subgroup, and as liaisons and technical staff.

The Board formed a Standing Advisory Group (SAG) to advise on the establishment of auditing and related professional practice standards. The SAG is composed of about 30 people, of which currently only six hold audit-related positions with firms that audit public companies. Indeed, a similar number (six) hold positions in public companies being audited, while another five are lawyers. Not only is SAG hampered by a lack of deep, current audit-related expertise, but it's currently limited to four two-day meetings per year and its agenda is full. Still, the Board and staff can and should bring requisite expertise to the standard-setting process by using other formal and informal means, such as ad hoc task forces. Apparently they are doing this, although there is little transparency around these activities. So, it is not surprising to find concerns expressed that auditor expertise is being excluded from the regulatory process (Wallison 2005).

Inspections is another PCAOB activity that requires extensive accounting and auditing expertise. The Public Oversight Board (POB), the prior self-regulatory body, relied on a peer review process, which utilized practicing audit partners and more senior managers from an outside audit firm to conduct reviews. This made sense given the need for broad and deep, current expertise in accounting, auditing, internal controls, audit firm practices and methodologies, client industries, etc. However, because it did not use paid employees who had severed all ties to their former accounting firms, the POB peer review process was criticized for lacking at least the perception of independence. So, while the PCAOB *decided* to hire its own inspectors, it has traded-off expertise for perceived independence. This is a very significant trade-off. The PCAOB's 2004

Annual Report discloses it had 120 inspectors in seven domestic offices (p. 23),[39, 40] and that "inspection teams are composed of accountants who have an average of 12 years of auditing experience" (p. 10). Twelve years is likely well below the average for POB peer reviewers.[41] In addition, anecdotal evidence suggests that the Board is having difficulty hiring and retaining people with extensive and high-level audit experience (including recently retired audit partners). While this evidence raises concerns, realistically, there is not enough publicly available information to assess the expertise of the inspectors employed by the PCAOB and how this expertise is being maintained over time.

The one profession not in short supply at the PCAOB is lawyers. The majority of current Board members are lawyers, as are a number of their aides, and nearly half of the holders of the major staff positions. In addition, many of the Board and staff members have prior associations with the SEC. Lawyers and prior SEC affiliates make up over 60 percent of the Board and major staff positions. Together, these imbue the PCAOB with an enforcement perspective, whether in perception or in fact.[42]

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[39] In 2004, the SEC chairman reported that 400 inspectors provide monitoring and oversight of 8,000 funds and 7,000 brokerage firms (*AccountingWeb.com* 2004).

[40] SOX requires annual inspections of registered firms that audit more than 100 public companies, of which there were eight U.S. accounting firms in 2004 (PCAOB 2004, p. 10). Other firms require inspection at least once every three years, and the PCAOB conducted 91 of these inspections in 2004 (p. 10). At the end of 2004, 1,423 audit firms were registered with the PCAOB, including 530 non-U.S. firms based in 76 countries (p. 8). (However, 585 of the 1,423 firms had no SEC registrants as clients.) The PCAOB adopted oversight rules that provide a model for inspections of non-U.S. firms so that the Board may rely on the work of a home-country regulator. In addition to these required inspections, the Board can use the Office of Registration and Inspections to conduct special inspections.

[41] As an example to benchmark these partner and (senior) manager experience levels, in a recent audit judgment study by Nelson et al. (2005) that gathered data from audit partners and managers of one B5 firm, audit partners average 21 years of experience and audit managers average 8.3 years.

[42] The inspection process, including using inspections as a source for both PCAOB and SEC discipline and enforcement, reinforces this perception. It is further exacerbated in the post-SOX environment by an emphasis on documentation in PCAOB standards, including Standard No. 2 implementing Section 404, and the notion that "if it isn't documented, then auditors (issuers) didn't do it." While the Panel on Audit

Furthermore, a legalistic focus may be contributing to making the operations and activities of the PCAOB more opaque. Certainly the Board is restricted from disclosing confidential audit firm and client information (e.g., see SOX Sections 102, 104, and 105). But, as discussed, a number of PCAOB activities seem to lack transparency. Indeed, there appears to be less information publicly available for insights into the practice of auditing under government regulation than under self-regulation (e.g., see Kinney forthcoming).[43] And, pre-SOX under self-regulation, the Panel on Audit Effectiveness (2000) even recommended that both the POB and SEC consider expanding their disclosures.

V. PCAOB Risk Management

With this background, I now turn to risk assessment and control activities from a PCAOB perspective. Here, arguably, the risks to be managed include all those described in Figure 2 and previously discussed from an auditor perspective. In addition, the PCAOB must assess and control its own form of business risk, namely the risk of loss of confidence in this SOX-created regulatory regime. The PCAOB must manage its own reputation to maintain confidence in the current regulatory process. To do this requires that the Board consider the media, the SEC, and Congress (along with market participants and the diverse groups that represent them). But the PCAOB must avoid tipping points at either end of spectrum – i.e., from either too much or too little regulation. Creating a reputation as a tough and unreasonable regulator risks a loss of confidence from over regulating. Perhaps paradoxically, to maintain its own reputation, the PCAOB must

Effectiveness (2000) recognized a need for appropriate documentation, it also emphasized the importance of qualitative information and the usefulness of interviews in the peer review (inspection) process.

[43] Kinney (forthcoming) explains this has inhibited both audit scholarship, particularly research on audit practice, and audit education.

maintain the reputation of the auditing profession. Most of the risks to be managed by the PCAOB are risks that it shares with auditors.

For example, a central focus for the PCAOB is misstatement risk related to audits of annual financial statements, reviews of interim financial statements, and auditor reporting on management assessments of internal controls. This is similar to misstatement risk from the perspective of auditors. Misstatement (audit) risk is clearly a shared risk for the PCAOB and auditors.

Audit standards are one mechanism to help mitigate misstatement risk. But, they can be crafted by the regulator to either share or transfer risk. This can be illustrated by considering two different conceptual approaches to audit standards. On one hand, the Board can promulgate output standards, which explicitly make the auditor responsible for detecting misstatements.[44] This attempts to transfer misstatement risk to auditors.[45] On the other hand, the Board can promulgate auditing standards (whether rules or principles-based) that provide guidance on or specify procedures for auditors to perform (audit inputs). This approach assumes that performing a particular procedure increases the likelihood of detecting misstatements. But the standard-setter bears the risk of this assumption. At least implicitly, it makes the auditor responsible for performance not detection, and this maintains some misstatement risk with the standard-setter.

The Board could go even further and make this risk-sharing explicit. For example, through its inspection process, the PCAOB could find that an auditor adhered to its audit,

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[44] For example, the PCAOB could specify that auditors do certain procedures, to say, detect management fraud and then "any other procedures that would be necessary under the circumstances to detect fraudulent financial reporting." Or, in the extreme, an output standard could specify just the latter.

[45] Output standards impose a strict liability system on auditors indirectly through audit standards rather than directly through the law. Another perhaps more subtle way to accomplish strict liability using standards is to remove extant protective (exculpatory) language from auditing standards, which has been suggested in speeches by some Board members.

quality control, and independence standards and, even though the auditor did not detect a misstatement, no discipline (or liability) would be appropriate. This is a point to which I will return in section VII. For now, it is worth emphasizing: The PCAOB's broad powers for standards, inspections, and enforcement may allow it to reduce audit failures, but the PCAOB has responsibility for the residual risk of failing to detect material misstatement when all of its standards have been followed (Kinney forthcoming).

Additional risk-sharing activities exist to mitigate misstatement risk. For example, the Board could facilitate continuous improvements in auditor performance by identifying and communicating "best practices" to auditors, thereby reducing misstatement risk by promoting more effective auditing.

Because it is a shared risk, auditors and regulators can and should work jointly and cooperatively to reduce misstatement risk. Again, audit standards are one way to do so. Ideally, both groups would coordinate and communicate on emerging practice issues and the need for additional standards, guidance, and/or risk alerts. There are indications that this process has not yet evolved, and it may be complicated by inspection lags, expertise, and other issues discussed in section IV. Such a process could have avoided the disruption of auditor/client communications and strained relations from implementing PCAOB Auditing Standard (AS) No. 2 (March 2004), which apparently did not rise to the PCAOB's attention until a 404 Roundtable in spring 2005 (Lumb 2005a).

The Board's reaction to criticisms of attestation on internal controls (under Section 404) also illustrates that, even though the PCAOB and auditors share misstatement risk, the Board can engage in activities to help mitigate misstatement risk for the PCAOB by trying to transfer more of it to auditors. The Board declined to reconsider AS No. 2.[46] The Board claimed that auditors misinterpreted the requirements of AS No. 2, failed to exercise reasonable judgment, applied checklist rather than tailored and flexible approaches, and generally over audited (Lumb 2005b). The Board framed it as an auditor problem, not a regulator problem.[47]

Moreover, having standards, inspections, and enforcement under one umbrella may exacerbate the occurrence of risk transfer rather than risk-sharing by the PCAOB. To maintain its reputation, the Board and staff have an incentive to label any detected deficiencies as performance problems (as occurred with AS No. 2) rather than as standard or inspection problems. Furthermore, the PCAOB is considering a proposed rule (Rule 3502), which would establish a *negligence* standard of secondary liability for individual accountants that appears to be inconsistent with the securities acts and not contemplated by SOX (Hamilton 2005). In this environment, it is difficult for auditors to rely on public statements by the Board that “the staff will not second-guess good faith audit judgments” (Lumb 2005b, p. 1), particularly during private and non-transparent inspection and enforcement processes.

But, recall from Figure 2 that misstatement risk is just one component of engagement risk. The PCAOB also needs to consider engagement risk because client business and misconduct risks influence misstatement risk. The PCAOB appears to be doing this for some tasks. For example, the Division of Registrations and Inspections relies on risk assessment to identify the audit firm engagements to inspect, with a goal of

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[46] The Board did issue a policy statement and a series of questions and answers, which could be interpreted as acknowledging a problem with AS No. 2. Nonetheless, the policy statement reinforces the message that “it is an auditor problem” and states that a failure to apply the concepts of the policy may reflect poor audit planning and result in unnecessary costs (Lumb 2005b).

[47] This is somewhat surprising considering that the crafting of AS No. 2 required the PCAOB staff have expertise not just in financial statement auditing, but in control process auditing as well as their integration (Kinney forthcoming).

identifying the engagements that may pose the most significant and consequential auditing challenges (PCAOB 2004, pp. 10-11). The Division staff considers general economic, industry, and issuer-specific factors. Further, inspections encompass the audit firm's quality control system, which includes client acceptance and retention decisions. So, the PCAOB's engagement risk considerations do overlap with those of auditors.

In addition, the Board has established an Office of Financial Analysis and Risk Assessment to monitor, analyze, and report on world and U.S. events which affect the capital markets and which present risks to U.S. public company financial reporting. The office intends to provide continuous and contemporaneous assessments of risk to the Board to identify trends and anomalies and assist the staff in selecting audit engagements for inspection, enforcement, or issues for standard-setting. Because this office is just being organized, it is too new to assess. But rather than orient this function internally and use it only to inform itself and the staff, the Board could also use this office to alert auditors to issues affecting misstatement risk (and overall engagement risk), and even develop and disseminate tools for doing so.

Perhaps more controversial is that the PCAOB also needs to consider auditor business risk. One of the objectives of the Federal Reserve is to maintain confidence in and the credibility of the banking system. Likewise, one objective of the SEC and PCAOB is to maintain confidence in the U.S. capital markets. To do this requires that the PCAOB maintain confidence in the firms that audit SEC registrants (American Assembly 2003). Auditor business risk is a risk shared by auditors and regulators alike. In the long run, the PCAOB cannot manage its own business risk by undermining confidence in the value of audits and the viability of the firms that audit public companies.

But, so far, the PCAOB appears reluctant to recognize audit firm business risk as a shared risk.[48] The PCAOB may even be exacerbating audit firm business risk as it manages its own business risk. For example, the PCAOB ignored early warnings that AS No. 2 went beyond SOX requirements and would be very costly (Hamilton 2004a), and when this prognostication proved true, the Board publicly aligned with client complaints over audit fees.[49] Recently, the PCAOB chairman said (*Business Week* 2005): "In a litigious society, there's no question that some auditors may be protecting themselves by doing work that all of us might think objectively is excessive. … That I want to see eliminated."

Unfortunately, lost sight of as the PCAOB, registrants, and the media question the extent of post-SOX audit effort is a more fundamental issue – namely, the effect of this new government regulatory regime on the risk of fraudulent financial reporting, which was the primary motivation for SOX. Users expect auditors to detect fraudulent financial reporting, and SOX has certainly increased this expectation (e.g., Solomon and Peecher 2004, Kinney forthcoming). Users have little appreciation for the reality that management can override controls in any company, even those with controls that appear to be operating effectively under Section 404; users have little appetite for the limitations

[48] An exception is the PCAOB's (2005) press release in response to the KPMG deferred prosecution agreement with the Justice Department, where the Board stated: "The PCAOB previously performed a limited inspection of KPMG's auditing work. … and based on the[se] inspection[s], the Board remains confident in KPMG's ability to perform high quality audits of public companies."

[49] Even though SOX assigns audit committees the responsibility for overseeing auditor compensation, early-on Board member Kayla Gillan assured registrants the PCAOB would be on the lookout for any evidence of "price gouging" (Hamilton 2004c). Historically, the Federal Trade Commission and the Anti-Trust Division of the Justice Department are the government regulators who focus on competitive conditions within all the professions, including competitive pricing in the accounting profession (Kinney forthcoming). Audit regulators like the POB and SEC have focused on audit quality and, in this regard, have been concerned about fees being too low, thus creating budget and time pressures that might compromise audit quality (Panel on Audit Effectiveness 2000). In testimony before the House Committee on Financial Services, the PCAOB chairman said the Board would in the future be as critical of auditors it discovered had done too much 'unnecessary' work as those who had done too little (*Financial Times* 2005).

of auditing in detecting intentional misstatements, even where management worked collusively and actively to conceal the misstatements from the auditors; and users have little tolerance for a non-zero defect rate, which is embodied in the notion of reasonable assurance.

Moreover, in the face of future instances of major financial frauds, the PCAOB, as the direct regulator of auditing, does not have the options to deflect criticism and avoid responsibility that were available to previous overseers of self-regulation, like the SEC pre-SOX. In addition to the issues previously discussion, the PCAOB cannot fall back on lack of funding and inadequate resources as rationales for regulatory failures. Even though the PCAOB's annual budget requires SEC approval, this approval is not conditioned on Congressional funding or limited by the SEC's own budgetary considerations. SOX (Section 109) instituted annual support fees from SEC registrants and registered audit firms to cover the PCAOB's budget.

Thus, fraudulent financial reporting represents an overarching risk for both auditors and the PCAOB. The next section discusses this risk in the context of the legal liability system faced by audit firms, explains why it threatens the viability of audit firms, and proposes a risk-sharing mechanism to mitigate this threat.

VI. Fraudulent Financial Reporting and Legal Liability

Fraudulent financial reporting increases the likelihood and severity of auditor litigation (e.g., see Palmrose 1987, Carcello and Palmrose 1994, Scholz and Palmrose 2004). To illustrate the threat to audit firm viability from fraudulent financial reporting, Table 1 uses a sample of 51 securities class actions filed and resolved between 1996 and mid-2002 (i.e., since the 1995 Reform Act, but prior to SOX). The sample consists of securities class actions with auditor defendants where both the total class settlement amount and the auditor's contribution, if any, are publicly available.[50] All but one of these actions involve the largest audit firms (i.e., the B6/B5/B4 or the three next largest firms), and this sample represents at least 25 percent of the class actions filed against the largest audit firms during the period.[51] The table overviews the sample (panel A), summarizes total and auditor resolutions (panel B), and provides selected characteristics for each total resolution category (panel C).

Insert Table 1

Table 1 (panel A) shows that the median decrease in the market value of equity of the public companies over the class period is slightly less than $473 million, although the decreases range from $12 million to almost $23 billion (not shown in the table).[52] The median total settlement is $14.5 million (3.6% of equity decrease); and, the median auditor payment is $1.8 million (with medians of 0.4% for percent of equity decrease and 21.5% for the percent of the total settlement amount).

The matrix in panel B of table 1 classifies auditor resolutions in three categories (auditor dismissed or no contribution, auditor contributed 100% of the total resolution, and auditor contributed to the resolution but less than 100%), and total resolution amounts in four categories (under $5 million, $5-$19.5 million, $20-$100 million, and

[50] These resolution amounts do not consider defense costs, which can be considerable.

[51] This is estimated from numbers disclosed by the POB, based on information reported to the POB's Quality Control Inquiry Committee (QCIC).

[52] This computation reflects the difference between the highest value of market capitalization during the class period and the market capitalization on the day after the class period ends. This represents a proxy for legally compensable losses, which likely are less because other factors unrelated to the allegations may also have caused companies' stock prices to decline. However, the computation does not reflect losses by other types of plaintiffs including debtholders.

over $100 million). Amounts in the latter category – over $100 million – are called mega-settlements.

Auditors are dismissed or make no contribution in 23% (12 of 51) of the class actions, and this most frequently occurs on total resolutions under $5 million (7 of 12, or 58%). In a few instances (3 of 51, or 6%), auditors contribute 100 percent of the settlement amount, and all of these are on total settlement funds under $5 million. In the majority of actions (36 of 51, or 71%), auditors contribute, but less than 100 percent.

Importantly, panel B (table 1) shows the median auditor resolution jumps to $75 million for the category of mega-settlements. Although the defendant audit firms managed each of these cases without compromising their firm's viability, before being resolved these cases likely posed the greatest risk to the firm. Panel C (table 1) describes some characteristics that distinguish these cases.

Panel C of table 1 reveals frequencies (or means) for selected client circumstances for each total resolution category. These circumstances include the class period, decreases in market value over the class period that exceed $3 billion, fraudulent financial reporting, NYSE listings, bankruptcy, and restatements. Restatements appear common across all resolution categories. Only one company with a mega-settlement declared bankruptcy. All the mega-settlements have decreases in market value during the class period of over $3 billion, while only one non-mega settlement does. Other distinguishing (and inter-related) circumstances for mega settlements are much longer class periods (mean 837 days), NYSE listings (78%), and fraudulent financial reporting

(89%). All but one of the mega-settlements involves fraudulent financial reporting, and the one without fraud has no auditor contribution (panel B).[53]

While these data highlight how failing to detect fraudulent financial reporting particularly on large clients (with high cap values) puts audit firms at risk in the litigation process, these data do not reflect resolutions for most lawsuits resulting from the bear market of 2000-2002, a number of which likewise involve fraudulent financial reporting, and the data precede SOX.[54] Not only has the dollar magnitude of subsequent securities class action settlements increased, but so has the number and magnitude of mega-settlements (Buckberg et al. 2005).

These trends likewise apply to auditor litigation, and the data suggest that current (unresolved) and potential "mega" cases can threaten the stability of even the largest audit firms. For example, consider data on auditor resolutions in excess of $100 million. The first auditor settlement of this magnitude occurred in the 1980's,[55] when there were two.[56] Similarly, there were two in the late 1990's (ignoring global settlements in the early 1990's by several firms over audits of multiple financial institutions). But, so far,

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[53] While the client acceptance/retention decision failed to filter out all these clients that eventuated in litigation against audit firms, note that the mega-settlements also tend to involve large companies listed on the NYSE. These are among the characteristics that can otherwise distinguish desirable audit clients, which helps make the client acceptance and retention decision an imperfect risk management mechanism, especially at the upper end of the risk distribution.

[54] In addition to other changes, auditor litigation exposure post-SOX has been increased because of Section 404 and AS No. 2. For example, pre-SOX a restatement did not equate to a failure in the financial statement audit or review (see Palmrose and Scholz 2004). But, post-SOX, a restatement presumes an unidentified material weakness in controls over financial reporting and, therefore, undermines defending the audit of internal control effectiveness.

[55] For the purposes of this illustration, auditor resolution data over time are not inflation-adjusted (Palmrose 1999).

[56] One of these involved payments of up to $163 million over audits of ESM. At that time the audit firm was reported to have adequate insurance coverage.

from 2001 to 2005, there have been eight auditor settlements of U.S. litigation that exceed $100 million (and all but two involved fraudulent financial reporting).[57]

Auditor legal liability is intended to both deter audit failures and compensate users for auditors' proportionate share of losses caused by such failures. If auditors fail to detect misstatements, including those due to fraudulent financial reporting, users expect to be compensated for their losses. Nonetheless, audit firms cannot cover user losses for significant or catastrophic amounts and remain viable businesses (especially considering audit firms cannot obtain insurance to cover any such amounts). For example, the net U.S. revenues from *all* sources for the four largest audit firms totaled about $20 billion for their 2003 fiscal years (*Public Accounting Report* 2004), as compared to the almost $23 trillion invested by public security-holders at the end of 2003 (FASB 2005).

Furthermore, to operate as deterrence mechanisms, civil litigation and regulatory enforcement cannot be random. That is, actual auditor liability and penalties need to reflect the merits of the claims against auditors, including the degree of departure from standards of due care, other applicable standards of the profession, and PCAOB rules. Obtaining a reasonable evaluation within the legal system of the merits for alleged audit failures and the worth, if any, of these claims continues to be a vexing problem, even a decade after passage of the 1995 Reform Act.

The legal system is premised on the option of trial. However, this premise is acknowledged to be very problematic for defendants in securities class actions

[57] The two without fraud involve failed financial/financial services institutions, which represents another characteristic that appears in some large auditor resolutions.

(Alexander 1991).[58] Decades ago non-jury (judge) trials were available in accounting and auditing litigation; but non-jury trials no longer occur unless agreed to by both plaintiffs and defendants (Palmrose 1991). Although judges can lack expertise in accounting and auditing matters, certainly, with limited exceptions, juries do. This makes it difficult for the legal system to determine the merits of users' claims and the relative contributions to users' losses from misstated financials, if any, due to GAAP, audit-related standards, auditor performance, (now) regulator performance, the actions of various other parties, and client characteristics (including declines in performance or failure).

So, even though defense lawyers "have become more sophisticated about honing their cases before mock juries" (MacLean 2005), trial itself is not really a viable option for auditors when users claim billions of dollars in losses, even where the probability of plaintiffs winning is very low. This is especially so under the circumstances of fraudulent financial reporting and/or a large unexpected business failures.[59] These circumstances engender great jury sympathy for plaintiffs and exacerbate jury unwillingness or inability to appreciate complex and technical responses to the essential question: Where were the auditors? Audit firms cannot take the risk of trying cases to verdict that "bet the entire audit firm." Importantly, these conditions likewise push

[58] Alexander (1991) explains this is partly due to directors' and officers' insurance, which is available to fund settlements, but not necessarily trial judgments where findings of fraud can trigger fraud exclusions and nullify coverage. Over 1,700 federal securities class actions were filed between 1996 and 2004 (MacLean 2005); around half had any accounting-related allegations, the majority of which involved allegations of misstated interim or annual financial statements, and a subset of these had auditor defendants. In spite of indications more cases may be going to trial (MacLean 2005), since the 1995 Reform Act, only four federal securities class actions with post-Reform Act claims (i.e., claims filed after 1995) have been tried to verdict (Tu 2005). Two of these trials had auditor defendants, who "won" both cases.

[59] Note that these represent large ex post realizations on client business risk and client misconduct risk described in Figure 2.

settlement amounts upward (e.g., see Alexander 1991, Palmrose 1991), and contribute to the mega-settlement trend just described.

Currently, when audit firms are sued for failing to detect and/or disclose misstated financials (including from fraudulent financial reporting) audit firms have to fully assume the risks and manage the limitations and disadvantages of the legal process. In fact, so far, the PCAOB has only added a new layer of potential discipline and enforcement.

The American Assembly recognizes this disconnect and proposes that the PCAOB share some risk (i.e., misstatement, engagement, and business risks) with audit firms. In their report (2003, p. 17), the American Assembly suggests:

> • When the PCAOB's inspection and evaluation of auditors finds an auditor has satisfactory quality control, that auditor could be given a measure of protection from civil liability.
>
> • The PCAOB plans to scrutinize audits of companies deemed to have a higher risk profile. When these examinations find the audits satisfactory, the auditors could receive an additional measure of protection.

These suggestions are worthwhile and I modify and extend them by proposing establishing an Auditing Master's Office within the PCAOB umbrella, but independent of the PCAOB.

VII. Auditing Master Proposal

Before describing the Auditing Master proposal, some of the major points discussed in the previous sections can be summarized as follows:

> • The PCAOB as the SOX-mandated government regulator shares a number of risks with audit firms and, therefore, could be allocated some responsibility for any audit failures.
>
> • The PCAOB is not an "objective" regulator. It has an incentive to maintain its operations, it lacks checks and balances, and it has issues related to expertise and transparency.

- Audit firms are highly regulated businesses. Regulations and market conditions foreclose audit firms from using most risk transfer and sharing mechanisms (including insurance against significant and catastrophic claims).

- The client acceptance/retention decision is an important risk management tool. But having retained the client, only misstatement risk can be mitigated by more effective auditing. And, even effective audits will not detect on a timely basis all instances of fraudulent financial reporting, or prevent client misconduct and unexpected declines in client performance or failure (Figure 2).

- The legal system currently cannot effectively assess the merits or determine the worth of claims involving accounting and auditing issues.

- Trial is not a viable option for auditor defendants on cases claiming multi-billion dollar damages (especially those involving fraudulent financial reporting).
    - This increases settlement amounts.

    - Current (unresolved) and potential future mega cases undermine the stability of even the largest audit firms.

Similar to the concept of a master that is occasionally used to advise the court in a legal proceeding, an Auditing Master's Office could be created to function within the PCAOB umbrella, but independent of the PCAOB (from the standpoint of supervision and control). An Auditing Master is one way to address a number of the issues raised in this paper, and respond to the overarching need for independent, objective accounting and auditing expertise to inform participants in the legal process. (Broad and deep accounting and auditing expertise would be a condition for staffing the Office.[60])

The purpose of the Office would be to assess auditor compliance with accounting and auditing standards (i.e. GAAP accounting standards and PCAOB auditing standards) over allegations of audit failure from litigation and regulatory enforcement on SEC registrants. Thus, the Office would be able to determine the merits, if any, of the allegations and the relative role of the various contributing factors whether auditor

[60] The Office should also be able to hire part-time staff and consultants for specialized expertise.

performance, audit firm quality control systems and methodologies, standards (i.e., auditing, quality control, independence, professional standards, etc.), other regulatory processes (e.g., inspections and risk assessment), GAAP, or client characteristics.[61] This determination would then be available to audit firms (to use in the legal process to resolve the allegations) and the PCAOB (to use in the regulatory process to improve its standards, inspections, etc.).

Audit firms (defendants) would voluntary decide to furnish assessments by the Auditing Master's Office to the court as part of the legal process. (This avoids violating confidentiality requirements imposed on the PCAOB by SOX.) Input from the Auditing Master's Office would represent "friend of the court" advice on the merits and reasonable worth of plaintiffs' claims, based on considering the facts and circumstances of the specific case *and* how these facts and circumstances compare with prior resolved cases (and resolution amounts).[62] Of course, declining to voluntarily disclose any information would be a negative signal as to its potential content and might disadvantage a defendant audit firm in a legal proceeding.

Having an Auditing Master's Office reside under the PCAOB umbrella has several advantages. It should avoid having to obtain Congressional approval to establish the office. The PCAOB should be able to establish it under its existing SOX authority,

[61] This determination could be made for U.S. versus foreign audit firm affiliates and for the PCAOB versus foreign regulators, too.

[62] Currently plaintiffs and defendants hire experts for these assessments. However, these experts do not necessarily have detailed knowledge of all the accounting and auditing facts and circumstances on the particular case (and certainly not relative to other auditor litigation cases). Instead, among the experts' tools for settlement negotiations are "high-level" regression models that explain variances in past settlements (Buckberg 2005). These models rely on variables that, at best, represent very crude proxies for accounting and auditing matters and the merits of allegations against auditors over departures from accounting and auditing standards.

with SEC concurrence. The PCAOB umbrella would give the Auditing Master's Office access to all necessary confidential data with appropriate legal protections. On the other hand, making it independent of the PCAOB gives it the appropriate incentives and objectivity to evaluate the regulator.[63] Also, an Auditing Master's Office would relieve the PCAOB's current inspection process from some of its workload and allow it to better focus its efforts.

There is precedent for an Auditing Master's Office within the regulatory structure. It actually modifies and redirects the POB's Quality Control Inquiry Committee (QCIC) process.[64] Under the POB self-regulatory system, member firms were required to report to the QCIC, within 30 days of being served, all matters of alleged audit failures involving SEC clients arising from litigation or regulatory investigations, including criminal indictments. The QCIC reviewed the allegations to determine whether there were deficiencies in the reporting firm's quality control system, its compliance with the system, or professional standards. The QCIC made no determination concerning guilt, innocence, or liability of the reporting firm (Panel on Audit Effectiveness 2000, p. 193). The PCAOB has not created a function that duplicates the QCIC process, although parts of it occur through registration, inspections, and enforcement.

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[63] The Board created an office of Internal Oversight and Performance Assurance (IOPA) to conduct internal reviews and examinations to help ensure the efficiency, effectiveness, and integrity of PCAOB programs and operations. While the IOPA serves a different purpose than an Auditing Master, the IOPA also reports to the Board, and so lacks the requisite independence to objectively evaluate the role of the regulator in instances of audit failure. Finally, the IOPA as currently constituted would not have the necessary expertise to function as an Auditing Master. Similar issues, previously discussed, arise with both the PCAOB inspections and enforcement offices.

[64] An Auditing Master's Office also incorporates elements of The National Transportation Safety Board (NTSB) (POB 1993). The NTSB is an independent agency that determines the probable cause of transportation accidents and promotes transportation safety through the issuance of safety recommendations. For some aviation accidents, the NTSB delegates the actual investigation to the Federal Aviation Administration.

Finally, an Auditing Master's Office represents an incremental change within the existing structure that is feasible. It does not require radical changes in long-standing contractual and market arrangements based on theoretical, controversial, and untested proposals, such as proposals for financial statement insurance (Ronen 2002), or major reform initiatives, such as proposals for liability caps (*Economist.com* 2004).

In the current climate, audit firms can expect to engender little sympathy and support for enacting radical changes. But, an Auditing Master's Office is one example of what can be done to address audit firm risk management and viability problems, which are mostly rooted in regulatory restrictions and market constraints. While a more limited proposal by the American Assembly (2003) has found no traction within the PCAOB, the burden is on the PCAOB to suggest reasonable alternatives.

In conclusion, there has been little consideration of the usefulness and limitations of this SOX-created government regulatory system. Hopefully, proposals such as an Auditing Master's Office will encourage further discussions and research on the impact of government regulation on external (independent) auditing and the future role of large, privately-owned audit firms as financial gatekeepers.

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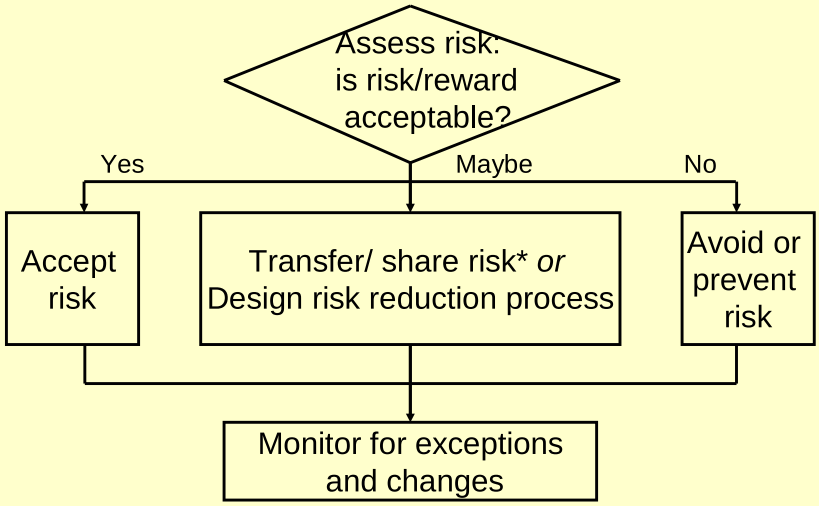
Figure 1
Risk assessment and control

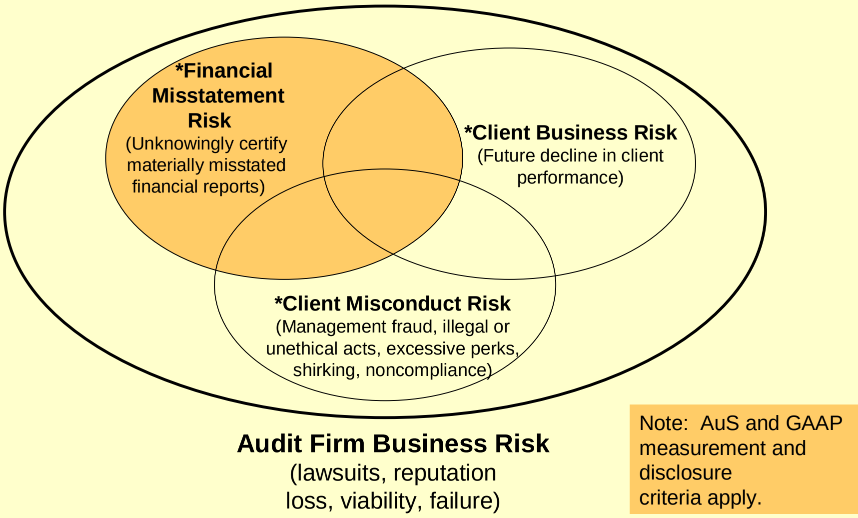


*Hedging, derivatives, insurance, contracting, pricing, joint ventures, alliances

Based on Kinney (2000)

Figure 2

Audit Firm Business Risk and *Engagement Risk



*Engagement risk consists of financial misstatement, client business, and client misconduct risks.

Adapted from Kinney (2000)

Table 1
Sample of 51 Class Actions Filed 1996-2001 and Resolved by 2002
With Auditor Defendants
With Data Available on Both Total and Auditor Resolution Amounts

Panel A: Overview	Median (n=51)
Decrease in equity over class period[1]	$472.9 million
Total settlement	
Amount	$14.5 million
As percent of equity decrease	3.6%
Auditor payment	
Amount	$1.8 million
As percent of total settlement	21.5%
As percent of equity decrease	0.4%

Panel B: Resolutions

		Total Resolution Amount (in millions)			
Auditor Contribution	Total (n=51)	Under $5 (n=16)	$5-$19.5 (n=15)	$20-$100 (n=11)	Over $100 (n=9)
None or dismissed					
Number	12	7	3	1	1
100%					
Median amount		$0.9			
Number	3	3			
Less than 100%					
Median amount		$0.7	$2.6	$11.7	$75
Number	36	6	12	10	8
Total	51	16	15	11	9

[1]Computed as the difference between the highest value of market capitalization during the class period and the market capitalization on the day after the class period.

Table 1 (continued)
Sample of 51 Class Actions Filed 1996-2001 and Resolved by mid-2002
With Auditor Defendants
With Data Available on Both Total and Auditor Resolution Amounts

Panel C: Total Resolutions Comparing Circumstances

		Total Resolution Amount (in millions)			
	Total (n=51)	Under $5 (n=16)	$5-$19.5 (n=15)	$20-$100 (n=11)	Over $100 (n=9)
Decreases in market value over $3 billion (number/percent)	10 (20%)	0	1 (7%)	0	9 (100%)
Mean class period (days)	622	530	612	592	837
Fraud (number/percent)	23 (45%)	5 (31%)	4 (27%)	6 (55%)	8 (89%)
NYSE listed (number/percent)	15 (29%)	1 (6%)	4 (27%)	3 (27%)	7 (78%)
Bankrupt (number/percent)	19 (37%)	5 (31%)	7 (47%)	6 (55%)	1 (11%)
Restatement (number/percent)	36 (71%)	10 (63%)	9 (60%)	9 (82%)	8 (89%)