

Auditor Liability: Implications for Auditor Regulation and the Irrational Auditor

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Auditors, as a group, have never been all that glamorous. Until recently, accountants in general have been viewed as a dull crowd, the sort of people you would not want to be caught in corner of the room with at a cocktail party. Auditors' reputation has gotten a bit edgier in the last few years; unfortunately, the perception of the profession has gone from boring to sleazy. After the now-familiar litany of corporate scandals – Waste Management, Sunbeam, Enron WorldCom, etc., etc. – auditors came into general disrepute, the subject of derision by the hosts of late night talk shows.

Of greater consequence than becoming the butt of jokes, the auditors found themselves in the sights of both Congress and the executive branch, the whipping boys for all the greed that tainted corporate America in the *fin de siècle* excess of the tech bubble. Arthur Andersen imploded under the weight of an indictment arising out of the Enron affair, which led to the firm's criminal conviction. By the time the Supreme Court eventually overturned that conviction, it was far too late to revive the one-time member of the accounting profession's Big Five.¹

It was also too late to repeal the Sarbanes-Oxley Act, enacted in 2002, which has a similar punitive feel to it. If any consistent theme can be found in the hodgepodge of reforms enacted by Congress in 2002 in the Sarbanes-Oxley Act, it is the legislature's intention to punish auditors for the sins of Arthur Andersen. Going forward, the remaining members of the Big Four were to be kept on a tight leash. And holding the leash would be a new quasi-governmental overseer, the Public Company Accounting Oversight Board (PCAOB). The PCAOB, or

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¹ Arthur Andersen LLP v. United States, 125 S. Ct. 2129 (2005).

Auditor Liability

“Peekaboo,” is charged specifically with keeping tabs on the auditors of public companies, so it has a narrow focus that will tend to push it toward close oversight of the industry.

Given all the punishment meted out, on top of the so recent and widespread public opprobrium toward the profession, it is more than a little surprising how well accountants are doing these days. Enrollment in undergraduate accounting programs is booming.² Who would have thought that accounting would become a “hot” career path? It is not difficult to see why bean counting has become so popular – audit fees have sky-rocketed in the wake of accounting reforms passed by Congress as part of the Sarbanes-Oxley Act.

The question this raises is whether the substantial sums creating the auditor’s new prosperity is matched by commensurate benefits for investors. Are investors receiving better, more accurate information that justifies the cost? The most controversial of the statutory provisions has been § 404 of the Sarbanes-Oxley Act, which requires the auditors to assess the integrity of the client’s internal controls.³ This requirement has been criticized for dramatically increasing the cost of audits. These criticisms have been supported by recent work by Eldridge and Kealey, who find that audit fees paid by a sample of 97 public companies increased, on average, from \$3.5 million to \$5.8 million, which can largely be attributed to § 404 compliance costs.⁴ This increase suggests that perhaps Congress was not as anxious to punish auditors as was implied by the legislators’ public fulminations against the industry at the height of the accounting crisis. From a financial perspective, this substantial spike in auditing revenues suggests that the profession is quite healthy, a welcome development for an industry in which

² Cite

³ Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262.

⁴ Susan W. Eldridge & Burch T. Kealey, SOX Costs: Auditor Attestation under Section 404 (Working Paper, University of Nebraska at Omaha, June 2005)..

Effectively conceding that there is a real problem here, the SEC recently delayed implementation of the § 404 requirements for smaller companies in response to a recommendation by its Advisory Committee on Smaller Public Companies. Michael Bologna, SEC’s Small Company Panel Recommends Relief From Section 404 Filing Requirements, Securities Regulation & Law Report (August 15, 2005).

Auditor Liability

auditing had become a loss leader for selling other services. “Don’t fling us into that briar patch, Brer Congress,” one can almost hear the accountants saying.

The PCAOB has been criticized for not taking steps to make the costs of § 404 compliance more manageable. William McDonough, chairman of the PCAOB, in a recent interview attempted to shift the blame for the recent spike in the cost of auditing from regulatory requirements to the auditors’ (irrational?) fear of litigation:

Auditors have to use judgment. They have a great deal of leeway. But 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. The leadership of the firms agrees. But [auditors] have to be convinced that their leaders will not be pleased by excessive work.⁵

Unraveling whether the spike in auditing costs stems from fear of litigation or regulatory overkill by the Congress, the SEC, and PCAOB is a tall order. It is difficult to quarrel, however, with McDonough’s suggestion that fear of litigation may drive auditors to employ auditing procedures that would not otherwise be warranted. It also seems clear that anticipated litigation costs are a substantial portion of the fees that auditors charge public companies.⁶

For many academic commentators, a renewed fear of litigation among auditors is a welcome development. In the wake of the salient accounting scandals, the professoriate explained that auditors had strayed from the path of righteousness because of the substantially reduced litigation exposure that they faced in the late 1990s after aiding and abetting liability was eliminated and the securities litigation was discouraged more generally by the Private Securities Litigation Reform Act.⁷ What was needed was a healthy dose of liability exposure to

⁵ Mr. McDonough, *You Have The Floor: The accounting watchdog on Sarbanes-Oxley, excessive auditing, and investor trust*, *Business Week* at 56 (August 1, 2005).

⁶ Ronald A. Dye, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 *J. Pol. Econ.* 887 (1993); Dan A. Simunic and Michael T. Stein, *The Impact of Litigation Risk on Audit Pricing: A Review of the Economics and the Evidence*, 15 *Auditing: A Journal of Practice & Theory* 119 (Supplement 1996).

⁷ See, e.g., John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 *Bus. Law.* 1403, 1409-1410 (2002); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 *Villanova Law Review* 1167, 1182 (2003).

Auditor Liability

bring the auditors back into line.⁸

More lawsuits are a fairly standard cure prescribed by law professors for the ills of society – haul the bad guys into court and make them pay. In this context, however, there are other factors at play – some structural and some behavioral – suggesting that more liability may not improve matters. Indeed, exposing auditors to potentially massive liability may in some respects make the problem *worse*. When accountants were largely self-regulated and operating in the partnership form, the deterrent stick of litigation may well have been a necessary and useful tool for encouraging thorough audits. The regulatory environment has shifted, however, in the post-Sarbanes-Oxley world. Auditors are now operate under the watchful eye of independent audit committees and are subject to thoroughgoing and intrusive regulation and inspection by the PCAOB. Exposing audit firms to billion dollar settlements and judgments may undermine the effectiveness of these forms of oversight, thereby diminishing integrity of audited financial statements, exactly the opposite of the stated goal for imposing liability.

My goal here is to raise, in a very preliminary way, the question of whether *less* liability for auditors in certain areas might encourage *more* accurate financial statements. The essay proceeds as follows. Part 1 explores the economics of auditing, the incentives that auditors have to perform quality audits, and the difficulties inherent in measuring audit quality. Part 2 briefly describes the sea change that occurred in the regulation of the auditing profession with the adoption of the Sarbanes-Oxley Act. Given these fundamental changes in the regulatory backdrop, Part 3 then explores the regulatory regime interacts with the liability regime, and how both regimes interact with the psychological strengths and weaknesses of auditors. I conclude in Part 4.

⁸ John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U. L. Rev. 301 (2004); Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53 (2003); Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 Wash. U. L.Q. 491(2001).

Auditor Liability

I. The Economics of Auditing

A. The Value of Auditing

Although they are loath to admit it, auditors thrive on dishonesty. Dishonesty by corporate insiders makes the job of auditors much harder, but without it, there would be little demand for their services. In a world where everyone was honest, auditing would offer relatively slight benefits for most users of financial statements – companies would report their assets, liabilities and financial returns in a straightforward way, and investors, creditors, employees and suppliers could take the company's word that its financial health was accurately represented. To be sure, companies would occasionally make mistakes, but the mistakes would be randomly distributed, sometimes making the company look better and sometimes worse. There would be little incentive to double-check the work of the company's accountants. Some investors might value the more accurate financial statements that review by an expert outsider auditor would produce, but the value of such review would not be all that great in a world where any errors were unbiased.

Fortunately for auditors, not all companies are honest. Company insiders will occasionally have incentives to shade the truth – job security, option grants, an impending stock offering, etc. The result is that a small percentage of companies will risk their credibility with the financial markets by actively misreporting their financial results. A larger number of companies are likely to have their financial statements infected by wishful thinking.⁹ Generally accepted accounting principles (GAAP) frequently leave some room for interpretation and discretion, and chief financial officers are apt to be persuaded that the interpretation that puts the company's financial health in the most favorable light is the one that is justified. An

⁹ Cite Langevoort

Auditor Liability

independent auditor can be a helpful check on the tendency to wear rose colored glasses. Moreover, we are inclined to think that more companies would stray from the path of truth and/or succumb to wishful thinking if no one were checking on them.

Auditors do check, although they recurringly complain about the difficulty of checking. Like it or not, auditors have put themselves in the integrity business. Essentially, auditors earn their living by renting their reputation.¹⁰ By attesting to the accuracy of a company's financial statements (more precisely, that the company's financial statements conform to generally accepted accounting principles), the auditor lends its credibility to that company. The certification of a company's financial reports provided by an accounting firm is only as good as the accounting firm's reputation for doing a thorough audit unhampered by conflict of interest. In an unregulated market, no one would pay for a shoddy audit because the auditor's attestation would confer no additional credibility to the company's financial statements.

Generally accepted auditing standards (GAAS) are intended to ensure a minimum quality level for audits. But those standards set a floor, not a ceiling; auditors are certainly free to do a better job than mandated by GAAS. And the greater the auditor's reputation for credibility, the more it can charge for its attestation services.¹¹ Although an auditor's reputation is built upon the quality of the audits that it performs, the incentive of auditing firms to perform thorough audits to maintain and enhance their reputations must be balanced against competitive pressures to keep the costs of audits down. The question is whether the reputation incentives are sufficient to maintain acceptable audit quality. Basic economic theory tells us that an auditor should have the incentive to refine its audit methodologies until the marginal increase in the cost of the audit

¹⁰ Reinier Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986).

¹¹ Fung and Gul provide evidence that firms that provide higher quality audits are able to charge higher fees. Simon Fung & Ferdinand A. Gul, Evidence of Audit Quality Difference Among Big Five Auditors (Working Paper, The Hong Kong Polytechnic University, 2005).

Auditor Liability

is equal to the marginal benefit conferred on the client company.¹² That marginal benefit takes the form of enhanced credibility for the client company's financial statements.

B. Assessing the Quality of Auditing

This simple economic account of the role of auditor reputation makes sense only as long as we ignore information costs. The problem with the story is that the quality of the accountant's audit may not be readily apparent to the intended audience for the auditor's attestation, i.e., creditors, suppliers, customers, and most of all, investors. The procedures generally followed by an auditor will not be transparent, much less the quality of the audit performed at an individual company. Even when an audit client subsequently restates its revenues or earnings, it will be hard to discern whether the auditor was negligent or duped by a tightly-knit conspiracy of insiders.

And this difficulty in assessing the audit firm's average audit quality will be made significantly harder when a particular audit team deviates from the firm's established procedures. Individual employees of an accounting firm may see their career prospects as being more closely tied to the success or survival of a particular client, rather than the overall reputation of the firm. Such an employee may be tempted to give in to a pressure from an important client to sign off on a questionable accounting treatment. That client pressure has become more acute as companies have increasingly relied on bonus and other incentive compensation schemes that depend heavily on accounting results. The value of stock options, too, may be heavily determined by reported earnings. So the insiders will frequently have strong incentives to see that the numbers come out at a certain level.

This concern that auditors may come under the sway of important clients has been

¹² Ross L. Watts & Jerold L. Zimmerman, Agency Problems, Auditing, and the Theory of the Firm: Some Evidence, 26 J. L. & Econ. 613 (1983).

Auditor Liability

exacerbated as accounting has become more complex, requiring independent auditors spend a larger percentage of their time with each client. To cite one conspicuous example, “Enron appears to have accounted for all of the filings of the lead partner assigned to the Enron audit and for several members of his team.”¹³ For that partner and his team, keeping Enron management happy was a (the?) top priority. From the auditing firm’s perspective, however, maintaining objectivity is critical; public findings that the auditor failed to live up to its reputation can be devastating, as Arthur Andersen learned. And this impact apparently spilled over to Andersen’s other clients.¹⁴

To make matters worse, the problem of assessing audit quality is aggravated by the recent push to make accounting standards reflect economic value rather than historical costs. An audit focused on making sure that assets have not been misappropriated by management is a manageable task is reasonably likely to succeed. An audit attempting to determine whether the value of the corporation is accurately represented is much more likely to fail because there are so many variables that go into such a valuation, and many of those variables are vulnerable to subjectivity in measuring them. Absent a well-developed and liquid market for an asset, economic values are notoriously difficult to quantify, opening up room for greater manipulation.¹⁵

In sum, consumers of audits may have difficulty distinguishing rigorous audits from sloppy ones. If so, auditors will not be able to capitalize fully on their efforts to do a thorough audit, which may tempt the auditor to cut corners in the audit. Cutting corners reduces the auditor’s expense, thereby bolstering the auditor’s profit margin. Even if the firm avoids such

¹³ Jonathan Macey & Hillary A. Sale, Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry, 48 Villanova Law Review 1167, 1170 (2003).

¹⁴ Paul K. Chaney & Kirk L. Philipich, Shredded Reputation: The Cost of Audit Failure, 40 J. Acct. Res. 1221 (2002) (finding a negative abnormal stock price reaction for Andersen clients after Andersen admitted shredding Enron-related documents).

¹⁵ George J. Benston, The Regulation of Accountants and Public Accounting Before and After Enron, 52 Emory Law Journal 1325, 1348 (2003).

Auditor Liability

temptations, employees of the firm will face a similar temptation to cut corners, particularly in the face of client pressure. Monitoring to discourage agency costs of this sort is likely to be expensive and far from fool-proof.

Of course, from time to time we will have conspicuous signals of poor quality auditing, such as Arthur Andersen's failures at Enron and WorldCom. Seldom, however, will an audit failure be as obvious and well-publicized. Worse yet, even a very public revelation of an audit failure can send an ambiguous signal. Were the auditors complacent, or were they duped by a concerted effort among the insiders? Evaluating the quality of audit services *ex post* is a difficult task, requiring highly-specialized expertise and access to an accounting firm's work records. Short of a full-blown forensic audit (an expensive proposition), insiders will be able to sneak some percentage of deceptions past their auditors even when the auditors have adopted appropriate procedures to check for fraud (i.e, the procedures that are cost justified given the likelihood of fraudulent misstatements by that client). We should not leap from the fact of a misstated financial statement to the conclusion that the auditors were asleep at the switch.

Indeed, one study comparing Arthur Andersen's performance relative to its peers finds no significant differences.¹⁶ And Deloitte & Touche, which conducted the audit quality peer review of Arthur Andersen just prior to Andersen's implosion, found that Andersen's systems were adequate to provide reasonable assurance that its audits complied with professional standards.¹⁷ Before Enron, there were cautionary flags, like the penalties imposed by the SEC against the firm for its failures in auditing Waste Management,¹⁸ but no smoking guns. If anyone knew that Arthur Andersen's work was deficient, there was money to be made selling its client's shares short.

¹⁶ Theodore Eisenberg & Jonathan R. Macey, Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients, 1 *Journal of Empirical Legal Studies* 263 (July 2004).

¹⁷ Paul R. Chaney & Kirk L. Philipich, Shredded Reputation: The Cost of Audit Failure, 40 *Journal of Accounting Research* 1221, 1223 (2002) (discussing Deloitte & Touche report of its peer review).

¹⁸ Cite

Auditor Liability

II. The Sarbanes-Oxley Act and the Regulation of Auditors

The difficulties that market participants may have in assessing audit quality suggest that regulation could potentially play a useful role in providing information to the market. As noted above, any convincing analysis of audit quality will require specialized expertise and access to the auditor's work papers. An expert in accounting with such access might provide a more precise evaluation of the quality of an auditor's work than the muddy signal provided by an audit failure. If so, an audit firm with confidence in its procedures and employees might be willing to commit itself to a review regime with sanctions, if the review were conducted and the sanctions determined by an expert. Under such a regime, audit firms would be confident that *ex post* sanctions would only be imposed when the firm had done an inadequate job. And auditors would presumably welcome *ex ante* advice on their audit methods if it helped them avoid the damaging loss to reputation that follows from an audit failure. This suggests that there may be a role for regulation, both in looking at the outcome of a particular audit engagement in hindsight, and looking at an audit firm's procedures more generally to determine if those procedures are likely to produce a credible attestation of the reporting company's financial statement.

The regulation of public accountants has recently undergone a sea change in the United States. We have gone from a predominantly self-regulatory regime to quasi-governmental oversight accompanied by stringent regulation of auditors and the auditor's relationships with its clients. This dramatic regulatory shift has important consequences for the assessment of the value of litigation in promoting quality audits, a question I turn to in Part 3. First, I summarize the most important changes in auditor regulation brought about by the Sarbanes-Oxley Act and the rules adopted pursuant to that law.

Auditor Liability

A. The Self-Regulatory Regime

Until 1933, the contents of financial statements included in public companies' prospectuses and annual reports were regulated only by some state laws and exchanges' listing agreements.¹⁹ The federal government played no role in accounting or the regulation of accountants. Notwithstanding the limited legal requirements, most corporations whose stock was publicly traded had their financial statements audited by independent public accountants.²⁰ With the adoption of the federal securities laws in 1933 and 1934, auditing of public companies in the United States was placed under the supervision of the Securities and Exchange Commission (SEC or Commission).²¹

The SEC, however, has generally used that authority sparingly until recently. Although the SEC briefly flirted in its early years with the creation of uniform accounting principles under the leadership of Chairman William O. Douglas, it ultimately chose to delegate the formulation of generally accepted accounting principles and generally accepted auditing standards to the accounting industry.²² Financial statements filed with the SEC were required to be prepared in accordance with principles having "substantial authoritative support."²³ In practice that meant delegation of the promulgation of accounting principles and auditing standards to the accounting industry's trade association, the American Institute of Certified Public Accountants (AICPA), and its predecessors.

¹⁹ George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 Emory L.J. 1325, 1325.

²⁰ Benston, *supra* note , at 1329.

²¹ Securities Act of 1933, § 19(a), 15 U.S.C. § 77s(a) (1933). The accounting authority now held by the SEC was held briefly by the Federal Trade Commission until the SEC was created by the Securities Exchange Act of 1934. See Securities Exchange Act of 1934, §§ 4(a), 210, 15 U.S.C. 78d(a) (1934) (creating SEC as an independent commission and vesting it with authority previously held by the Federal Trade Commission under the Securities Act of 1933). The Exchange Act also authorizes the SEC to require audited financial statements in public company's periodic filings. Securities Exchange Act of 1934, § 12(b)(1)(J) & (K), § 13(a)(2), 15 U.S.C. § 78l(b) & § 78m(a)(2).

²² Joel Seligman, *The SEC and Accounting: A Historical Perspective*, 7 J. of Comp. Bus. & Capital Market Law 241, 253-254 (1985).

²³ Administrative Policy on Financial Statements, SEC Accounting Series Release No. 4 (April 25, 1938) (advising that financial statements filed based on "accounting principles for which there is no substantial authoritative support" would be presumed to be misleading)

Auditor Liability

The AICPA eventually delegated the promulgation of accounting principles to the Financial Accounting Standards Board (FASB), a part of the non-profit Financial Accounting Foundation (FAF).²⁴ The FASB's principles have been specifically endorsed by the SEC as providing "substantial authoritative support."²⁵ The FASB, until recently, has been funded by the FAF, which receives most of its funding from the subscriptions and sales of FASB publications and a smaller portion of its funding from voluntary contributions.²⁶ The FASB has a professional staff and a mandate to narrow the available accounting choices.²⁷

The AICPA delegated the promulgation of auditing standards to what eventually became the Auditing Standards Board.²⁸ The Auditing Standards Board was originally overseen directly by the AICPA, but oversight was briefly shifted in 2001 to the Public Oversight Board (POB), an independent entity that was funded by the AICPA.²⁹ The POB was created in 1977 to administer a self-regulatory system for auditors, in part to head off the threat of government regulation of the accounting industry.³⁰ At the same time the AICPA created the SEC Practice Section (SECPS), which all of its member firms auditing public companies were required to join.³¹

Oversight of accounting firms took two forms under the AICPA's guidance. Firms that joined the SECPS were required to adhere to its standards and submit to periodic peer reviews.³²

Allegations of an audit failure in litigation filed against a member of the SECPS were reviewed

²⁴ Financial Accounting Standards Board, Facts About FASB (2005), available at www.fasb.org.

²⁵ Statement of Policy of the Establishment and Improvement of Accounting Principles and Standards, SEC Accounting Series Release No. 150, (Jan. 7, 1974).

²⁶ Framework for Enhancing the Quality of Financial Information Through Improvement of the Auditing Process, Securities Act Release No. 8109 n. 92 (July 5, 2002) (reporting that in 2001, the FAF received approximately \$5 million in net contributions and yielded \$12 million from the sales of FASB publications).

²⁷ Benston, *supra* note, at 1334.

²⁸ American Institute of Certified Public Accountants, *The Enron Crisis: The AICPA, The Profession & The Public Interest: A Brief History of Self-Regulation* (2002).

²⁹ Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 Notre Dame L. Rev. 975, 989-990 (2005).

³⁰ SEC, Framework for Enhancing the Quality of Financial Information Through Improvements of Oversight of the Auditing Process, at 12, Securities Act Release 8109 (June 26, 2002) (hereinafter, SEC, *Framework*). The POB disbanded in early 2002 after the SEC announced its intention to create a new oversight body for the accounting profession. Nagy, *supra* note, at 995.

³¹ SEC, *Framework*, Appendix A.

³² SEC, *Framework*, Appendix A.

Auditor Liability

by Quality Control Inquiry Committee (QCIC). The member firm was required to review the performance of its senior personnel and report the matter to the QCIC. The QCIC would then review the matter, and, if warranted, refer the engagement to the AICPA Professional Ethics Division for possible investigation.³³

Self-regulation of the accounting industry increasingly came in for criticism. In 2002, the SEC determined that a new regulatory structure was needed for the auditing industry. It identified six weaknesses with self-regulation:

1. Peer reviews may not consistently be as thorough as necessary.
2. The disciplinary process is voluntary.
3. There is no independent and dependable funding source.
4. The disciplinary process relies solely on information gathered from accountants.
5. Sanctions are weak.
6. The disciplinary proceedings are not public.³⁴

To be sure, some of these concerns were overstated. The SEC's first concern was that the process of peer review was inadequate. Peer reviews were intended to evaluate whether the firm being reviewed had systems in place to meet the AICPA's Quality Control Standards and in fact complied with them, as well as the SECPS's membership requirements. The SEC worried that firms were receiving "clean" reviews in the peer-review process despite well-publicized problems at the firm.³⁵ The SEC provided no evidence, however, that the peer-review process had failed in any systematic fashion, relying instead on isolated anecdotes. More recent evidence suggests that the peer review process did have a significant influence on the market for auditors, suggesting that it did add to their credibility.³⁶

The second concern, that the disciplinary process was "voluntary," overstated the case

³³ SEC, *Framework*, n. 30.

³⁴ SEC, Framework for Enhancing the Quality of Financial Information Through Improvements of Oversight of the Auditing Process, Securities Act Release 8109, at 8-9 (June 26, 2002).

³⁵ SEC, *Framework*, at 8.

³⁶ Giles Hillary & Clive Lennox, The credibility of self-regulation: Evidence from the accounting profession's peer review program, *Journal of Accounting and Economics* (forthcoming 2005) (finding that audit firms receiving "clean" peer reviews had a net increase in the number of clients of 3.5%, while audit firms with adverse opinions lost 6.8%).

Auditor Liability

considerably. The AICPA's disciplinary process was voluntary in the sense that an accounting firm could resign its membership in the SECPS, but it is hard to imagine a public company that would hire a firm that was not a member of the SECPS. Doing so would surely invite careful scrutiny by the SEC of that company's financial filings. The more substantial concern was that the AICPA was "dominated by accounting firms"³⁷ (hardly a surprise for the accounting industry's trade association), and that accountants would be tempted to go light on their peers.

The third concern, funding, was salient because of the SECPS' then-recent threat to pull funding from the POB. The POB had drawn the wrath of the accounting industry with its plan (encouraged by the SEC) to review the accounting firms' independence. Independence is, of course, a fundamental issue for "independent" public accountants. Given the elasticity in many accounting principles, objectivity is important in determining whether those principles are being applied fairly. More to the point, independence was an issue that had become a priority for the SEC in the late 1990s under the chairmanship of Arthur Levitt.³⁸ In hindsight, it seems clear that the accounting firms overplayed their hand with their threat to withdraw funding from the POB. This bullying greatly undermined the argument that the POB was independent and could therefore be trusted to carry out the accounting industry's self-regulatory responsibilities in the interest of investors. As Levitt puts it "The lesson of this episode is crystal clear: self-regulation by the accounting profession is a bad joke. ... The firms would never subject themselves to scrutiny unless forced to do so."³⁹

The fourth concern, that the AICPA lacked the power to obtain information from third parties, is a common weakness of self-regulatory organizations. Because their disciplinary power arises from a member firms' consent to be disciplined, a self-regulator can coerce the

³⁷ SEC, *Framework*, at 8.

³⁸ Nagy, *supra* note, at 994-995.

³⁹ Arthur Levitt, *Take on the Street* 127 (2002)

Auditor Liability

consent of the member to cooperate with an investigation by threatening expulsion, but the self-regulator has no comparable threat to wield against non-members. A complete and thorough investigation, however, may require cooperation from third parties, such as the clients of the member firms. But the clients may have good reasons not to cooperate, such as litigation risk. A problem with an audit suggests an underlying problem with the client corporation's accounting, and the corporation faces substantially greater litigation exposure than the auditors.

The SEC's fifth concern, that sanctions were weak, flips the problem on its head. The SEC worried that "The most stringent sanction in an AICPA proceeding is expulsion from the AICPA, which does not directly affect an accountant's ability to practice before the Commission or elsewhere."⁴⁰ But this was hardly the fault of the AICPA – the SEC had the power to keep firms expelled from the AICPA from practicing before the SEC;⁴¹ it was up to the SEC to use it. The bigger concern is that the AICPA's sanctions were too severe – expulsion from the AICPA meant a death knell to a firm's business auditing public companies because expulsion would prod the SEC into taking action to bar the accountant. Because the sanction was so severe, the AICPA was understandably reluctant to use it. A study by the *Washington Post* found that the AICPA disciplined accountants who had been found to have engaged in professional misconduct by the SEC only 20% of the time.⁴² What was needed was a broader range of intermediate sanctions, such as fines, to give the regulator some flexibility in meting out punishment short of a "death penalty," but still carrying some deterrent teeth.

The sixth concern, the lack of public disciplinary proceedings, is an important one. As noted in Part I, the loss of reputation is an important deterrent against both negligence and affirmative wrongdoing, particularly in a business like accounting, in which firms are effectively

⁴⁰ SEC, *Framework*, at 9.

⁴¹ SEC Rules of Practice § 102.

⁴² David S. Hilzenrath, Auditors Face Scant Discipline: Review Process Lacks Resources, Coordination, Will, *Washington Post*, December 6, 2001.

Auditor Liability

“renting” their reputations to their clients. A public censure from the accounting regulators would seriously compromise an audit firm’s reputation.

These concerns came to a head in 2002 in the wake of a number of high-profile accounting scandals, highlighted by the Enron meltdown. The number of accounting problems relative to the number of U.S. public companies was small, to be sure, but the prominence of the Enron fiasco suggested to at least some observers that U.S. public companies had a pervasive audit failure problem. Even members of the accounting profession were calling for a revamping of the regulatory structure. James Turley, Chairman of Ernst & Young LLP, called for:

a new regulatory body for the profession. It should have its own funding, offices and staff. It should have direct power over the profession’s disciplinary and audit quality control programs, replacing the current ‘peer review’ process in which firms review each other. To ensure maximum public credibility, this oversight should come from a body other than the American Institute of Certified Public Accountants, because many believe it has not maintained its historic focus on professional responsibility.⁴³

With Congress clamoring for action, the SEC decided to finally exercise the authority over accounting that Congress had given it nearly seventy years earlier. The SEC proposed the creation of a “Public Accountability Board” (PAB), which accounting firms would be required to join if they wanted to audit public companies. The SEC’s proposed PAB was swept aside, however, with the implosion of WorldCom amidst a particularly bald-faced accounting fraud. Congress rushed to get tough on accountants with the Sarbanes-Oxley Act; legislators were delighted to give the SEC all the tools the agency needed to get the job done. The criticisms leveled at the prior self-regulatory regime, with minor exception, cannot be fairly charged against the new regulatory order for accountants.

B. The PCAOB

⁴³ James S. Turley, *How Accounting Can Get Back Its Good Name*, Wall St. J. A16 (Feb. 4, 2002) (quoted in SEC, *Framework*, at 11).

Auditor Liability

The most important tool given to the SEC was the PCAOB. The PCAOB is charged with “protect[ing] the interests of investors and further[ing] the public interest in the preparation of informative, accurate, and independent audit reports” for public companies.⁴⁴ To achieve these goals, Congress gave the PCAOB comprehensive authority over the accounting industry (at least the portion of that industry that audits public companies).

The disciplinary process is no longer voluntary. Accounting firms auditing public companies are all required to register with the PCAOB.⁴⁵ Once registered, the accounting firms are subject to the auditing, quality control, and ethics standards adopted by the PCAOB.⁴⁶ To ensure that registered firms are following its standards, the PCAOB is charged with conducting periodic inspections of registered accounting firms.⁴⁷ The Board is also empowered to investigate possible violations by registered accounting firms of the Sarbanes-Oxley Act, the securities laws, and the PCAOB’s own rules.⁴⁸ So the PCAOB now exercises both the authority to set auditing standards and the disciplinary power previously held by the AICPA and the POB. There can be little question that the PCAOB’s scope of regulatory authority is adequate to the task set for it by Congress.

Congress not only gave the PCAOB broad authority, it stipulated detailed requirements for the new accounting regulator. Although Congress specifically stated that the PCAOB would not be a government agency,⁴⁹ the PCAOB operates under the close oversight of the SEC. Rather than relying on the implicit authority over accountants conferred by the SEC’s authority over the financial statements of public companies, Congress followed the existing statutory framework for the self-regulatory organizations (SROs), making it explicit that the PCAOB

⁴⁴ Sarbanes-Oxley Act § 101, 15 U.S.C. § 7211

⁴⁵ Sarbanes-Oxley Act § 102, 15 U.S.C. § 7212.

⁴⁶ Sarbanes-Oxley Act § 103, 15 U.S.C. § 7213.

⁴⁷ Sarbanes-Oxley Act § 104(a), 15 U.S.C. § 7214(a).

⁴⁸ Sarbanes-Oxley Act § 105(b)(1), 15 U.S.C. § 7215(b)(1).

⁴⁹ Sarbanes-Oxley Act § 101(a) & (b), 15 U.S.C. § 7211(a) & (b).

Auditor Liability

would be subject to the SEC's direction and control. That direction and control, however, is substantially more intrusive than the authority that the SEC exercises over the SROs. To start, unlike the SROs, all five of the PCAOB board members are selected by the SEC.⁵⁰ Board members serve staggered five-year terms, but they are subject to removal by the SEC "for good cause shown."⁵¹ The influence of the accounting profession over the PCAOB is limited by the stricture that "[t]wo members, and only 2 members, of the Board shall be or have been certified public accountants"⁵²

In addition to appointing the PCAOB's members, the SEC has extensive oversight authority over the Board analogous to that exercised by the Commission over the SROs.⁵³ The PCAOB is required to make an annual report of its activities to the SEC and to Congress.⁵⁴ All rules proposed by the PCAOB must be approved by the SEC.⁵⁵ More intrusively, the SEC can amend any PCAOB rule.⁵⁶ The SEC's oversight authority extends to review of disciplinary actions taken by the Board, either at the behest of an aggrieved party (i.e., an accounting firm or an accountant) or on the SEC's own motion.⁵⁷ The SEC can not only overturn disciplinary proceedings if they are not conducted in accordance with law, it can also review the sanctions imposed by the Board and reduce, modify or increase the sanction.⁵⁸ Moreover, the SEC can censure the Board itself, or rescind its authority, if the SEC is not satisfied with how the Board does its job.⁵⁹ The bottom line is that if the SEC believes that the PCAOB is not regulating in a sufficiently vigorous fashion, the SEC has all the power it needs to correct that deficiency.

⁵⁰ Sarbanes-Oxley Act § 101(e)(1) & (4), 15 U.S.C. § 7211(e)(1) & (4).

⁵¹ Sarbanes-Oxley Act § 101(e)(5) & (6), 15 U.S.C. § 7211(e)(5) & (6).

⁵² Sarbanes-Oxley Act § 101(e)(2), 15 U.S.C. § 7211(e)(2). If the chairperson is a CPA, he or she must not have practiced as an accountant for at least five years before appointment to the PCAOB. *Id.*

⁵³ Sarbanes-Oxley Act § 107(a), 15 U.S.C. § 7217(a).

⁵⁴ Sarbanes-Oxley Act § 101(h); 15 U.S.C. § 7211(h).

⁵⁵ Sarbanes-Oxley Act § 107(b)(2), 15 U.S.C. § 7217(b)(2).

⁵⁶ Sarbanes-Oxley Act § 107(b)(5), 15 U.S.C. § 7217(b)(5).

⁵⁷ Sarbanes-Oxley Act § 107(c)(2), 15 U.S.C. § 7217(c)(2).

⁵⁸ Sarbanes-Oxley Act § 107(c)(3), 15 U.S.C. § 7217(c)(3).

⁵⁹ Sarbanes-Oxley Act § 107(d), 15 U.S.C. § 7217(d).

Auditor Liability

The PCAOB's independence from the accounting industry is further bolstered by its funding sources. The first source is annual fees to be paid by each registered public accounting firm, "in amounts that are sufficient to recover the costs of processing and reviewing applications and annual reports."⁶⁰ The second, and considerably more substantial, source is "annual accounting support fees" to be paid by public companies based on their market capitalization.⁶¹ Once each year, the Board will compute the fees based on the Board's budget for that year, less the sum of the sum of all registration fees and annual fees received during the preceding calendar year from public accounting firms, as approved by the SEC.⁶² Under this formula, the overwhelming share of the cost of regulating accountants is paid by public companies, rather than accountants, who paid the cost of the prior self-regulatory regime.⁶³ The PCAOB clearly enjoys the independent and dependable funding source that the POB lacked.

In sum, there can be no doubts about the PCAOB's independence from the accounting industry. The new accounting regulator is squarely under the thumb of the SEC's oversight and control. And the PCAOB's funding has been guaranteed by Congress for the foreseeable future.

Nor can there be any substantial doubt about the thoroughness of the PCAOB's inspection of registered auditing firms. The Board is required to "inspect and review selected audit and review engagements" and "evaluate the sufficiency of the quality control system of the firm."⁶⁴ These on-site inspections of registered accounting firms are performed by accountants with public company auditing experience.⁶⁵ An inspection must at minimum include an inspection and review of selected audit and review engagements of the firm, performed at

⁶⁰ Sarbanes-Oxley Act § 102(f), 15 U.S.C. § 7212(f).

⁶¹ Sarbanes-Oxley Act § 109, 15 U.S.C. § 7219.

⁶² Sarbanes-Oxley Act § 109(b), 15 U.S.C. § 7219(b).

⁶³ For 2005, the Board adopted a \$137.1 million budget. Of this amount, \$136.1 million was raised from accounting support fees. PCAOB, *Board Approves Revised 2005 Budget* (Dec. 30, 2004) (available at http://www.pcaobus.org/news_and_events/news/2004/12-30.aspx)

⁶⁴ Sarbanes-Oxley Act § 104(c), 15 U.S.C. § 7214(c).

⁶⁵ The PCAOB expects to have a staff of 450 by the end of 2005, with its current hiring focused on experienced auditors who will conduct the Board's program of inspections. PCAOB 2005 Budget, at 3.

Auditor Liability

various offices and by various associated persons of the firm; an evaluation of the sufficiency of the quality control system of the firm and the manner of the documentation and communication of that system by the firm. In addition, the performance of audit testing, supervisory, and quality control procedures of the firm are also assessed as necessary or appropriate.⁶⁶ The PCAOB inspects firms annually providing they audit more than 100 issuers on a yearly basis. Firms providing audit reports to 100 or less issuers are inspected at least every three years.

The PCAOB's inspection process is backed up by broad-ranging enforcement authority. The Board is empowered to investigate possible violations by registered accounting firms of the Sarbanes-Oxley Act, the securities laws, and the PCAOB's own rules.⁶⁷ In conducting its investigations, the PCAOB can compel registered firms and persons associated with those firms to testify and produce documents, including audit work papers.⁶⁸ The rules also permit the Board to seek information from other persons, including clients of registered firms.⁶⁹ In addition, the PCAOB can also call on the SEC to exercise its wide-ranging subpoena authority to compel others to testify and produce documents.⁷⁰ The PCAOB should therefore have access to all the information that it needs to conduct thorough investigations.

Firms that refuse to cooperate in the Board's investigation can have their registration suspended or revoked.⁷¹ Persons associated with the registered accounting firms can be suspended or barred from associating with the firm; the firm can be required to fire a person who does not cooperate.⁷² Lesser sanctions are also available for non-cooperation.⁷³ The Board recently exercised its authority to sanction firms that fail to cooperate for the first time, revoking

⁶⁶ Sarbanes-Oxley Act § 104(d), 15 U.S.C. § 7214(d).

⁶⁷ Sarbanes-Oxley Act § 105(b)(1), 15 U.S.C. § 7215(b)(1).

⁶⁸ Sarbanes-Oxley Act § 105(b)(2)(A) & (B), 15 U.S.C. § 7214(b)(2)(A) & (B).

⁶⁹ Sarbanes-Oxley Act § 105(b)(2)(C) 15 U.S.C. § 7214(b)(2)(C).

⁷⁰ Sarbanes-Oxley Act § 105(b)(2)(D), 15 U.S.C. § 7215(b)(2)(D).

⁷¹ Sarbanes-Oxley Act § 105(b)(3)(A)(ii), 15 U.S.C. § 7215(b)(3)(A)(ii).

⁷² Sarbanes-Oxley Act § 105(b)(3)(A)(i), 15 U.S.C. § 7215(b)(3)(A)(i).

⁷³ Sarbanes-Oxley Act § 105(b)(3)(A)(iii), 15 U.S.C. § 7215(b)(3)(A)(iii).

Auditor Liability

the registration of a public accounting firm and barring its managing partner for having falsified documents in an audit file in an effort to conceal a violation of the independence rules.⁷⁴

According to the PCAOB rules, if the Board determines that there was a potential malfeasance on the part of the participating audit firm, it is to inform the SEC and the appropriate state regulatory authority, and it is also entitled to investigate.⁷⁵ If the Board concludes that there has been a violation, it is empowered to impose a wide range of sanctions, including:

- (1) money penalties of up to \$100,000 for associated persons and \$2 million for firms;
- (2) censure;
- (3) required education or training; and
- (4) other penalties provided for in the Board's rules.⁷⁶

More stringent penalties can be imposed for intentional or knowing misconduct or repeated negligence:

- (5) temporary or permanent suspensions of registration of firms or bars of their associated persons;
- (6) limits on the operations and activities of the firm and its associated persons; and
- (7) money penalties of up to \$750,000 for associated persons and \$15 million for firms.⁷⁷

Thus, the PCAOB has considerable discretion to ensure that sanction imposed is appropriate to the violation. If the sanctions meted out by the PCAOB are inadequate, it will not be for lack of will, not lack of statutory authority.⁷⁸

Congress also directed the PCAOB to establish quality control standards (a skeleton of

⁷⁴ PCAOB, *Board Revokes Firm's Registration, Disciplines Three Accountants for Failure to Cooperate* (May 24, 2005).

⁷⁵ PCOAB Rule 4004.

⁷⁶ Sarbanes-Oxley Act § 105(c)(4), 15 U.S.C. § 7215(c)(4).

⁷⁷ Sarbanes-Oxley Act § 105(c)(4) & (5), 15 U.S.C. § 7215(c)(4) & (5).

⁷⁸ So far, the PCAOB has so far only sanctioned one firm, and that was for obstructing its inspection. *See supra* note.

Auditor Liability

the standards is provided by the Sarbanes-Oxley Act)⁷⁹ and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, to meet the requirements of the Act and the public interest.⁸⁰ Currently, public accounting firms involved in the preparation or issuance of audit reports are to follow the ethics standards and independence standards as set out in the AICPA's Code of Professional Conduct to the extent that those standards have not been superseded or amended by PCAOB rules. The PCAOB adopted the AICPA's standards as its own on an interim basis,⁸¹ but going forward the responsibility for revising those standards lies with the PCAOB.⁸² The PCAOB has taken up the task, issuing standards on audits of internal controls, audit documentation,⁸³ and the evaluation of efforts to correct weaknesses in internal controls.⁸⁴ So the early evidence would certainly not cause any concern that the PCAOB will be lax in adopting rules for the industry.

C. New Regulations of Auditors

1. Independence

Congress was not satisfied to delegate the regulation of auditors to the PCAOB; it also adopted a number of specific restrictions on auditor's practice. Congress came down firmly on the side of a stringent definition of auditor independence when it enacted the Sarbanes-Oxley Act. Congress worried that the lure of lucrative contracts for other services created strong incentives for auditors to knuckle under to management pressure, thereby compromising the integrity of the audit. Consequently, auditors are now banned from providing a broad array of

⁷⁹ Sarbanes-Oxley Act §103(a)(2)(B), 15 U.S.C. § 7213(a)(2)(B).

⁸⁰ Sarbanes-Oxley Act § 103(a), 15 U.S.C. § 7213(a). These rules are required to include seven year retention of work papers, peer review of audits, disclosure of auditors' testing of issuers internal controls, monitoring of ethics and independence, consultation within auditing firms, supervision, hiring, acceptance of engagements and internal inspection. Sarbanes-Oxley Act § 103(a)(1 & 2), 15 U.S.C. § 7213(a)(1 & 2).

⁸¹ PCAOB Professional Standards, Rules 3200T, 3300T, 3400T & 3500T.

⁸² Sarbanes-Oxley Act § 103, 15 U.S.C. § 7213(a)(3)(A).

⁸³ PCAOB Auditing Standard No. 3, Audit Documentation (June 9, 2004).

⁸⁴ PCAOB Auditing Standard No. 4, Reporting on the Elimination of a Material Weakness(July 26, 2005).

Auditor Liability

services to their audit clients, including: bookkeeping, designing financial systems, appraisal and valuation services, actuarial services, internal auditing functions, management and human resources services, investment services and legal services.⁸⁵ The PCAOB is authorized to ban the provision of other services as well.⁸⁶

Congress adopted additional rules to bolster independence. Audit firms are required to rotate the partner in charge of the audit for each client at least once every five years.⁸⁷ Too familiar a relationship between the partner and company executives can compromise independence. In the same vein, Exchange Act § 10A(l) of the Exchange Act now bans audit firms from auditing companies whose CEOs, CFOs, or controllers were employed by the audit firm and that employee participated in the audit of the company during the prior year.⁸⁸

2. New duties for auditors

In addition to the new independence requirements discussed above, Congress also imposed new responsibilities on auditors. Auditors must adopt procedures to detect “illegal acts that would have a direct and material effect” on financial statements and identify material related party transactions,⁸⁹ a responsibility that auditors have long resisted out of fear that it would create additional fodder for litigation. This duty was added to existing responsibilities to report

⁸⁵ Exchange Act § 10A(g), 15 U.S.C. § 78j-1(g). Not all non-audit, consulting services are banned. Auditors may still provide, among other things, tax planning advice to their clients so long as they obtain prior approval from the audit committee. Exchange Act § 10A(h), 15 U.S.C. § 78j-1(h).

⁸⁶ Exchange Act § 10A(g)(9), 15 U.S.C. § 78j-1(g)(9). The PCAOB recently took advantage of this authority to ban auditors from offering tax advice (1) on a contingent basis; (2) that is deemed to be an “aggressive interpretation” of the tax laws; or (3) to management members who serve in financial reporting oversight roles. PCAOB Professional Standards, Rules 3521, 3522, 3523. The concern is that acting in the role of tax advisor, in which the goal is to minimize the client’s tax liability, may undermine the objectivity required to an independent audit. In that role, the auditor is not supposed to sign on to the company’s goal of maximizing its reported profits. The auditor’s role is to ensure that the report is accurate, not maximized. See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 *University of Chicago Law Review* 1233, 1238 (2002) (“this tax planning approach all too readily carries over to ‘accounting planning,’ in which the accountant aggressively construes accounting rules to maximize reported income irrespective of less illuminating disclosure to the ultimate client, the shareholders.”).

⁸⁷ Exchange Act § 10A(j), 15 U.S.C. § 78j-1(j).

⁸⁸ Exchange Act § 10A(l), 15 U.S.C. § 78j-1(l).

⁸⁹ Exchange Act § 10A(a)(1) & (2), 15 U.S.C. § 78j-1(a)(1) & (2). Auditors are also required to evaluate the ability of the client to continue as a going concern through its next fiscal year. Exchange Act § 10A(a)(3), 15 U.S.C. § 78j-1(a)(3).

Auditor Liability

illegal acts to management and the audit committee or entire board of directors.⁹⁰ A board of directors receiving such a report must notify the SEC; if it fails to do so, the audit firm must provide notice to the SEC itself. The political compromise extracted by the auditing profession is that reports by auditors of illegal acts to the SEC cannot be the basis for liability in any private action.⁹¹

The auditor's duties include not only the *ex post* detection of fraud; they are also charged with evaluating the procedures that the company has in place to *prevent* fraud. Section 404 of the Sarbanes-Oxley Act requires the company's managers to include a statement in the company's annual report on the manager's responsibility for the company's internal controls for financial reporting and provide an assessment of those controls.⁹² Section 404 also requires that "each registered public accounting firm that prepares or issues the audit report for the issuer" shall attest to the management's assessment of the firm's system of internal controls for financial reporting.⁹³ Auditors are now required to not only certify the integrity of their client's financial statements, but also assess the mechanisms that their corporate clients have adopted to generate the financial information that goes into those statements.

D. Corporate Reforms

1. Accuracy Requirements for Managers

In addition to reforming the regulation of auditors, Congress increased the pressure on company managers to provide accurate financial statements. A somewhat draconian provision added by the Sarbanes-Oxley Act intended to make officers think hard about the accuracy of company's financial statements is § 304. That section requires CEOs and CFOs to return bonus

⁹⁰ Exchange Act § 10A(b), 15 U.S.C. § 78j-1(b).

⁹¹ Exchange Act § 10A(c), 15 U.S.C. § 78j-1(c)

⁹² Sarbanes-Oxley Act § 404(a), 15 U.S.C. § 7262(a).

⁹³ Sarbanes-Oxley Act § 404(b), 15 U.S.C. § 7262(b).

Auditor Liability

and other incentive compensation to the company for any period that the company is required to restate its financial results as a result of “misconduct.” “Misconduct” is not defined, nor is it limited to misconduct by the CEO and CFO.

Officers and directors of the issuer are prohibited from misleading the auditor in connection with any filing to be made with the SEC.⁹⁴ More intrusively, § 302 of the Sarbanes-Oxley Act (as implemented in Rules 13a-14(a) and 15d-14(a) of the Exchange Act) requires that the CEO and CFO personally certify the accuracy of the periodic reports filed with the SEC.⁹⁵ A parallel criminal provision requires certification of financial statements by CEOs and CFOs that “the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act ... and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.”⁹⁶

These certification requirements do two things. First, they focus the CEO and the CFO on the need for accuracy in reporting. These officers are unlikely to skimp on resources for

⁹⁴ Exchange Act Rule 13b2-2.

⁹⁵ Specifically, CEOs and CFOs must certify that:

- They have reviewed the report;
- Based on the officer’s knowledge, the report does not contain material misstatements or omissions;
- Based on the officer’s knowledge, the financial statements “*fairly present in all material respects*” the issuer’s results and financial condition;
- They are responsible for establishing and maintaining internal control and have:
 - Designed those controls so that material information is made known to them,
 - Evaluated the effectiveness of those controls within 90 days of the report, and
 - Presented the conclusion of their evaluation in the report;
- They have disclosed to the company’s auditors and audit committee any weaknesses in those internal controls and any fraud by persons who have a significant role in the issuer’s internal controls;
- Any changes to internal controls made subsequent to the evaluation are disclosed in the report.

⁹⁶ 18 U.S.C. § 1350. Violators of this provision “knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both.” More serious sanctions of a \$5,000,000 fine and/or 20 years in prison are available for a defendant who “willfully certifies any statement ... knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section.” *Id.*

Auditor Liability

financial reporting if they have to sign off on the results, particularly if they risk jail time for a false certification. Moreover, the provision requiring the CEO and CFO to return incentive compensation earned during a period for which the company was forced to restate its financial statements provides a powerful incentive to get the numbers right. Second, the certification provisions reduce the ability of the CEO and CFO to claim ignorance of misstatements or omissions in the periodic reports. Furthermore, if they certify that the report contains no misstatements or omissions, they have made an additional misstatement in certifying if the report does not contain a misstatement or omission. As a result, the certification requirement may make it difficult for the CEO and CFO to evade personal liability in a private antifraud action. The bottom line for the auditors is that they can have more confidence in the numbers that they are being asked to review.

2. Corporate Governance Reforms

Congress also adopted a number of significant changes to the corporate governance of public companies as part of the effort to clean up auditing. The retention, compensation and oversight of the company's external auditor now must be entrusted to an independent audit committee of the board of directors.⁹⁷ The audit committee also has the authority to hire its own advisors (typically legal counsel) at the company's expense.⁹⁸ The auditors must report to the audit committee "critical accounting policies and practices," alternative treatments of financial information discussed with management and any other "material written communications"

⁹⁷ Exchange Act § 10A(m)(2), 15 U.S.C. § 78j-1(m)(2). The audit committee must be made up exclusively of independent directors (meaning that the only compensation the director can receive from the company is the director's fee – no consulting or other employment arrangements are permitted). Exchange Act § 10A(m)(3), 15 U.S.C. § 78j-1(m)(3). The SEC has bolstered this independence requirement with a disclosure requirement relating to the expertise of the audit committee. The SEC now requires the company to disclose whether any member of the audit committee qualifies as a "financial expert," which requires either experience as an accountant or an accounting officer, or experience supervising an accounting officer or overseeing public accountants. Regulation S-K Item 309. Listing requirements for the NYSE and Nasdaq require financial literacy for *all* audit committee members. NYSE Listed Company Manual § 303A.07; Nasdaq Independence Rule Provisions, Rule 4350(d)(2). Both the NYSE and Nasdaq also require that a majority of the board of directors of listed companies meet their respective independence standards. Listed Company Manual § 303A.01; Nasdaq Independence Rule Provisions, Rule 4350(c)(1).

⁹⁸ Exchange Act § 10A(m)(5) & (6), 15 U.S.C. § 78j-1(m)(5) & (6)

Auditor Liability

between the auditor and management.

The audit committee is also responsible for approving any non-audit services (now strictly limited, as discussed above) provided by the company's auditor.⁹⁹ Finally, the audit committee is charged with establishing procedures for dealing with complaints relating to auditing and internal controls.¹⁰⁰ In sum, the relationship between the auditors and their client is now firmly the responsibility of independent directors, who are presumably more concerned with the maintenance of their reputation than ensuring that the numbers are sufficient to keep their stock options in the money.

The result of all the new requirements and restrictions imposed on audit committees has been a substantial spike in the fees paid to outside directors of public companies in the U.S. According to a survey by Mercer Human Resource Consulting, the median compensation at the 350 largest U.S. public companies went from \$105,000 in 2000 to \$155,000 in 2004.¹⁰¹ The increase was attributed to sharp increase in demands imposed on directors under the new regulatory regime.¹⁰²

E. Summary

So where do we stand now with the regulation of accountants? In a nutshell, Congress executed a complete governmental takeover of the regulation of auditors with the adoption of the Sarbanes-Oxley Act. Accountants are being held on a very tight leash by government regulators. And we are spending a lot more to ensure the integrity of financial statements.

The hastily drawn Sarbanes-Oxley Act was a strong signal of reform, but it has proved to

⁹⁹ Exchange Act § 10A(h), 15 U.S.C. § 78j-1(h).

¹⁰⁰ Exchange Act § 10A(m)(4), 15 U.S.C. § 78j-1(m)(4). "Whistleblowers" who make such complaints are protected from retaliation by both civil and criminal sanctions against those who retaliate. Sarbanes-Oxley Act § 806.

¹⁰¹ Amy Strahan, U.S. firms forced to sweeten the pot to attract directors, Bloomberg (August 30, 2005) (reporting on results of Mercer survey).

¹⁰² Id.

Auditor Liability

be quite expensive for public companies in the U.S., not to mention quite lucrative for the auditing profession. Moreover, the regulatory burden imposed by Sarbanes-Oxley has fallen disproportionately on the smallest issuers, creating the risk that some of these firms will “go dark,” removing their securities from public trading and that other firms will remain closely-held rather than pursuing growth through an initial public offering. These costs, however, do not raise any questions about the quality of auditing. They just mean that investors in the U.S. capital markets will have fewer choices.

For larger issuers, however, the reforms adopted by the Sarbanes-Oxley Act have created a more adversarial relationship between company management and independent auditors. Outside auditors are no longer seen by company managers as trusted business advisors. Instead, they are seen as agents of the state. The growth of auditors’ fees in the last few years no doubt helps fuel this resentment. A survey of 147 public companies conducted by the law firm Foley & Lardner found increasing resentment toward outside accountants. One (anonymous) quote from a survey participant: “[I]t has created an adverse relationship with the auditors. They are no longer an advisor the company can count on during the normal course of business. Public company auditors are now privatized regulators for the SEC.”¹⁰³ This may be a necessary cost to ensure the goal of auditor independence, but it clearly must be counted as a cost. An adversarial relationship between the monitors and those that they monitor does not encourage those being monitored to be forthcoming with information.¹⁰⁴ Has this more adversarial relationship has made auditors more objective or unduly chilled information flows between the auditors and management?

The burden that this plethora of new regulation imposes on auditors and public

¹⁰³ Thomas E. Hartman, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 16, 2005).

¹⁰⁴ Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 *J. Corp. L.* at .

Auditor Liability

companies raises substantial questions about the cost of trading as a public company and raising capital in the U.S. It is too soon to tell whether this cost will yield corresponding benefits in bolstering the integrity of the capital markets. At this point, all we can say about the weighing of costs and benefits is that Congress has embarked on a very expensive regulatory experiment. The tallying of the benefits must await further experience under the new regulatory regime.

We can, however, say with reasonable confidence that the new regulatory efforts are largely consistent with the role of reputation and market forces in ensuring audit quality. The worst that can be said about the most important of the changes is that they curtail the available range of audit quality at the bottom end. This implicit cartelization has to be considered a cost in terms of efficiency – Does every company need gold-plated internal controls? – but it is a cost that Congress was willing to bear in the name of restoring investor confidence.

The good news is that inspections conducted by the PCAOB should enhance the reputational market for auditors by bringing additional transparency on the subject of audit quality. Moreover, the PCAOB has a valuable role to play in facilitating the exchange of information concerning the state of the art in auditing procedures. More stringent definitions of auditor independence are likely to encourage objectivity in the application of GAAP. And given the PCAOB's expertise in the field of accounting (and lack of conflicting interests), the sanctions it imposes on audit firms and their associated persons are likely to be inflicted with reasonable accuracy. It seems safe to predict that being sanctioned by the PCAOB will have a significant effect on an audit firm's reputational capital.

The same can be said of the certification requirements and corporate governance changes adopted by Congress. Auditors can have greater confidence in the integrity of the information that they will be reviewing, which should allow them to do their job better. And placing the audit relationship squarely under the direction of an independent audit committee should

Auditor Liability

diminish pressures to acquiesce in questionable accounting treatments.

All of these changes enhance the efficiency of the reputation market. The question that remains is how well the costly regulatory experiment of Sarbanes-Oxley fits in with the other primary incentive for auditors to perform quality audits – the risk of securities fraud class action litigation. I turn now to that question.

III. Suing Auditors

Private civil liability, particularly securities fraud class actions, promises to provide deterrence, above and beyond that already provided by the threat of enforcement action from the SEC.¹⁰⁵ Of course, the *marginal* deterrence provided by securities fraud class actions has presumably been diminished by the possibility of enforcement from the PCAOB. The creation of the PCAOB effectively leverages the enforcement efforts of the SEC, and provides a guaranteed stream of revenues to support the effort to boot. This shift has presumably taken us farther along the curve toward the optimal level of government enforcement. Given the accuracy advantages that government enforcement in the hands of the relatively disinterested and expert PCAOB and SEC, the private enforcement of securities fraud class actions can only be justified if it provides marginal deterrence at an acceptable cost. Among the costs that must be considered is the effect that securities fraud class actions have on other enforcement mechanisms and regulatory tools.

I will focus here on three potential costs raised by using litigation as a deterrent: (1) the

¹⁰⁵ In this regard, it is well to remember that auditing firms also remain under the chilling threat of criminal liability, although it may have diminished somewhat. KPMG recently avoided a fate akin to Arthur Andersen's for having offered bad advice on tax shelters by throwing itself at the mercy of the Justice Department. Given the damage to competition that resulted from the reduction of the Big Five to the Big Four (and the embarrassment of having Arthur Andersen's conviction reversed), an indictment of KPMG was probably never the likely outcome. At this point, the Justice Department probably will not brandish the threat of indicting any of the remaining Big Four without very persuasive evidence of corruption at the firm level. Individual partners, however, are unlikely to receive such kid glove treatment, as a number of KPMG's partners learned.

Auditor Liability

limits of the sorting process provided by litigation; (2) the limited effect that litigation risk is likely to have on auditor behavior; and (3) the effect that litigation risk has on regulatory approaches to promoting audit quality.

A. Limits of litigation as a sorting process

Litigation leaves much to be desired as a means of promoting audit quality. The most obvious concern is the precision with which litigation sanctions audit firms for their derelictions. The messiness of the signal conveyed by an audit failure means that the hit to an auditor's reputation from a problem at a client company will be muffled at worst. The litigation response to an audit failure will not be so restrained. Publicity regarding auditing problems creates a high likelihood of lawsuit, particularly if the misstated financials involve earnings or revenues.

The litigation sorting process also leaves much to be desired. For the external observer, lacking access to work papers and other relevant evidence, it is easy to confuse the effects of fraud with the effects of an innocent mistake. Enron's implosion is tied in the public mind to the accounting problems to which Arthur Andersen turned a blind eye. Enron was likely to fail, however, whether or not it cooked the books, because the business decisions that it had made did not pan out. If there is a sufficient stock price drop to generate sufficient damages, a restatement or other accounting problem is likely to lead to a lawsuit against the auditors, particularly if the corporation, an easier target, has gone bankrupt.¹⁰⁶ The cost of defending the lawsuit is the first sanction imposed by the litigation process, and it is a sanction that may be only tenuously related to how well the auditing firm has performed its job. The lawsuits, like the rain, fall on the good and bad auditors alike after a client's financials need to be restated. Many such complaints will

¹⁰⁶ Ross D. Fierman, Naming Auditor Defendants in Securities Class Actions, 7 J. Legal Econ. 72 (1997).

Auditor Liability

be dismissed,¹⁰⁷ but only after a significant cost in lawyers' fees and distraction.

Those costs will rise as the process goes forward beyond the complaint stage, but confidence in the sorting ability of lawsuits increases only marginally. To be sure, the plaintiffs' lawyers will gain access to the auditor's work papers if the litigation proceeds beyond the motion to dismiss stage, but that access to additional information has a mixed effect on the accuracy of the sorting process. The sheer burden imposed by the discovery process – a task made worse by Sarbanes-Oxley requirements mandating the retention of work papers for seven years after the audit¹⁰⁸ – creates a powerful incentive for settlement, whatever the merits of the case.

The final stage of the litigation sorting process further pushes audit firms toward settlement. A number of cognitive biases fuel the fear of trying a case to a judgment. The great fear posed by going to trial is the hindsight bias – the tendency to place excessive weight on events that actually did occur in the past (relative to events that might have occurred but did not) in predicting the probability of events.¹⁰⁹ The auditors “must have known” of the fraud when it was being committed in light of the subsequently revealed evidence. For auditors, the central concern is that the established fact of an audit failure (hence the litigation), will be construed as persuasive evidence of high engagement risk, which called for more extensive procedures. Audit failure becomes equated to audit laxity.

But most business reversals are just business reversals. The overall rate of fraud by

¹⁰⁷ A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL. LEG. STUD. 125 (2005)

¹⁰⁸ Sarbanes-Oxley Act § 103, 15 U.S.C. § 7213.

¹⁰⁹ See generally See Baruch Fischhoff, *Hindsight Is Not Equal to Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL: HUM. PERCEPTION & PERFORMANCE 288, 288 (1975). See also Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, in JUDGMENT AND UNCERTAINTY: HEURISTICS AND BIASES 335, 341 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982) (quoted in Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 572 (1998)) (“In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also to view it as having appeared ‘relatively inevitable’ before it happened. People believe that others should have been able to anticipate events much better than was actually the case.”); Mitu Gulati et al., *Fraud by Hindsight*, 98 Nw. U. L. Rev. 773 (2004) (discussing the effect of the hindsight bias in the securities litigation context.).

Auditor Liability

corporations is very low, and the percentage of those frauds in which the auditors participate is lower still.¹¹⁰ The temptation—when faced by the salient evidence of huge losses that typically prompt securities fraud suits—is to ignore this very low base rate in assessing whether there has been fraud.¹¹¹ If the operative working hypothesis is that the audit failure was caused by the auditors being asleep at the switch, contrary evidence may get short shrift.¹¹²

Other cognitive limitations may affect the accuracy of the litigation sorting process. The salience of audit failure may also trigger the availability heuristic, further distorting jurors judgment.¹¹³ Finally, the fundamental attribution bias may lead courts to exaggerate the influence of perceived disposition (for example, fraud-prone) in explaining a person's behavior while overlooking the influence of the person's particular circumstances in any given situation.¹¹⁴ And given the disrepute that auditors have fallen into, evidence about the behavior of any particular audit firm's work may be viewed through the skewed lens of the confirmation

¹¹⁰ See Robert F. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 Nw U. L. Rev. 133, (2000) (“[I]n the general run of things, there is no reason to suspect that auditors are auditing fraudulently or recklessly, any more than there is reason to believe that drivers are driving recklessly. Most audits are completed competently, just as most car trips are.”).

¹¹¹ See *id.* at 158-59 (discussing representativeness heuristic). Others have put forth recommendations for “debiasing” human decisionmakers in the jury context (with respect in particular to the hindsight bias). See Hal R. Arkes, *Principles in Judgment/Decision Making Research Pertinent to Legal Proceedings*, 7 BEHAV. SCI. & L. 429, 450-51 (1989). These attempts, however, have not met with much success. See, e.g., Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post Not Ex Ante: Determining Liability in Hindsight*, 19 L. & HUM. BEHAV. 89, 99 (1995).

¹¹² See Clifford R. Mynatt, Michael E. Doherty & William Dragan, *Information Relevance, Working Memory, and the Consideration of Alternative*, 46A Q.J. EXPERIMENTAL PSYCHOL. 759 (1993) (finding that subjects who had developed a plausible hypothesis were less able to recognize alternatives).

¹¹³ Under the availability heuristic, people place undue weight on recent events and other readily available information. The availability heuristic may lead people to discount excessively the possibility of losses from high magnitude but low probability risks if such a loss has not occurred recently. Conversely, immediately after a loss does occur (for example, an earthquake in San Francisco or a financial meltdown at Enron), people may exaggerate the probability of future loss. See Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1127-1128 (1974) [hereinafter Tversky & Kahneman, *Judgment Under Uncertainty*] (describing the availability heuristic).

¹¹⁴ See Justin Kruger & Thomas Gilovich, *Naïve Cynicism in Everyday Theories of Responsibility Assessment: On Biased Assumptions of Bias*, 76 J. PERSONALITY & SOC. PSYCHOL. 743 (1999); see also Donald C. Langevoort, *Monitoring: The Behavior Economics of Inducing Agents' Compliance with Legal Rules*, 2002 COLUM. BUS. L. REV. 71, 89 (“My suspicion, however, is that concealed compliance wrongdoing by agents is only occasionally the product of inherently bad moral dispositions. More often, a morally normal person gets caught in a situation that leads gradually to increasingly bad choices. Here, we revisit the fundamental attribution bias: the idea that observers underestimate in others the influence of situational factors, and overestimate character.”).

Auditor Liability

bias.¹¹⁵ In the opposite direction, judges may rely on simple heuristic-like rules to get cases off their dockets.¹¹⁶ Judges may prefer to dispose of cases quickly, particularly if securities law cases are a disfavored class due to their complexity or other reasons. Although heuristics may cut down on decisionmaking costs, they may not produce a rule of law that provides the most cost-effective protection for investors and the capital markets.

The result of these conflicting biases is uncertainty, and defendants facing enormous damages judgments do not like uncertainty. The combined effect of these forces pushing toward settlement is reinforced by the threat of potentially bankrupting damages. Audit firms may choose to settle – even when they have strong defenses – rather than put their business fates in the hands of a judge or jury. Trials in securities fraud class actions are virtually unheard of.

The vagaries and expense of the litigation process dictate that a substantial percentage of the audit fees charged by public accountants go to insuring against litigation risk. Those fees, of course, are paid by corporations, and therefore, indirectly by the shareholders of those corporations. Shareholders would be happy to shoulder the cost of the securities class action mill, *if* it imposed sanctions with sufficient accuracy to provide confidence that it produced useful deterrence above and beyond that already produced by government enforcement.¹¹⁷ As noted above, the question of marginal deterrence also requires us to account for the deterrence coming from other sources. Unless litigation produces a more precisely targeted sanction than the sanctions administered by the SEC, PCAOB, and the market for reputation, it is difficult to

¹¹⁵ The confirmation bias induces people to confirm prior decisions regardless of whether the decisions were correct when made. *See, e.g.*, Robert Forsythe, Forrest Nelson, George R. Neumann & Jack Wright, *Anatomy of an Experimental Political Stock Market*, 82 AM. ECON. REV. 1142 (1992); Charles G. Lord, Lee Ross & Mark R. Lepper, *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098 (1979).

¹¹⁶ Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 100-05; *see* Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903 (2002). Donald C. Langevoort's response can be found in Donald Langevoort, *Are Judges Motivated To Create "Good" Securities Fraud Doctrine?*, 51 EMORY L.J. 309 (2002).

¹¹⁷ John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 Business Lawyer 1403, 1415 (August 2002) (arguing that "a system of reputational intermediaries works only if fault can be reliably assigned.").

Auditor Liability

say that it produces much in the way of marginal deterrence. Simply adding to the punitive weight of those other sources is unlikely to do much to push audit firms toward higher quality auditing practices, given the questionable precision with which the current litigation regime adds that marginal sanction.¹¹⁸

B. The “irrational auditor”

Another reason to question the role of litigation in promoting audit quality is that lawsuits may do little to deter bad auditing. Business professors Max Bazerman, George Loewenstein and Don Moore paint a bleak picture of the ability of accountants to respond to rational incentives, arguing that “the corporate auditing arena is a particularly fertile ground for self-serving biases.”¹¹⁹ Their main points about auditor’s cognitive limits:

Ambiguity. Bias thrives wherever there is the possibility of interpreting information in different ways. ... Auditors and their clients have considerable leeway ... in answering some of the most basic financial questions: What’s an investment? What’s an expense? When should revenue be recognized? ...

Attachment. Auditors have strong business reasons to remain in clients’ good

¹¹⁸ I have proposed an alternative that I believe promises greater accuracy. A.C. Pritchard, *Markets as Monitors: A Proposal To Replace Class Actions with Exchanges as Securities Fraud Monitors*, 85 VA. L. REV. 925 (1999).

¹¹⁹ See Max H. Bazerman, George Loewenstein & Don A. Moore, *Why Good Accountants Do Bad Audits*, HARV. BUS. REV. Nov. 2002, at 97, 100

Robert Prentice has similarly written about the “irrational auditor” who jeopardizes a firm’s reputation by signing off on misleading financial statements. Prentice argues at length that behavioral law and economics demonstrates the likelihood that auditors will succumb to this seemingly irrational risk to their firm’s reputation. Prentice, *supra* note . Prentice made his arguments in an effort to rebut the presumption, used by some courts that it would be irrational for an auditor to succumb to client pressure and ignore cooking of the books. *Id.* at 136 (citing *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990)).

In fact, Prentice is badly overreading the case. Judge Easterbrook dismissed the complaint is based not blind faith that people cannot act irrationally, but rather the plaintiffs failure to provide any evidence that they had. In the passage immediately following the one quoted by Prentice, Easterbrook argues:

People sometimes act irrationally, but indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another has behaved irrationally has to make a strong case. The complaint does not come close. *It does not identify any of E & W’s auditors or explain what the person might have had to gain from covering up Continental’s wrongs.*

DiLeo, 901 F.2d at 629 (emphasis supplied). Easterbrook dismisses the complaint, not because of an irrebuttable presumption of rationality, but because the plaintiffs have alleged no facts to rebut that presumption. The complaint alleged no facts about the accounting firm that would distinguish it from any other accounting firm that had a client suffer a business reversal.

Auditor Liability

graces and are thus highly motivated to approve their clients' accounts. ... once people equate their own interests with another party's they interpret data to favor that party. Attachment breeds bias.

Approval. An audit ultimately endorses or rejects the client's accounting – in other words, it assesses the judgments that someone in the client firms has already made. Research shows that self-serving biases become even stronger when people are endorsing others' biased judgments – provided those judgments align with their own biases – than when they are making original judgments themselves. ...

Familiarity. People are more willing to harm strangers than individuals they know, especially when those individuals are paying clients with they have ongoing relationships. An auditor who suspects questionable accounting must thus choose, unconsciously perhaps, between potentially harming his client (and himself) by challenging a company's accounts or harming faceless investors by failing to object to the possibly skewed numbers. ...

Discounting. People tend to be far more responsive to immediate consequences than delayed ones, especially when the delayed outcomes are uncertain. ... the costs of a positive report when a negative report is called for – protecting the accounting firm's reputation or avoiding a lawsuit, for example – are likely to be distant and uncertain.

Escalation. It's natural for people to conceal or explain away minor indiscretions or oversights, sometimes without even realizing that they're doing it. ... It's our belief that some of the recent financial disasters we've witnessed began as minor errors of judgment and escalated into corruption.¹²⁰

In sum, Bazerman, Lowenstein and Moore make a strong argument that accountants may not *consciously* tolerate fraud – it may frequently result instead from their cognitive shortcomings.

If cognitive limitations are a central cause of audit failure, it has profound implications for antifraud liability. Fraud traditionally requires scienter.¹²¹ Presumably a person is not intentionally misleading anyone if he is making false statements under the influence of a cognitive defect. Even recklessness would seem a stretch: If cognitive defects, such as irrational optimism, are pervasive, then a false statement that resulted from such a defect could not be an extreme departure from the standard of ordinary care because ordinary care would arguably encompass the cognitive defect.

Could the risk of liability encourage audit firms to take measures to correct the cognitive

¹²⁰ Bazerman et al., *supra* note , at 98-100.

¹²¹ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

Auditor Liability

failings of their audit staff? Cognitive defects may be extremely difficult to overcome. As Bazerman and his co-authors put it “Research on motivated reasoning and self-serving biases suggest ... that those with conflicts of interest may be biased in ways they are not consciously aware, and that they therefore may not be able to correct these biases even when they try to do so.”¹²² Moreover, experts, such as accountants, tend to be overly optimistic in assessing their own decisionmaking ability.¹²³ As Dale Griffin and Amos Tversky put it, experts are “often wrong but rarely in doubt.”¹²⁴ This confidence may cause auditors to discount evidence of their own propensity for cognitive failure.

Even if corrections are feasible, is litigation the correct lever to induce such changes? Part of the difficulty with correcting cognitive failings is the uncertainty about what measures will be effective in a particular, highly specialized setting such as auditing. The adversarial process of litigation, where the focus is on assigning blame, is unlikely to shed much light on this topic. The specialized expertise of the PCAOB, with its staff exposed many diverse audit contexts, seems much more likely to generate useful measures to improve the auditing process. And the PCAOB’s legitimacy as an expert regulator makes its recommendations much more palatable.¹²⁵

In sum, if cognitive defects lead auditors to sign off on misleading financial statements, imposing anti-fraud liability on those auditors serves no useful purpose. Liability would be pointless in changing behavior. Imposing liability for misstatements would simply transfer

¹²² Don A. Moore, George Loewenstein, and Max H. Bazerman, Auditor Independence, Conflict of Interest, and the Unconscious Intrusion of Bias, (Harvard NOM Research Paper, No. 02-40, 2002). On the possibility of corrective measures for cognitive failings, see Chip Heath, Richard P. Larrick, and Joshua Klayman, Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings, 20 Res. Org. Behav. 1 (1998).

¹²³ See Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411, 427, 430 (1992)

¹²⁴ *Id.* at 412.

¹²⁵ See Jennifer S. Lerner & Philip E. Tetlock, Accounting for the Effects of Accountability, 125 Psychological Bulletin 255, 259 (1999) (concluding that “when people perceive accountability as illegitimate, such undesired effects as attitude polarization away from the advocated position, decline in intrinsic motivation, and excessive stress are all possible responses.”).

Auditor Liability

money from audit firms to investors and lawyers, with no reduction in fraud. In that scenario, auditor liability needlessly reduces social welfare.

C. The effect of litigation on the quantity and quality of information

In addition to concerns about the precision and efficacy of litigation as a deterrent, there are also reasons to worry about the way that litigation interacts with other approaches to audit quality. Litigation is supposed to complement regulation and reputation. There are reasons to believe, however, that litigation actually undermines those approaches. Even more worrisome, the specter of litigation may be having a deleterious effect on the usefulness of financial statements.

1. Regulation & Reputation

Perhaps the most important work product that the PCAOB is likely to generate will be the inspection reports that it is required to produce after each inspection of a registered accounting firm. These reports promise to offer important information about the quality of auditing, information that is likely to be critical to the market in evaluating an auditor's reputation.

Unfortunately, the PCAOB's inspection reports are hamstrung by litigation fears. Under the Sarbanes-Oxley Act and PCAOB rules, the Board must provide a copy of each inspection report, in appropriate detail, to the SEC and to certain state regulatory authorities.¹²⁶ Portions of those reports are also made available to the public, subject to restrictions in the Act that prohibit, or require a delay in, the public disclosure of certain information.¹²⁷ The public portions of the inspection reports include descriptions of the types of matters on which the Board focused its inspection procedures, the procedures the Board staff carried out to examine those matters, and descriptions of issues identified by Board staff in the course of the inspection, such as apparent

¹²⁶ Sarbanes-Oxley Act § 104(g), 15 U.S.C. § 7214(g).

¹²⁷ Sarbanes-Oxley Act § 104(g)(2), 15 U.S.C. § 7214(g)(2).

Auditor Liability

departures from auditing standards, related attestation standards, ethical standards, independence standards, and the quality control policies and procedures of the firm itself.¹²⁸

The Sarbanes-Oxley Act limits public access, however, to portions of the inspection report criticizing potential defects in the quality control systems of the firm under inspection. If a final report identified quality control defects, the firm may demonstrate to the Director of the PCAOB Division of Registration and Inspections that it has remedied the defects within twelve months. If the defects were successfully remedied, the defects will not be made public.¹²⁹ The Board is further restricted from publicizing any information subject to the protection of § 105(b)(5)(A) of the Sarbanes-Oxley Act.¹³⁰ The Board is therefore prohibited from releasing any documents or information specifically acquired by the Board, and any related Board deliberations in connection with an inspection.

Criticisms and defects in auditing practices are withheld from the public because, as a policy matter, “the Board is concerned that discussing aspects of a firm’s quality controls, in a context where criticisms and potential defects cannot be discussed, may create a distorted and misleading impression.”¹³¹ This rationale does not hold up to serious scrutiny. If the PCAOB is concerned about creating “a distorted and misleading impression” in the minds of users of financial statements, it is not clear why its “criticisms and potential defects cannot be discussed.” Firms subject to a report are provided a draft of the inspection report to that firm. The firm is entitled to respond to the draft within thirty days indicating for which portions of the report they

¹²⁸ *Supra*, note 113 at 6.

¹²⁹ PCAOB Rule 4009. The PCAOB issued “Limited Inspection Reports” in August 2004 for the Big Four firms, so if any of the deficiencies identified in the course of the PCAOB’s inspections have not been corrected by the firms, the PCAOB should soon make public those deficiencies. Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

¹³⁰ Sarbanes-Oxley Act § 104(g)(2), 15 U.S.C. § 7214(g)(2).

¹³¹ Gordon Seymour, PCAOB Rel. No. 104-2004-001 at 5. Available at: http://www.pcaobus.org/Inspections/Statement_Concerning_Inspection_Reports.pdf

Auditor Liability

request confidentiality.¹³² This thirty-day review period, however, would give the auditing firm plenty of time to prepare response and release it simultaneously with the PCAOB's report. The more likely parties to suffer from a distorted and misleading impression are plaintiffs' lawyers, who would be avid readers of such reports in their quest for litigation fodder. What better evidence of accounting incompetence than criticism from the experts at the PCAOB?

Greater publicity of findings of material weaknesses in audit procedures would provide more of a deterrent for audit firms to do a good job with their audits. Reputation is critical to auditors. Providing the public with information to assess the adequacy and thoroughness of the auditor's work, however, stands in tension with the audit firms' litigation concerns. Public airing of weaknesses in their audit procedures would quickly find their way into complaints. Similarly, making publicly available documents provided to the PCAOB would be very tempting to current and prospective private litigants.

The fear of litigation may affect not just the information available to the reputational market. The risk of litigation may also impair audit quality more directly, by undermining the incentive of audit firms to discipline their partners. As George Benston explains: "Should the firms fire or otherwise punish a partner for having supervised and approved an incompetent or inadequate audit or for having agreed too readily to a client's demands, the firm would be admitting its collective guilt to regulators and present, or potential, plaintiffs."¹³³ Perhaps the firing of a partner for doing bad audit work is even more persuasive evidence than criticism coming from the PCAOB.

2. The Usefulness of Financial Statements

The threat of securities fraud class actions also has potentially perverse consequences for

¹³² Sarbanes-Oxley Act § 104(f), 15 U.S.C. § 7214(f).

¹³³ George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 *Emory Law Journal* 1325, 1345 (2003).

Auditor Liability

users of financial statements. To stave off litigation, auditing firms continually push the FASB for more and more detailed rules. As Bill Bratton notes, “Auditors in this country like rules. They want more of them. Indeed, the then Big Five accounting firms responded to the Enron crisis by demanding more rules and blaming regulators for failing to supply them.” The affection of auditors for rules is understandable – the more detailed the rules, the better auditors can defend themselves against charges of a negligent audit by demonstrating that the financial statements were prepared in accordance with generally accepted accounting principles.¹³⁴ (More detailed standards also bolster the auditor’s willingness to resist pressure from the client to fudge the numbers – if the rules are clear, no independent auditor is likely to sign off on their violation, so “shopping” for a more compliant auditor is pointless.)

The problem is that as accounting principles become more detailed, financial statements may become so complex that are rendered opaque to even the informed user, much less the average investor. Moreover, increased complexity may create greater space for manipulation.¹³⁵ The fog engendered by complex accounting standards is further fueled by complex financial structures. For example, the financial engineering that goes into the creation of derivative securities creates a virtually infinite range of securities types.¹³⁶ This flexibility creates considerable room for polishing a company’s financial picture.

IV. Conclusion

In this essay, I have raised a number of reasons to question the call for greater liability for

¹³⁴ William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 *Villanova Law Review* 1023, 1045 (2003).

¹³⁵ Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 *Cornell Law Review* 394, 421 (2004) (“The current, highly technical accounting system is easy to manipulate because of its complexity, and firms will take advantage of this fact because of the intense pressure to produce a profit.”).

¹³⁶ Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 *William and Mary Law Review*, 1, 11-12 (2004) (“the fact that each derivative is customized makes valuation difficult individually and impossible in the aggregate. The contingencies written into the arrangements are mind-numbingly intricate.”).

Auditor Liability

auditors. Litigation is a substitute for regulation and the market for reputation, not a complement, and arguably a poor one in the context of promoting audit quality. The new regulatory regime faced by auditors of public companies in the post-Sarbanes-Oxley world substantially undercuts the arguments for imposing liability on auditors. If we know of ways that auditors can improve their auditing practices in a cost justified way, the PCAOB can require them. We do not need the stick of litigation exposure to make the auditors improve their procedures.

In any event, the Private Securities Litigation Reform Act did not eliminate, but merely limited, the liability exposure faced by auditors. To my mind, the PSLRA struck a sensible balance at the time of its enactment. The Act adopts proportionate, rather than joint and several, liability for defendants who are not found to have knowingly violated the securities laws.¹³⁷ That protection is most important for secondary defendants, such as accountants, lawyers and investment bankers, who may be implicated in frauds that will typically be orchestrated by the insiders of their corporate clients. If those secondary defendants can show that they did not know of the fraud, their liability exposure will be limited substantially.

Is the reduction in liability for accountants a real concern? The PSLRA does not let secondary defendants off scot-free. Proportionate liability does not mean that accountants are immune from liability. It only means that they are responsible only for the incremental harm caused by their participation in the fraud. Prior to the PSLRA, plaintiffs' lawyers routinely went after accountants even if their culpability for the fraud was slight, particularly when the audit client had gone bankrupt. It seems clear to me that the auditors were excessively exposed under the old regime, and the exposure varied in a rather haphazard fashion. Under the PSLRA, defendants who are only tangentially involved in the fraud will not face potentially bankrupting

¹³⁷ Exchange Act § 21D(f)(2), 15 U.S.C. § 78u-4(f)(2).

Auditor Liability

liability, so accountants do not have to serve as quasi-guarantors for the solvency of their clients.

But auditors who actively participate in the fraud get no such relief. Under the PSLRA, defendants are only entitled to the protection of proportionate liability when they lack knowledge of the fraud. Even then they can be required to pay an additional 50 percent above the damages based on their fault if the issuer is insolvent.¹³⁸ Proportionate liability offers no protection at all for secondary defendants if a jury concludes that they were knee deep in the fraud. Accountants must still consider the risk of a securities fraud class action when a client tries to pressure them into acquiescing in a dubious interpretation of accounting principles.

Should we go further and eliminate liability for auditors altogether? This would eliminate the deleterious effect that the threat of litigation has on the regulation of auditors and the reputational market. A broad immunity, however, would excuse those auditors who knowingly acquiesce in their clients' frauds (although the threat of enforcement by the SEC and PCAOB would remain). The problem is determining how common knowing acquiescence is, although one suspects that it is much less common than the frequency of negligence. The ratio of the latter to the former is important – the knowing fraud is something that we believe can be deterred in many cases by the threat of litigation. For the cognitive reasons set forth above, however, we are much less sanguine that the merely negligent acts are as likely to be deterred. The line between negligence and recklessness is far from bright, and many cases of negligence will be sufficient to get past a motion to dismiss, thereby creating at least some settlement value, so there is an argument for requiring the pleading of knowledge by the auditor in all cases.

A stringent knowledge standard, however, poses the risk that knowing frauds will go unsanctioned. When we are talking about primary violaters (i.e., the corporate insiders), that risk of unsanctioned fraud would be clearly unacceptable. But as an incremental reform to further

¹³⁸ Exchange Act § 21D(f)(2), 15 U.S.C. § 78u-4(f)(4).

Auditor Liability

protect auditors from the risk of frivolous suit, it is something should be considered for accountants if we are going to keep the costs of audits manageable for public companies.