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The Irrational Auditor and Irrational  
Liability

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# The Irrational Auditor and Irrational Liability

Pritchard:

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*Forthcoming, Lewis and Clark Law Review*

## Abstract:

This essay argues that *less* liability for auditors in certain areas might encourage *more* accurate and useful financial statements, or at least equally accurate statements at a lower cost. Audit quality is promoted by three incentives: reputation, regulation, and litigation. When we take reputation and regulation into account, exposing auditors to potentially massive liability may undermine the effectiveness of reputation and regulation, thereby diminishing integrity of audited financial statements. The relation of litigation to the other incentives that promote audit quality has become more important in light of 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, I argue that the marginal benefit of litigation has been substantially diminished and in many cases that it is likely to be ineffective in promoting greater audit quality. I propose a knowledge standard for auditor liability in securities fraud cases.

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\* Professor, University of Michigan Law School. This essay was prepared for 2005 Fall Business Law Forum at the Lewis & Clark Law School. I thank participants at the Forum for helpful comments on an earlier draft of this paper. Remaining errors are the result of my own cognitive limitations or ignorance.

## *Auditor Liability*

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 with whom you would not want to be caught in corner of the room at a cocktail party. Auditors' reputation has gotten a bit edgier in the last few years – 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 object 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 prosecutors, the whipping boys for all the greed that tainted corporate America in the *fin de siècle* excess of the tech bubble. Arthur Andersen collapsed 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.<sup>1</sup>

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 found in that law, it is Congress's intention to punish auditors for the sins of Arthur Andersen. Going forward, Congress meant to keep the remaining members of the Big Four 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 "Peekaboo," is charged specifically with keeping tabs on the auditors of public companies. Consequently, unlike the SEC which has demonstrated a tendency to be distracted by the scandal *du jour*, the PCAOB has a narrow focus that will tend to push it toward close oversight of the accounting industry. What else does it have to do?

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[http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57)

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

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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.<sup>2</sup> Who would have thought that accounting would become a “hot” career path? The question of why bean counting has become so popular is readily answered – audit fees have sky-rocketed in the wake of accounting reforms passed by Congress as part of the Sarbanes-Oxley Act.

The question raised by auditors’ new-found prosperity is whether this increase in fees is matched by commensurate benefits for investors. Are investors receiving better, more accurate information? Almost certainly. Is it worth the cost? We don’t know.

The most controversial of the Sarbanes-Oxley provisions has been § 404, which requires the auditors to assess the integrity of the client’s internal controls.<sup>3</sup> 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 compliances costs.<sup>4</sup> This increase in audit fees suggests that perhaps Congress was not as anxious to punish auditors as one might have thought from the legislators’ public fulminations against the industry at the height of the accounting crisis. This surprisingly large spike in auditing revenues suggests that the profession is quite healthy, a welcome development for an industry in which 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

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<sup>2</sup> Claude Solaik, Schools open new chapter in accounting offerings, Long Island Business News (July 22, 2005).

<sup>3</sup> Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262.

<sup>4</sup> 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).

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accountants saying.

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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.<sup>5</sup>

Unraveling whether the spike in auditing costs stems from a paranoid 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.<sup>6</sup>

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. Accountants were getting a free pass, the story goes, after the Supreme Court read aiding and abetting liability out of Rule 10b-5 and Congress discouraged securities litigation more generally with its adoption of the Private Securities Litigation Reform Act.<sup>7</sup> What was needed was a healthy dose of liability exposure to

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

<sup>6</sup> 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).  
[http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57)

<sup>7</sup> See, e.g., John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid," 57 *Bus. Law.* 1403,

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bring the auditors back into line.<sup>8</sup>

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More lawsuits are the 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. Liability is only one tool for promoting audit quality; reputation and regulation also play vital roles. Let’s call these three incentives the triad of audit quality.

Auditor reputation has always been important, leading some to suggest that jeopardizing it would be “irrational.”<sup>9</sup> That has not changed. The regulatory environment, however, has shifted in the post-Sarbanes-Oxley world. Auditors now operate under the watchful eye of independent audit committees and are subject to thoroughgoing and intrusive regulation and inspection by the PCAOB, so regulation has been ramped up. Less clear is whether the third side of the audit quality triad – the threat of litigation – will have that much effect in encouraging quality audits in this new environment. If auditors “irrationally” ignore reputation and regulation, will litigation help steer them back to the path of virtue? The cognitive limitations of individual auditors are fueled by the unavoidable affiliation that the members of the audit team

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1409-1410 (2002); Jonathan Macey & Hillary A. Sale, Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry, 48 Villanova L. Rev. 1167, 1182 (2003).

<sup>8</sup> 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).

<sup>9</sup> Judge Easterbrook had this to say about auditor reputation in the course of discussing a securities fraud complaint against an audit firm for failure to adequately plead scienter:

The complaint does not allege that E[rnst] & W[hinney] had anything to gain from any fraud by [it’s client]. An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years’ audits could not approach the losses E & W would suffer from a perception that it would muffle a client’s fraud. And although the interests of E & W’s partners and associates who worked on the Continental audits may have diverged from the firm’s covering up fraud and imposing large damages on the partnership will bring a halt to the most promising career. E & W’s partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with [the client].

DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7<sup>th</sup> Cir. 1990) (Easterbrook, J.).

Robert Prentice is critical of Easterbrook’s point here, arguing that an “irrational auditor” may jeopardize 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. For a response to Prentice, see Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 Stan. L. Rev. 1, 49 n. 228 (2003).

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will have with the audit client's management. That affiliation colors everything that the auditor does in the performance of its audit, making the auditor particularly vulnerable to cognitive errors. Worse yet, these cognitive errors are particularly difficult to overcome. Punishing audit firms for mistakes that they cannot realistically overcome is a recipe for massive wealth transfers that will ultimately be passed along to shareholders in the form of higher audit fees. Worse yet, those wealth transfers will be accompanied by heavy deadweight losses in the form of litigation costs. The third component of the audit quality triad is potentially its weakest leg.

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 and useful financial statements, or at least equally accurate statements at a lower cost. When we take reputation and regulation into account, exposing auditors to potentially massive liability may in some respects hurt more than help. My thesis is that exposing audit firms to billion dollar settlements and judgments may undermine the effectiveness of reputation and regulation, thereby diminishing integrity of audited financial statements. Liability should *enhance* reputation and regulation not undercut them.

I proceed as follows. Part I explores the role of reputation, including economics of auditing, the incentives that auditors have to perform quality audits, and the difficulties inherent in measuring audit quality. Part II 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 III then explores how the new regulatory regime interacts with the liability regime, and how all three legs of the audit quality triad interact with the psychological strengths and weaknesses of auditors. I offer some preliminary thoughts on the appropriate standard for auditor liability in Part IV. Part V concludes.

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### **I. The Economics of Auditing**

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#### 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, the demand for their services would be much reduced. In a world where everyone were honest, external 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. Accounting would still be important, of course, as would generally accepted accounting principles (GAAP), because of the importance that financial statement users put on comparability. But the demand for external auditing of those accounts would be considerably diminished. To be sure, companies would occasionally make mistakes in the application of accounting principles, 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 produced by review by an expert outside auditor. The value of such review would not be all that great, however, in a world where company accountants made a good faith effort to comply with generally accepted accounting principles and any errors that they did make 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 – who knows how many – 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 7 wishful

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thinking.<sup>10</sup> Generally accepted accounting principles frequently leave some room for interpretation and discretion, and chief financial officers are apt to persuade themselves that the interpretation that puts the company's financial health in the most favorable light is the one that is justified. An 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.<sup>11</sup> 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 – a critical asset – 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.<sup>12</sup>

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.<sup>13</sup> Although an auditor's reputation is built upon

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<sup>10</sup> Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. Pa. L. Rev. 101 (1997).

<sup>11</sup> Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53 (1986).

<sup>12</sup> Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. Leg. Stud. 295, 302 (1988) (“The clients’ willingness to pay will depend ultimately on the quality of the information produced.”).

<sup>13</sup> *Id.* At 312 (“The good accountant can charge a high price to clients because they can use the accountant’s good name to sell their securities at a premium or to borrow at lower interest rates.”). Fung and Gul provide evidence that

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the quality of the audits that it performs, the incentive to perform thorough audits to maintain and enhance the audit firm's reputation must be balanced against competitive pressures to keep the cost of audits manageable. The question is whether the reputational 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 is equal to the marginal benefit conferred on the client company.<sup>14</sup> That marginal benefit takes the form of enhanced credibility for the client company's financial statements, which should provide more favorable contract terms and a reduced cost of capital for the client.

### B. Assessing the Quality of Auditing

This straightforward 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 by the audit team assigned at an individual company, which may or may not follow all of those procedures (which will necessarily vary with the size of the company, the type of business it is in, and the audit team's assessment of the litigation risk). Moreover, the intensity of effort from the audit team members is likely to be an important determinant of audit quality and that intensity will be largely unobservable. Finally, audit procedures will need to evolve to keep pace with the evolution of business practice. Are the auditors keeping up? For the outside observer, the independent audit is largely a black box.

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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).

<sup>14</sup> Ross L. Watts & Jerold L. Zimmerman, Agency Problems, Auditing, and the Theory of the Firm: Some Evidence, 26 J. L. & Econ. 613 (1983).

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And this difficulty in assessing the quality of audits 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.

This concern that auditors may come under the sway of important clients has been exacerbated as accounting has become more complex, requiring independent auditors to spend a larger percentage of their time with each client. To cite one well-worn 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."<sup>15</sup> 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.<sup>16</sup>

The client pressure that brought Andersen down 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.

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

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<sup>15</sup> 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).

<sup>16</sup> Paul K. Chaney & Kirk L. Philipich, Shredded Reputation: The Cost of Audit Failure, 40 J. Acct. Res. 1221 (2002) ([http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57); finding a negative abnormal stock price reaction for Andersen clients after Andersen admitted shredding Enron-related documents).<sup>10</sup>

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focused on making sure that assets have not been misappropriated by management is a manageable task that 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 measurement. Absent a well-developed and liquid market for an asset, economic values are notoriously difficult to quantify, opening up room for greater manipulation.<sup>17</sup>

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.<sup>18</sup> Cutting corners reduces the auditor's expense, thereby bolstering the auditor's profit margin. Even if the firm avoids such temptations, employees of the firm will be similarly tempted to cut corners, particularly in the face of client pressure. Most of the time such short cuts will have no adverse consequences, so 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.<sup>19</sup> And to complicate matters, even a very public revelation of an audit failure can send an ambiguous signal. Even when an audit client subsequently restates its revenues or earnings, it will be hard to discern whether the auditor was

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<sup>17</sup> George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 *Emory Law Journal* 1325, 1348 (2003).

<sup>18</sup> See J.A. Borzovsky & F.M. Richardson, *The Effects of Information Availability on the Benefits Accrued from Enhancing Audit-Firm Reputation*, 23 *Accounting, Organizations & Society* 767 (1998).

<sup>19</sup> It certainly was not obvious before those firms collapsed. See, e.g., Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 *U. Chi. L. Rev.* 1233, 1236 (2002) ("it was known and widely discussed in the analytic community that Enron's financial structure was highly complex and that the bodies were buried in off-balance sheet entities that were described cryptically in Enron's disclosure document. No one on the outside really understood Enron's financial condition, but they also knew they did not know. As one analyst put it, Enron was 'faith' stock.").

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negligent or duped by a tightly-knit conspiracy of insiders.<sup>20</sup> The restatement itself is ambiguous: does it reflect poor auditing in the past, or particularly diligent auditing today?<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup> Before Enron, there were cautionary flags, like the penalties imposed by the SEC against the firm for its failures in auditing Waste Management,<sup>24</sup> 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.<sup>25</sup>

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

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<sup>20</sup> Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. Corp. L. 1, 31 ("the serious issue is whether even strong regulation will change auditors' practical ability to find corporate fraud when determined corporate insiders want to hide it.").

<sup>21</sup> James D. Cox, Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements, 81 Wash. U. L.Q. 301, 318 (2003) ("The [rise in] restatements may well portend both a greater diligence on the part of the auditors as well as a stiffening of their resolve.").

<sup>22</sup> 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 (2004).

<sup>23</sup> 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).

<sup>24</sup> SEC v. Arthur Andersen LLP, Exchange Act Rel. No. AE-1410 (June 19, 2001).

<sup>25</sup> See Chaney & Philipich, *supra* note.

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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. 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 marginal value of litigation in promoting quality audits, a question I turn to in Part III. In this part, I summarize the most important changes in auditor regulation brought about by the Sarbanes-Oxley Act and the rules adopted pursuant to that law.

### A. The Self-Regulatory Regime

Until 1933, the contents of financial statements included in public companies'

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prospectuses and annual reports were regulated only by some state laws and stock exchanges' listing agreements.<sup>26</sup> 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.<sup>27</sup> 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).<sup>28</sup>

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.<sup>29</sup> Financial statements filed with the SEC were required to be prepared in accordance with principles having "substantial authoritative support."<sup>30</sup> In practice that meant delegation of the promulgation of accounting principles and auditing standards to the accounting industry's trade association, now known as the American Institute of Certified Public Accountants (AICPA).

The AICPA eventually delegated the promulgation of accounting principles to the Financial Accounting Standards Board (FASB), a part of the non-profit Financial Accounting

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<sup>26</sup> Benston, *supra* note , at 1325.

<sup>27</sup> Benston, *supra* note , at 1329.

<sup>28</sup> 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).

<sup>29</sup> Joel Seligman, *The SEC and Accounting: A Historical Perspective*, 7 J. of Comp. Bus. & Capital Market Law 241, 253-254 (1985).

<sup>30</sup> 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)

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Foundation (FAF).<sup>31</sup> The FASB's principles have been specifically endorsed by the SEC as providing "substantial authoritative support."<sup>32</sup> 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.<sup>33</sup> The FASB has a professional staff and a mandate to narrow the available accounting choices.<sup>34</sup>

The AICPA delegated the promulgation of auditing standards to what eventually became the Auditing Standards Board.<sup>35</sup> 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.<sup>36</sup> 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.<sup>37</sup> 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.<sup>38</sup>

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.<sup>39</sup> Allegations of an audit failure in litigation filed against a member of the SECPS were reviewed 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

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<sup>31</sup> Financial Accounting Standards Board, Facts About FASB (2005), available at [www.fasb.org](http://www.fasb.org).

<sup>32</sup> Statement of Policy of the Establishment and Improvement of Accounting Principles and Standards, SEC Accounting Series Release No. 150, (Jan. 7, 1974).

<sup>33</sup> 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).

<sup>34</sup> Benston, *supra* note, at 1334.

<sup>35</sup> American Institute of Certified Public Accountants, *The Enron Crisis: The AICPA, The Profession & The Public Interest: A Brief History of Self-Regulation* (2002).

<sup>36</sup> Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 Notre Dame L. Rev. 975, 989-990 (2005).

<sup>37</sup> 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.

<sup>38</sup> SEC, *Framework*, Appendix A. Published by University of Michigan Law School Scholarship Repository, 2005

<sup>39</sup> SEC, *Framework*, Appendix A.

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review the matter, and, if warranted, refer the engagement to the AICPA Professional Ethics Division for possible investigation.<sup>40</sup>

*Law & Economics Working Papers Archive: 2003-2009, Art. 57 [2005]*

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.<sup>41</sup>

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.<sup>42</sup> The SEC provided no evidence, however, that the peer-review process had failed in any systematic fashion, relying instead on isolated anecdotes. More recent research finds that the peer review process did have a significant influence on the market for auditors, suggesting that it did add to auditor credibility.<sup>43</sup>

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

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<sup>40</sup> SEC, *Framework*, n. 30.

<sup>41</sup> 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).

<sup>42</sup> SEC, *Framework*, at 8.

<sup>43</sup> 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%).

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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"<sup>44</sup> (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 reinforces our confidence that 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.<sup>45</sup> 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."<sup>46</sup>

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 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

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<sup>44</sup> SEC, *Framework*, at 8.

<sup>45</sup> Nagy, *supra* note, at 994-995. Published by University of Michigan Law School Scholarship Repository, 2005

<sup>46</sup> Arthur Levitt, *Take on the Street* 127 (2002)

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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."<sup>47</sup> But this was hardly the fault of the AICPA – the SEC had the power to exclude firms from practicing before it if they had been expelled;<sup>48</sup> it was up to the SEC to use that power. 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.<sup>49</sup> 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 "renting" their reputations to their clients. A public censure from the accounting regulators would seriously compromise an audit firm's reputation and therefore serve as an important

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<sup>47</sup> SEC, *Framework*, at 9.

<sup>48</sup> SEC Rules of Practice § 102.

<sup>49</sup> David S. Hifzenrath, *Auditors Face Scant Discipline: Review Process Lacks Resources, Coordination, Will*, *Washington Post*, December 6, 2001.

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deterrent.

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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.<sup>50</sup> 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.<sup>51</sup>

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

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

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<sup>50</sup> 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.

James S. Turley, *How Accounting Can Get Back Its Good Name*, Wall St. J. A16 (Feb. 4, 2002) (quoted in SEC, *Framework*, at 11).  
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<sup>51</sup> SEC, *Framework*, supra note

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informative, accurate, and independent audit reports” for public companies.<sup>52</sup> 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.<sup>53</sup> Once registered, the accounting firms are subject to the auditing, quality control, and ethics standards adopted by the PCAOB.<sup>54</sup> To ensure that registered firms are following its standards, the PCAOB is charged with conducting periodic inspections of registered accounting firms.<sup>55</sup> 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.<sup>56</sup> 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,<sup>57</sup> 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 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,

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<sup>52</sup> Sarbanes-Oxley Act § 101, 15 U.S.C. § 7211

<sup>53</sup> Sarbanes-Oxley Act § 102, 15 U.S.C. § 7212.

<sup>54</sup> Sarbanes-Oxley Act § 103, 15 U.S.C. § 7213.

<sup>55</sup> Sarbanes-Oxley Act § 104(a), 15 U.S.C. § 7214(a).

<sup>56</sup> Sarbanes-Oxley Act § 105(b)(1), 15 U.S.C. § 7215(b)(1).

<sup>57</sup> Sarbanes-Oxley Act § 101(a) & (b), 15 U.S.C. § 7211(a) & (b).

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unlike the SROs, all five of the PCAOB board members are selected by the SEC.<sup>58</sup> The  
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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 . .  
..”<sup>59</sup>

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.<sup>60</sup> The  
PCAOB is required to make an annual report of its activities to the SEC and to Congress.<sup>61</sup> All  
rules proposed by the PCAOB must be approved by the SEC.<sup>62</sup> More intrusively, the SEC can  
amend any PCAOB rule.<sup>63</sup> 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.<sup>64</sup> 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.<sup>65</sup> 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.<sup>66</sup> 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,  
despite the PCAOB’s nominal status as a “private” entity.

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

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<sup>58</sup> Sarbanes-Oxley Act § 101(e)(1) & (4), 15 U.S.C. § 7211(e)(1) & (4). Board members serve staggered five-year terms, but they are subject to removal by the SEC “for good cause shown.” Sarbanes-Oxley Act § 101(e)(5) & (6), 15 U.S.C. § 7211(e)(5) & (6).

<sup>59</sup> 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.*

<sup>60</sup> Sarbanes-Oxley Act § 107(a), 15 U.S.C. § 7217(a).

<sup>61</sup> Sarbanes-Oxley Act § 101(h); 15 U.S.C. § 7211(h).

<sup>62</sup> Sarbanes-Oxley Act § 107(b)(2), 15 U.S.C. § 7217(b)(2).

<sup>63</sup> Sarbanes-Oxley Act § 107(b)(5), 15 U.S.C. § 7217(b)(5).

<sup>64</sup> Sarbanes-Oxley Act § 107(c)(2), 15 U.S.C. § 7217(c)(2).

<sup>65</sup> Sarbanes-Oxley Act § 107(c)(3), 15 U.S.C. § 7217(c)(3).  
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<sup>66</sup> Sarbanes-Oxley Act § 107(d), 15 U.S.C. § 7217(d).

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firm, “in amounts that are sufficient to recover the costs of processing and reviewing applications and annual reports.”<sup>67</sup> The second, and considerably more substantial, source is “annual accounting support fees” to be paid by public companies based on their market capitalization.<sup>68</sup> 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.<sup>69</sup> 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.<sup>70</sup> The PCAOB clearly enjoys the independent and dependable funding source that the self-regulatory 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. Better yet, from the perspective of vigorous regulation, 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 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 Board is required to “inspect and review selected audit and review engagements” and “evaluate the sufficiency of the quality control system of the firm.”<sup>71</sup> These on-site inspections of registered accounting firms are performed by accountants with public company auditing experience.<sup>72</sup> An inspection must at minimum

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<sup>67</sup> Sarbanes-Oxley Act § 102(f), 15 U.S.C. § 7212(f).

<sup>68</sup> Sarbanes-Oxley Act § 109, 15 U.S.C. § 7219.

<sup>69</sup> Sarbanes-Oxley Act § 109(b), 15 U.S.C. § 7219(b).

<sup>70</sup> 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](http://www.pcaobus.org/news_and_events/news/2004/12-30.aspx))

<sup>71</sup> Sarbanes-Oxley Act § 104(c), 15 U.S.C. § 7214(c).

<sup>72</sup> The PCAOB expects to have a staff of 450 by the end of 2005, with its current hiring focused on experienced

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include an inspection and review of selected audit and review engagements of the firm,  
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performed at 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.<sup>73</sup>

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.<sup>74</sup> 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.<sup>75</sup> The rules also permit the Board to seek information from other persons, including clients of registered firms.<sup>76</sup> 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.<sup>77</sup> The PCAOB should therefore have access to all the information that it needs to conduct thorough investigations.<sup>78</sup>

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

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auditors who will conduct the Board's program of inspections. PCAOB 2005 Budget, at 3.

<sup>73</sup> Sarbanes-Oxley Act § 104(d), 15 U.S.C. § 7214(d).

<sup>74</sup> Sarbanes-Oxley Act § 105(b)(1), 15 U.S.C. § 7215(b)(1).

<sup>75</sup> Sarbanes-Oxley Act § 105(b)(2)(A) & (B), 15 U.S.C. § 7214(b)(2)(A) & (B).

<sup>76</sup> Sarbanes-Oxley Act § 105(b)(2)(C) 15 U.S.C. § 7214(b)(2)(C).

<sup>77</sup> Sarbanes-Oxley Act § 105(b)(2)(D), 15 U.S.C. § 7215(b)(2)(D).

<sup>78</sup> Firms that refuse to cooperate in the Board's investigation can have their registration suspended or revoked. Sarbanes-Oxley Act § 105(b)(3)(A)(ii), 15 U.S.C. § 7215(b)(3)(A)(ii). 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. Sarbanes-Oxley Act § 105(b)(3)(A)(i), 15 U.S.C. § 7215(b)(3)(A)(i). Lesser sanctions are also available for non-cooperation. Sarbanes-Oxley Act § 105(b)(3)(A)(iii), 15 U.S.C. § 7215(b)(3)(A)(iii). The Board recently exercised its authority to sanction firms that fail to cooperate for the first time, revoking 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. PCAOB, *Board Revokes Firm's Registration, Disciplines Three Accountants for Failure to Cooperate* (May 24, 2005).

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appropriate state regulatory authority, and it is also entitled to investigate.<sup>79</sup> If the Board concludes that there has been a violation, it is empowered to impose a wide range of money sanctions, as well as practice limitations.<sup>80</sup> 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 be for lack of will, not lack of statutory authority.<sup>81</sup>

Congress also directed the PCAOB to establish quality control standards<sup>82</sup> and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports.<sup>83</sup> 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,<sup>84</sup> but going forward the responsibility for revising those standards lies with the PCAOB.<sup>85</sup> The PCAOB has taken up the task, issuing standards on audits of internal

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<sup>79</sup> PCOAB Rule 4004.

<sup>80</sup> Those sanctions include:

- (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.<sup>80</sup>

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

Sarbanes-Oxley Act § 105(c)(4), 15 U.S.C. § 7215(c)(4). More stringent penalties can be imposed for intentional or knowing misconduct or repeated negligence:

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

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

<sup>81</sup> So far, the PCAOB has so far only sanctioned one firm, and that was for obstructing its inspection. *See supra* note.

<sup>82</sup> A skeleton of the standards is provided by the Sarbanes-Oxley Act. Sarbanes-Oxley Act §103(a)(2)(B), 15 U.S.C. § 7213(a)(2)(B).

<sup>83</sup> 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).

<sup>84</sup> PCAOB Professional Standards, Rules 3200T, 3300T, 3400T & 3500T.

<sup>85</sup> Sarbanes-Oxley Act § 103, 15 U.S.C. § 7213(a)(3)(A).

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controls, audit documentation,<sup>86</sup> and the evaluation of efforts to correct weaknesses in internal controls.<sup>87</sup> 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.<sup>88</sup> Consequently, auditors are now banned from providing a broad array of 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.<sup>89</sup> The PCAOB is authorized to ban the provision of other services as well.<sup>90</sup>

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<sup>86</sup> PCAOB Auditing Standard No. 3, Audit Documentation (June 9, 2004).

<sup>87</sup> PCAOB Auditing Standard No. 4, Reporting on the Elimination of a Material Weakness (July 26, 2005).

<sup>88</sup> For evidence in support of that view, see Richard Frankel, Marilyn F. Johnson & Karen K. Nelson, The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management, 77 *The Accounting Review* 71 (Supp. 2002).

<sup>89</sup> 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).

<sup>90</sup> 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

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Congress adopted additional rules to bolster independence. Too familiar a relationship between the partner and company executives can compromise independence. So audit firms are now required to rotate the partner in charge of the audit for each client at least once every five years.<sup>91</sup> 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.<sup>92</sup>

### 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,<sup>93</sup> 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 illegal acts to management and the audit committee or entire board of directors.<sup>94</sup> 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.<sup>95</sup>

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

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disclosure to the ultimate client, the shareholders.”).

<sup>91</sup> Exchange Act § 10A(j), 15 U.S.C. § 78j-1(j).

<sup>92</sup> Exchange Act § 10A(l), 15 U.S.C. § 78j-1(l).

<sup>93</sup> 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).

<sup>94</sup> Exchange Act § 10A(b), 15 U.S.C. § 78j-1(b). [http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57)

<sup>95</sup> Exchange Act § 10A(c), 15 U.S.C. § 78j-1(c)

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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.<sup>96</sup> 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.<sup>97</sup> 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. One worries that assessment will be tinged by self-interest; the more extensive the company's internal controls, the more confidence the auditor can have in the numbers generated. As suggested by the quote from William McDonough in the introduction, self-interest will be reinforced by liability concerns, as the auditor's attestation of its client's internal controls will expose the auditor to securities fraud class actions if those internal controls later prove to be insufficient.<sup>98</sup> Being more demanding in assessing internal controls reduces the auditor's litigation exposure. The cost of those controls, of course, comes out of the client's pocket.

### 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, § 304 is intended to make officers think hard about the

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<sup>96</sup> Sarbanes-Oxley Act § 404(a), 15 U.S.C. § 7262(a).

<sup>97</sup> Sarbanes-Oxley Act § 404(b), 15 U.S.C. § 7262(b).

<sup>98</sup> Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability, and Safe Harbors*, 55 *Hastings L.J.* 1449, 1475-1476 (2004) ("Auditors must describe material weaknesses, their actual and potential effects on financial statements and related control objectives, and their effect on the auditor's financial statement audit. When these disclosures are false or misleading, the speaker becomes a primary actor under any of the various formulations interpreting *Central Bank*" and likely within "Section 10b's reach").

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accuracy of company's financial statements. That section requires CEOs and CFOs to return bonus 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.<sup>99</sup> 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.<sup>100</sup> This certification of financial statements is backed up by a parallel criminal provision.<sup>101</sup>

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 financial reporting (paid for by the shareholders) if they have to sign off on the results, particularly if they risk jail time for a false certification. That instinct is reinforced by the provision requiring the CEO and CFO to return incentive compensation earned during a period

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<sup>99</sup> Exchange Act Rule 13b2-2.

<sup>100</sup> 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.

<sup>101</sup> Under the criminal provision, 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." 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.

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for which the company was forced to restate its financial statements provides a powerful incentive to get the numbers right. <sup>Pritchard:</sup> 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.<sup>102</sup> The audit committee also has the authority to hire its own advisors (typically legal counsel) at the company's expense.<sup>103</sup> 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" between the auditor and management.

The audit committee is also responsible for approving any non-audit services (now

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<sup>102</sup> 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).<sup>29</sup>

<sup>103</sup> Exchange Act § 10A(m)(5) & (6), 15 U.S.C. § 78j-1(m)(5) & (6).

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strictly limited, as discussed above) provided by the company's auditor.<sup>104</sup> Finally, the audit committee is charged with establishing procedures for dealing with complaints relating to auditing and internal controls.<sup>105</sup> In sum, the relationship between the auditors and their client is now firmly the responsibility of independent directors, who presumably are more concerned with the maintenance of their reputation than ensuring that the numbers are sufficient to keep their stock options in the money.<sup>106</sup>

### 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 enactment of the Sarbanes-Oxley Act. Accountants are being held on a very tight leash by government regulators. The criticisms leveled at the prior self-regulatory regime have largely been addressed.

On the other side of the audit relationship, companies are spending a lot more to ensure the integrity of their financial statements. The hastily drawn Sarbanes-Oxley Act was a strong signal of reform, but it has proved to 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

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<sup>104</sup> Exchange Act § 10A(h), 15 U.S.C. § 78j-1(h).

<sup>105</sup> 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.

<sup>106</sup> 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. Amy Strahan, U.S. firms forced to sweeten the pot to attract directors, Bloomberg (August 30, 2005) (reporting on results of Mercer survey). The increase was attributed to sharp increase in demands imposed on directors under the new regulatory regime. *Id.*

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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.

Pritchard:

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."<sup>107</sup> 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.<sup>108</sup> Has this more adversarial relationship made auditors more objective, or has it unduly chilled information flows between the auditors and management?

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

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<sup>107</sup> Thomas E. Hartman, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 16, 2005).

<sup>108</sup> Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. at .

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We can say with reasonable confidence, however, that the new regulatory efforts work in tandem with the role of reputation and market forces to promote audit quality. The worst that can be said about the most important of the changes is that they curtail – at the bottom end – the available range of audit quality. 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 impose on investors in the name of restoring their 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 send an unambiguous signal the market, with a correspondingly 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 diminish pressures on auditors to acquiesce in questionable accounting treatments.

All of these changes enhance the efficiency of the reputation market outlined in Part I. The question that remains is how well the costly regulatory experiment of Sarbanes-Oxley fits in with the third leg of the audit quality triad – the risk of securities fraud class action litigation. I

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turn to that question in Part III.

Pritchard:

### **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.<sup>109</sup> 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 a junior varsity SEC – leverages the SEC’s enforcement efforts. Moreover, the PCAOB’s enforcement efforts are supported by a guaranteed stream of revenues to support the effort. This shift has presumably taken us farther along the curve toward (past?) the optimal level of government enforcement. Given the accuracy advantages of relatively disinterested and expert PCAOB and SEC enforcement, 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.

The efficacy of litigation as an incentive for quality audits is also open to serious question. At the most fundamental level, auditors are not (usually) the bad guys – they are on the hook for the malfeasance of their clients, not their own. Auditors do not get rich from fraud; at best, they preserve a steady paycheck from the audit client. So the incentives to turn a blind eye to client fraud are muted at best. Corporate managers may take seemingly unreasonable risks in

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<sup>109</sup> 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. Jonathan Weil, KPMG’s Settlement Provides for New Start, *Wall St. J. C1* (Aug. 29, 2005). 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.

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the hope of getting rich quick, but auditors cannot expect a similar payday.

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There is also reason to doubt whether the threat of litigation has the deterrent force that it once did. 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. Inadequate self-regulation potentially could be ameliorated by the additional deterrence afforded by securities fraud class actions. Audit partners would do a more thorough job and perhaps more importantly, their co-partners would monitor their work more closely if their personal fortunes were on the line. The structure of accounting partnerships has changed, however, as the firms have shifted to the LLP form and the incentive for the partners to monitor each other has eased. The threat of liability for the firm is less of a stick when it will not extend to the partners' personal assets. Collective action problems mean no that individual partner will have a strong incentive to monitor their fellow partners. In this environment, the threat of litigation from audit failure may add little beyond the threat to the firm's reputation.

My focus here, however, is on three potential costs raised by using litigation as a deterrent: (1) the limits of the litigation sorting process; (2) the limited effect that litigation exposure is likely to have on auditor behavior; and (3) the effect that litigation exposure 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 lawsuits sanction 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 accounting problems creates a

[http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57)

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high likelihood of lawsuit against the auditor, particularly if the misstated financials involve earnings or revenues.

Pritchard:

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 or a risky business decision that did not pan out. 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 risky business decisions that it had made did not pan out. If there is a sufficient stock price drop to generate the necessary 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.<sup>110</sup> 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 be dismissed,<sup>111</sup> but only after a significant cost in lawyers' fees and distraction.

Those costs will rise as the process moves 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 their complaint survives the motion to dismiss, but that access to additional information is not an unalloyed good for the accuracy of the litigation 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 audit<sup>112</sup> – 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

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<sup>110</sup> Ross D. Fuerman, Naming Auditor Defendants in Securities Class Actions, 7 J. Legal Econ. 72 (1997).

<sup>111</sup> Cf. 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) (reporting results of study of motions to dismiss securities fraud complaints).  
Published by University of Michigan Law School Scholarship Repository, 2005

<sup>112</sup> Sarbanes-Oxley Act § 103, 15 U.S.C. § 7213.

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settlement. Trials are virtually unheard of in this area. 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.<sup>113</sup> The auditors “must have known” of the fraud when it was being committed – at least when the question is viewed 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 at the time of the engagement which called for more extensive procedures. Audit failure becomes equated with audit laxity.

But most business reversals are just business reversals. The overall rate of fraud by corporations is very low, and the percentage of those frauds in which the auditors participate is lower still.<sup>114</sup> 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.<sup>115</sup> 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.<sup>116</sup> And the worse the

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<sup>113</sup> 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.).

<sup>114</sup> 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.”).

<sup>115</sup> 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).<sup>36</sup>

<sup>116</sup> See Clifford R. Mynatt, Michael E. Doherty & William Dragan, *Information Relevance, Working Memory, and*

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consequences of the audit failure, the more likely the jurors are to blame the auditor, whatever the quality of the audit.<sup>117</sup>

Pritchard:

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.<sup>118</sup> 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.<sup>119</sup> 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 bias.<sup>120</sup>

In the opposite direction, judges may rely on simple heuristic-like rules to get cases off their dockets.<sup>121</sup> 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

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*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).

<sup>117</sup> Kathryn Kadous, *The Effects of Audit Quality and Consequence Severity on Juror Evaluations of Auditor Responsibility for Plaintiff Losses*, 75 *Accounting Review* 327 (2000).

<sup>118</sup> 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).

<sup>119</sup> 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.").

<sup>120</sup> 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).

<sup>121</sup> 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).

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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.

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The result of these conflicting biases is uncertainty, and defendants facing potentially bankrupting judgments do not like uncertainty. 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. As noted above, trials in securities fraud class actions are as rare as the dodo.

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 *marginal* deterrence above and beyond that already produced by government enforcement and the market for reputation.<sup>122</sup> 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 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 of the current litigation regime.<sup>123</sup>

### B. The “irrational auditor”

Another reason to question the role of litigation in promoting audit quality is that lawsuits may do little to deter many of the causes of bad auditing. Business professors Max Bazerman, George Lowenstein and Don Moore paint a bleak picture of the ability of accountants to respond

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<sup>122</sup> 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.”).

<sup>123</sup> 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).

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to rational incentives, arguing that “the corporate auditing arena is a particularly fertile ground for self-serving biases.”<sup>124</sup> Pritchard: Delving into the vast literature exploring the ways that cognitive biases may influence auditors would be an article unto itself;<sup>125</sup> Bazerman et al.’s main points about auditors’ cognitive limits suffice for our purposes here:

**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 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.<sup>126</sup>

In sum, Bazerman, Lowenstein and Moore argue that accountants may not *consciously* tolerate fraud – it may frequently result instead from their cognitive shortcomings. The audit context

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<sup>124</sup> See Max H. Bazerman, George Loewenstein & Don A. Moore, *Why Good Accountants Do Bad Audits*, HARV. BUS. REV. Nov. 2002, at 97, 100

<sup>125</sup> Useful surveys include Robert Libby, Robert Bloomfield & Mark W. Nelson, *Experimental Research in Financial Accounting, Accounting, Organizations and Society* (200-) and Mark Nelson & Hun-Tong Tan, *Judgment and Decision Making Research in Auditing: A Task, Person, and Interpersonal Interaction Perspective* (Working Paper, 2005).  
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<sup>126</sup> Bazerman et al., *supra* note , at 98-100.

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puts auditors in a situation where they are particularly vulnerable to cognitive error.

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If cognitive limitations are a central cause of audit failure, it has profound implications for antifraud liability. Fraud traditionally requires scienter.<sup>127</sup> Presumably an auditor is not intentionally misleading anyone if she signs off on 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 a departure from the standard of ordinary care because ordinary care would arguably encompass the cognitive defect. Recklessness, of course, requires an *extreme* departure from the standard of ordinary care. The work of the behavioralists, however, shows us that cognitive biases are not only ordinary, they are pervasive.

Could the risk of liability encourage audit firms to take measures to correct the cognitive failings of the members their audit teams? Cognitive defects may be extremely difficult to overcome. “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.”<sup>128</sup> Moreover, experts, such as accountants, tend to be overly optimistic in assessing their own decisionmaking ability.<sup>129</sup> As Dale Griffin and Amos Tversky put it, experts are “often wrong but rarely in doubt.”<sup>130</sup> This confidence may cause auditors to discount evidence of their own propensity for cognitive failure: “That other guy has cognitive failings; I’m too smart for that.”

Even if corrections are feasible, is litigation the correct lever to induce such changes?

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<sup>127</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>128</sup> 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).

<sup>129</sup> See Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 *COGNITIVE PSYCHOL.* 411, 427, 430 (1992) http://repository.law.umich.edu/law\_econ\_archive/art57

<sup>130</sup> *Id.* at 412.

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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. For example, perhaps the compensation structures of accounting firms need to be adjusted.<sup>131</sup> The adversarial process of litigation, where the focus is on assigning blame, is unlikely to shed much light on this topic. The audit firm will not be focused on the cause underlying the audit failure, but instead on justifying the adequacy of its procedures. This tendency will be exacerbated by the perception among auditors – warranted or not – that securities fraud class actions are largely random occurrences. The specialized expertise of the PCAOB, with its staff exposed to 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.<sup>132</sup>

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

### 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 the other legs of the audit

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<sup>131</sup> Elliott J. Weiss, Some Thoughts on an Agenda for the Public Company Accounting Oversight Board, 53 Duke L.J. 491, 502 (2003) (arguing that “the Board should require registered public accounting firms to adopt incentive systems that promote, rather than threaten, the independent performance by audit partners and employees of their public responsibilities.”).

<sup>132</sup> 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.”).

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quality triad. 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 usefulness of the PCAOB's inspection reports is 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.<sup>133</sup> 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.<sup>134</sup> 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 departures from auditing standards, related attestation standards, ethical standards, independence standards, and the quality control policies and procedures of the firm itself.<sup>135</sup>

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

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<sup>133</sup> Sarbanes-Oxley Act § 104(g), 15 U.S.C. § 7214(g).

<sup>134</sup> Sarbanes-Oxley Act § 104(g)(2), 15 U.S.C. § 7214(g)(2).

<sup>135</sup> [http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57)  
PCAOB Rel. No. 104-2004-001 at 6. Available<sup>42</sup> at:  
[http://www.pcaobus.org/Inspections/Statement\\_Concerning\\_Inspection\\_Reports.pdf](http://www.pcaobus.org/Inspections/Statement_Concerning_Inspection_Reports.pdf).

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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.<sup>136</sup> The Board is further restricted from publicizing any information subject to the protection of § 105(b)(5)(A) of the Sarbanes-Oxley Act.<sup>137</sup> 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.”<sup>138</sup> 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 request confidentiality.<sup>139</sup> This thirty-day review period, however, would give the auditing firm plenty of time to prepare a 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, i.e., “recklessness,” than criticism from the experts at the

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<sup>136</sup> 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). The inspection reports are now available at the PCAOB’s website, <http://www.pcaobus.org/inspections>.

<sup>137</sup> Sarbanes-Oxley Act § 104(g)(2), 15 U.S.C. § 7214(g)(2).

<sup>138</sup> PCAOB Rel. No. 104-2004-002, *supra* note, at 5. Published by University of Michigan Law School Scholarship Repository, 2005

<sup>139</sup> Sarbanes-Oxley Act § 104(f), 15 U.S.C. § 7214(f).

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PCAOB?

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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."<sup>140</sup> Perhaps the firing of a partner for doing bad audit work is even more persuasive evidence than criticism coming from the PCAOB. Under the current liability regime, the rational response for the audit firm in the wake of an audit failure is to circle the wagons rather than cut the deficient partner loose.

### 2. The Usefulness of Financial Statements

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

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[http://repository.law.umich.edu/law\\_econ\\_archive/art57](http://repository.law.umich.edu/law_econ_archive/art57)

<sup>140</sup> Benston, *supra* note , at 1345.

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crisis by demanding more rules and blaming regulators for failing to supply them.”<sup>141</sup> The Pritchard: 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.<sup>142</sup>

The problem is that as accounting principles become more detailed, financial statements may become so complex that they are rendered opaque to even the informed user, much less the average investor. Moreover, increased complexity may create greater space for manipulation.<sup>143</sup> And if complexity is accompanied by subjectivity in application, the auditor will have a difficult time resisting pressures from the client to approve a more favorable treatment.<sup>144</sup> 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.<sup>145</sup> This flexibility creates considerable room for polishing a company’s financial picture. By applying very precise rules to complicated financial structures, we may end up with financial statements that are very extensive, but which shed very little light on the financial health of an enterprise.

## **IV. What Should the Standard Be?**

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<sup>141</sup> William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 *Villanova Law Review* 1023, 1045 (2003).

<sup>142</sup> *Id.* 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. See Benston, *supra* note , at 1335 (“Accounting standards are particularly advantageous to [independent public accountants as a means of withstanding pressure from clients to sign statements that are potentially misleading, if not fraudulent.”).

<sup>143</sup> Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 *Cornell L. Rev.* 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.”).

<sup>144</sup> Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 *William and Mary L. Rev.*, 1, 17 (2004) (“As the accounting norms themselves became more complicated and subjective, the ability to confidently say ‘no’ to a client diminished.”).

<sup>145</sup> *Id.* at 11-12 (“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.”).

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So far I have offered reasons to question the calls for more stringent liability for auditors.

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For some readers, my arguments will invite the question: Why not eliminate auditor liability altogether? The Private Securities Litigation Reform Act did not eliminate, but merely limited, the liability exposure faced by auditors. The Act adopts proportionate, rather than joint and several, liability for defendants who are not found to have knowingly violated the securities laws.<sup>146</sup> 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.<sup>147</sup> If those secondary defendants can show that they did not know of the fraud, their liability exposure will be limited substantially.

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 that the auditors were excessively exposed under the old regime, and the exposure varied in a rather haphazard fashion, correlating largely with the depth of the auditor's pocket. If larger firms produce higher quality audits, this effect is perverse. Under the PSLRA, defendants who are only tangentially involved in the fraud will not face potentially bankrupting 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

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<sup>146</sup> Exchange Act § 21D(f)(2), 15 U.S.C. § 78u-4(f)(2).

<sup>147</sup> On the liability standards for secondary defendants generally, see Jill E. Fisch, *The Scope of Private Securities Litigation: In search of Liability Standards for Secondary Defendants*, 99 Colum. L. Rev. 1293 (1999).

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based on their fault if the issuer is insolvent.<sup>148</sup> 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 step would eliminate the deleterious effect that the threat of litigation has on the regulation of auditors and the reputational market, not to mention the dead-weight cost of the litigation itself. A broad immunity, however, also would excuse those auditors who knowingly acquiesce in their clients' frauds. (To be sure, the threat of enforcement by the SEC and PCAOB would remain.) At a minimum, a broad immunity would not be politically feasible.

So, if we are to retain liability for auditors, we are left with the question: knowledge or recklessness? Answering this question is hard, primarily because of the difficulty in 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 that the threat of litigation can usually deter if the probability of enforcement and the sanctions assessed are high enough. 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. Thus, 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 even some knowing frauds will go unsanctioned. When we are talking about primary violators (i.e., the corporate insiders),

<sup>148</sup> Exchange Act § 21D(f)(2), 15 U.S.C. § 78u-4(f)(4).

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that risk of unsanctioned fraud would be clearly unacceptable. But as an incremental reform to further protect auditors (who already enjoy proportionate liability for reckless fraud) from the risk of frivolous suit or even an arguably meritorious suit that is unlikely to deter, a consistent knowledge standard for liability (not just relief from joint and several liability) is something that should be considered for accountants if we are going to keep the costs of audits manageable for public companies. Moreover, a knowledge standard would ensure that actions against auditors were more precisely targeted than under the current regime. A finding of liability under a knowledge standard would send a much stronger signal to regulators and users of financial statements, thereby enhancing the efficiency of the reputational market for auditors.

### **V. Conclusion**

In this essay, I have raised a number of reasons to question the call for greater liability for auditors. My overall theme has been that 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. The marginal deterrence provided by the threat of litigation is substantially reduced under that stringent new regulatory structure. If we know of ways that auditors can improve their auditing practices in a cost justified way, the PCAOB can (and should) require them. We do not need the (very expensive) stick of class actions to make the auditors improve their procedures. And the class action threat is limiting the available information about audit quality.

Behavioral economics give further reason to doubt the efficacy of litigation in promoting audit quality. We do not know how many audit failures result from the cognitive biases of “irrational auditors,” and how many result from sloth and indifference. Indeed, it seems likely

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that many audit problems will stem from a combination of both. Combining this uncertainty  
Pritchard:  
over the source of audit failure with the very real possibility that the management team of the  
audit client has been actively and energetically concealing its fraudulent behavior, the challenge  
of assigning “the cause” of the audit failure becomes exceedingly complex. Only an irrationally  
optimistic believer in the efficacy of the litigation process could trust it to sort out this  
complexity. In the real world, irrational liability is not likely to cure the problem of the irrational  
auditor.