

AUDITING: A PROFESSION AT RISK



U.S. Chamber of Commerce



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Auditing plays a unique role in our economy. By law, all companies whose securities are available to the general public through U.S. exchanges are required to have their financial statements audited by an independent registered public accounting firm. The goal has historically been to provide confidence to investors and bring standardization and discipline to corporate accounting, thereby increasing the liquidity and economic potential of U.S. capital markets.

While there are legitimate debates about the meaning of financial statement audits, there are certain facts about the auditing profession that are hard to deny:

- Not only is auditing required by law, but recent regulations and legislation (most notably the Sarbanes-Oxley Act of 2002) greatly increased its role in public companies. The political determination has been made that auditing is central to public confidence in our capital markets.
- The pressure for auditors to “do more” when conducting audits means that the auditor-client relationship is becoming more involved and continuous, with much more frequent interactions, rather than simply holding periodic

discussions geared around financial statement reporting cycles.

- The auditing profession faces a number of significant legal challenges. It is subject to new regulation under the auspices of the Public Company Accounting Oversight Board (PCAOB). More important, the profession finds itself the target of a difficult litigation and regulatory enforcement environment, where business losses by a client can result in lawsuits, and a single indictment — even without a conviction — can result in the destruction of thousands of jobs.
- Because of the Sarbanes-Oxley Act and other requirements, auditing expenses have increased tremendously. At the same time, many clients believe that they are receiving less overall advice and support from their auditors. Audit firms feel that they are caught in a no-win situation between the demands of regulators, law enforcement, the plaintiffs' bar, and their clients.
- The process of developing accounting principles remains in flux, even as business transactions become ever more complex. In addition to the respective roles of FASB, the PCAOB, and the SEC, there are many emerging issues related to international harmonization and the IASB.

- There remain significant misunderstandings about the meaning and nature of accrual accounting systems and the level of precision inherent in such systems. Changes of 1 or 2 cents per share in a company's earnings can have a great market impact — and create significant litigation risk — even if such changes indicate nothing about the health of a company's underlying business.
- The profession — through voluntary mergers as well as through the elimination of Andersen — is severely contracted, with only four major firms serving a large majority of the listed and actively traded public companies in the United States. While four appears to be a sustainable number, any further contraction in this industry would present a major challenge to the viability of the profession, with potential for a negative effect on public confidence in our markets. William McDonough, former chair of the PCAOB, said, “None of us [regulators] has a clue what to do if one of the Big Four failed.” He also said that if one of the Big Four were to collapse, the best accountants could choose to quit the profession¹.

There continue to be debates about the role that the auditing profession itself has played in bringing about some of these

¹ *Financial Times*, September 28, 2005, p. 26.

circumstances, and what it can do on its own to address the current challenges. Nevertheless, the simple facts are that (i) confidence and stability are critical to the success of capital markets, and (ii) auditing helps bring these attributes to our markets. Instead of risking a crisis, it is important to act now to try to bring some stability back to the auditing profession. At the same time, action must be taken to ensure that the needs of companies are met and that they have access to high-quality, reasonably priced auditing services.

ACTION PLAN

The U.S. Chamber of Commerce is committed to supporting policies that enhance the value of audits and ensure the long-term viability of the auditing profession. In that regard, we propose the following three-part action plan:

- Help the profession become insurable
- Clarify PCAOB standards
- Support expansion of and competition among the Big Four firms

This plan will require a broad-based effort, involving coordinated support among policymakers, Wall Street, the auditing profession, and the broader business community. The U.S. Chamber stands

ready and willing to be at the center of these efforts.

HELP THE PROFESSION BECOME INSURABLE

Auditing firms are required by state professional licensing laws and ethical rules to operate as partnerships that do not seek outside equity capital. As voluntary organizations funded by individual partners, auditing firms cannot be successful if there are concerns about their stability and survival. Clients and valuable partners can — and will — leave if these concerns arise. This is even more true at the international level, where local affiliates can move whole national practices at the first sign of trouble. Andersen is a perfect example of the damage that can be done to a large, international confederation of partnerships as a result of the actions of a few bad employees and one ill-considered indictment.

While it would be neither possible nor desirable to limit all risks to the stability of auditing firms, there are particular concerns about growing legal threats. Overlitigation and unfair enforcement threaten many parts of our economy — and the Chamber has been at the forefront of efforts to bring rationality back to our legal system. But professional partnerships that can dissipate overnight are particularly vulnerable. One indictment or excessive judgment that

jolts the confidence of clients or partners has the potential to immediately destroy an audit firm, even if that indictment or judgment is later overturned or reduced on appeal.

Furthermore, these legal risks are so uncertain — and their implications are so dire — that the profession is effectively uninsurable. Without this standard tool for business planning and protection, the profession sits on a knife's edge.

This is not only bad for firms and their clients, but it also makes the auditing profession increasingly unattractive to high-quality personnel. Qualified auditors face ever-growing incentives to exercise their professional options and may opt to leave the profession altogether.

It is vital that we better define the responsibilities and appropriate potential legal risks of the profession and establish the conditions that would allow for commercial insurability and, therefore, stability. Part of the answer may involve tort reform. The U.S. Chamber Institute for Legal Reform is the nation's premier advocate for bringing rationality back to our legal system, and we stand ready to support responsible options for bringing tort relief to the auditing profession. However, even short of comprehensive tort reform, we believe that the following four initiatives could have a substantially

positive effect on the environment surrounding auditing:

(i) **Better define an auditor's procedures for fraud detection and the limits of an auditor's responsibility**

Auditors are neither detectives nor arms of law enforcement. They do not and should not have the ability to issue subpoenas, establish wiretaps, or conduct lie detector tests. They are not trained in criminal law and cannot reasonably monitor the personal behavior of executives. Nonetheless, while auditors cannot eliminate the risk of fraud, they are inevitably blamed when it occurs — even when it is the auditor who ultimately uncovers the fraud. This is a standard that no law enforcement agency could meet. The increasing burdens on auditors for fraud detection result in increasing audit cost burdens on all clients.

Auditors should neither be expected to detect or prevent all cleverly designed collusive frauds, nor should they necessarily be liable when such frauds occur. The auditing profession accepts and should continue to accept some responsibility for detecting fraud, but the limitations on this responsibility should be clearly defined. A clean audit opinion is not a guarantee that no fraud

has occurred — only evidence that reasonable and thorough efforts have been made to detect fraud. In that respect, we recommend that the PCAOB promulgate a safe harbor standard for fraud detection, which clearly defines the nature and extent of procedures that an auditing firm must employ to detect fraud.

A safe harbor would provide clarity to the investing public about the meaning of an audit opinion, and it would allow firms to determine when they have satisfied their responsibilities. Such a standard would also protect auditing firms from legal liability when the PCAOB-prescribed procedures have been reasonably performed.

Without such a standard, auditing firms are effectively asked to be criminal investigators and insurers of the character of corporate managers. This is not only unfair; it is also a strong disincentive for firms to accept new and entrepreneurial clients with unproven management. The reluctance to accept such clients places a significant burden on the many innovative small companies that are led by good, but unknown, managers. This ultimately undermines the future growth and development of the U.S. economy.

(ii) **Create an ADR System for Disputes About Audits**

The U.S. Chamber supports alternative dispute resolution (ADR), particularly for industries where ADR would clearly be more efficient and fairer than normal litigation procedures.

Auditing is an example of a highly technical profession where the standards require the application of significant professional judgment. It is simply not reasonable to expect juries and nonexpert judges to properly evaluate arcane accounting judgments and auditing methodologies.

There have been proposals for specialized “accounting courts” for almost 50 years. Whether through this or another proven ADR mechanism (such as mandatory expert arbitration), the Chamber calls upon the auditing profession, the PCAOB, and Congress to establish a civil structure where disputes about accounting issues are considered and decided by experts with a deep understanding of the issues. There are areas where ADR may not make proceedings more efficient or fairer — large and complex class action suits, for example — but certainly not all audit disputes should end up in the courts.

(iii) Permit Parties to Agree to ADR and to Reasonable Limits on Litigation

There have been calls for the SEC and banking regulators to limit the ability of auditing firms and their clients to agree to ADR and to limitations on punitive damages, among other things, as part of their engagement negotiations. This is an attempt to deprive private parties of standard tools that are used in other industries to manage litigation risk and is clearly misplaced regulatory overreach. More litigation risk won't make for better audits; it will simply make for more defensive audits.

(iv) Regulate Threats of Indictment Against Firms

An auditing firm lives or dies by its reputation, and a criminal indictment can immediately destroy a reputation, without regard to ultimate criminal culpability. The inappropriate indictment of Andersen led directly to severe job dislocations for 28,000 people in the United States — and many tens of thousands overseas. This was wrong, unfair, and bad for our economy.

If crimes are committed, enforcement authorities should indict and prosecute individuals involved in those crimes. This would include managers with knowledge of the criminal activity or with responsibility for the operations

in which the activity took place. Other individuals with an interest in the firm — who had no knowledge of the activity or any ability to affect it — should simply not be punished.

Unfortunately, enforcement authorities realize that indicting and prosecuting individuals is hard, while threatening to slap an indictment on a professional partnership is very easy. Audit firms cannot afford to be indicted, and they have very limited means to defend themselves if accused of a crime. The mere threat of an indictment is a prosecutorial club that can produce guilty pleas and monetary settlements — without the need to prove any facts in a court of law. (This is not only a problem for auditing firms but for a wide range of enterprises in financial services and other industries.)

We call upon Congress to rein in this misused weapon of the Department of Justice and other regulatory authorities and to establish clear rules under which enterprises may be criminally indicted, according to clear processes for having such indictments carefully evaluated. The goal should be to acknowledge the disparate impact indictments can have on enterprises and the corresponding unchecked prosecutorial power.

Enterprises need a chance to be heard before indictments are handed down — including an opportunity to object to the appropriateness of a threatened indictment in light of the respective roles of individuals versus the institution.

CLARIFY PCAOB STANDARDS

Auditing Standard #2, the primary implementing standard for Section 404 of Sarbanes-Oxley, is a large, expansive, principles-based document. While it provides a great deal of room for auditors to exercise judgment and to determine the meaning of words like “significant” and “relevant,” it doesn’t provide much guidance as to when “enough is enough” with respect to the auditing of internal controls. Auditors must be allowed to exercise professional judgment, but the lack of specific guidance subjects them to substantial second guessing — by the plaintiffs’ bar, the inspection staff of the PCAOB, and others — that their audits did not go far enough.

Senior PCAOB officials have stated that they can’t identify overauditing. If the primary regulator doesn’t know the outer limits of the standards, then how can audit firms or their clients be expected to? The PCAOB’s own inspection process — without a standard for determining excessive auditing — encourages auditors,

given their structure and liability risks, to continually exceed whatever anyone may think is the standard for control testing and review.

It is incumbent upon the PCAOB to step in and define “enough,” at least in certain key areas (such as IT systems), and let everyone know the outer boundaries of what is expected under Section 404. Further, even where “enough” cannot be reasonably defined, the inspection process should be used as a means to educate and reveal reasonable limits, rather than to second guess professional judgments.

Overauditing, much like liability-inspired “defensive medicine,” exists and has been the cause of serious deterioration in many auditor-client relationships. The PCAOB has played a large role in creating the circumstances for overauditing. It has the responsibility to clarify Auditing Standard #2, provide reliable safe harbors, and bring the Section 404 cost-benefit equation back into balance by allowing auditors and their clients some measure of predictability and freedom from second guessing.

The business community is primarily interested in knowing that someone is ultimately responsible for ensuring that the auditor-client relationship is healthy *and* productive. As the regulator for this profession, it is incumbent upon the PCAOB to step up and accept this responsibility.

SUPPORT EXPANSION AND COMPETITION AMONG TOP-TIER FIRMS

In the end, competition is the best way to ensure good customer service. Given the small number of top-tier firms, many public companies feel that they have a limited ability to negotiate with auditors about fees or terms of service. In fact, a common concern among smaller public companies is being dropped by their long-standing auditing firms. These companies believe that they have practically no negotiating power.

Many companies also hire other members of the Big Four for advisory and other nonaudit services that preclude these firms from bidding on audit work. Some large companies even have ongoing relationships with all the Big Four.

In order to offer companies more choice in choosing an auditor and to increase competition among the Big Four, we call upon the SEC to reexamine the regulations that prohibit the Big Four firms from competing for audit assignments when they have performed disqualifying services in prior years. A modification in this policy that allows for greater flexibility and greater competition among the Big Four would enhance market forces in the profession and ultimately benefit our capital markets.

In addition to fostering greater competition among the top-tier firms, we need to remove nonmarket barriers impeding competition with the Big Four. Unfortunately, there are no easy means to that end, as there are tremendously high barriers for entry into this group. It would be unreasonable to try to expand the group by unwinding previous mergers — no matter how those mergers may appear in retrospect. In that same vein, a number of responsible commentators have said that mergers among second-tier firms would be unlikely to create a truly competitive alternative to the Big Four. These and other methods could create more weak firms, when what is needed are more strong ones.

Although the task of expanding the Big Four is difficult, it does not mean that it is impossible or unimportant. We call upon the SEC and the PCAOB, as well as the New York Stock Exchange, NASDAQ, and FASB, to make long-term expansion of the Big Four a high policy priority. We recommend, in particular, that these entities do the following:

- Support policies that help the entire profession become insurable (as described previously). Risk management is a huge barrier to growth for any firm seeking to audit public company clients.

- Clarify and streamline the accounting standards process to make it less expensive for firms to stay current of the latest pronouncements. FASB must address the problem of “infinite complication” in accounting rules, which makes it almost impossible for even the most knowledgeable and well-intentioned accountants to keep up. Further, the SEC should immediately end the process of “Speech GAAP,” whereby accounting policy changes are simply announced by staff without prior public examination or discussion. More generally, the SEC must move away from the expectation that its policies are only of interest to a small cadre of Big Four accountants and affirmatively reach out to meet the needs of smaller firms — and include them in all debates about new rules and interpretations.
- All parties should actively encourage public companies to consider high-quality firms outside the Big Four — particularly by encouraging Wall Street underwriters and the investing public to accept other choices. This would include encouraging companies to use high-quality second-tier firms for (i) outsourced internal audit functions, (ii) the provision of tax and other accounting advice, (iii) separate authentication of control systems, and (iv) other nonaudit work.

At the end of the day, the engagement of an auditor is a private commercial matter, and reforms that increase the overall competitiveness of the profession may, in some instances, also help members of the Big Four become even more competitive. However, there should be some general acceptance of the view that intense consolidation has left many clients unhappy and our capital markets vulnerable to the shock of even further consolidation. It is important for all the players in the system to reconsider their roles in the current competitive situation and work to redress the risks inherent in it.

CONCLUSION

The action plan described in this paper offers no guarantees about the continued health of the auditing profession. Nothing is offered, for example, to resolve the considerable litigation that is already outstanding or to immediately address current staffing challenges. Nonetheless, we believe that it is significant to highlight some of the critical issues and offer a positive plan to address them.

Losing another auditing firm — or making auditing so unattractive that firms or their partners no longer want to provide the service — would have very negative consequences for the U.S. capital markets and the U.S. economy as a whole. The Chamber is committed to

preventing that development, and we hope that policymakers in Washington and on Wall Street are or will become similarly committed.

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