SOME THOUGHTS ON AN AGENDA FOR THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INTRODUCTION

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)[1] was enacted in response to widespread concern that there is "a serious problem in financial reporting and disclosure" and that "Enron and like cases are aberrational only in size and severity."[2] The Act includes provisions regulating corporate boards of directors,[3] corporate audit committees,[4] transactions between corporations and their executives,[5] the obligations of attorneys who represent public corporations in securities

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1. Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2003)).

2. Donald Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1151 (2003).

3. The regulations imposed are both direct and indirect. *See* section 406 of Sarbanes-Oxley (15 U.S.C.A. § 7264) (illustrating indirect regulation through required disclosure of the company's code of ethics for senior financial officers); *see also* sections 303 (15 U.S.C.A. § 7242) (regulating conduct of directors relating to an audit of financial statements), 304 (15 U.S.C.A. § 7243) (requiring forfeiture of bonuses or profits obtained due to misstated financial reports), and 306 (15 U.S.C.A. § 7244) (prohibiting trading during pension fund blackout periods).

4. *See* section 301 (15 U.S.C.A. § 78j–1(m)) (listing the standards and requirements applicable to public company audit committees).

5. *See* section 402 (15 U.S.C.A. § 78(m)) (prohibiting corporate loans to executives).

matters,[6] and the compensation and autonomy of securities analysts.[7] At the heart of the Act, though, are the provisions that authorize the creation of a new regulatory body, the Public Company Accounting Oversight Board (PCAOB or Board), require all accounting firms that audit the books of public corporations to register with the Board, and grant the Board broad authority to regulate those firms and their associated professionals.[8]

Sarbanes-Oxley directs the PCAOB to take such actions as it deems "necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons . . . in order to protect investors, or to further the public interest."[9] The Board's mission quite clearly is to develop regulations and implement regulatory procedures that will bolster—and may even restore—the public's confidence in the integrity of public accounting firms and the credibility of the financial reports they audit and certify.[10]

Public confidence in the integrity of public companies' financial reports has been shaken by numerous, highly publicized instances of financial fraud[11] at companies as prominent as

6. *See* section 307 (15 U.S.C.A. § 7245) (charging the SEC with the task of establishing rules of professional responsibility for attorneys practicing before the Commission).

7. *See* section 501 (15 U.S.C.A. § 78o–6) (requiring the Commission to set rules addressing conflicts of interest that can arise "when security analysts recommend equity securities in research reports and public appearances").

8. *See* sections 101 (15 U.S.C.A. § 7211) (establishing the Board), 102 (15 U.S.C.A. § 7212) (requiring registration with the Board), 103 (15 U.S.C.A. § 7213) (granting the Board authority to set auditing, quality control, and independence standards).

9. Sarbanes-Oxley Act of 2002 § 101(c)(5), 15 U.S.C.A. § 7211(c)(5).

10. One study found that audit firms "gave a clean bill of health to 93.9% of public companies that were subsequently involved in accounting problems." Martin D. Weiss, *The Worsening Crisis of Confidence on Wall Street: The Role of Auditing Firms*, *at* http://www.weissratings.com/worsening-crisis.pdf (July 5, 2002) (on file with the *Duke Law Journal*).

11. *See* Deborah Solomon, *Fraud Detector: SEC Sets a New Rule*, WALL ST. J., May 28, 2003, at C1 (noting that the SEC's recent rulemaking efforts are designed to prevent frauds, such as those at Enron and HealthSouth, which undercut investor confidence); David Wessel, *Capital: Jitters over War with Iraq May Not be the Only Factor Weighing on the Economy*, WALL ST. J., Feb. 20, 2003, at A2 (stating that financial scandals hurt not only public confidence in business but also attitudes of investors, bankers, corporate directors, and executives toward each other); Robert J. Shiller, *Celebrity CEOs Share the Blame for Street Scandals*, WALL ST. J., June 27, 2002, at A20 (noting that scandals like Rite-Aid and WorldCom have the potential to upset investor confidence by changing fundamental beliefs about management's ability to promote long-term earnings growth over short-term share price increases).

Enron,[12] Rite-Aid,[13] WorldCom,[14] and HealthSouth,[15] and by the failure of auditors to detect that those companies had been "cooking their books" for many years.[16] There is no doubt that one prominent item on the PCAOB's substantive agenda will be figuring out how to encourage or require auditors to detect such frauds.

This Article, however, does not focus on the ways in which the PCAOB should deal with fraud-related issues. Rather, it is directed at two more pervasive problems that also have sapped the public's confidence in the integrity of corporations' financial reports:

- Earnings management, by which I mean the tendency of many corporate managers to make the numerous accounting judgments that generally accepted accounting principles (GAAP)[17] permit or require not in good faith, but with a view to reporting some desired level of corporate income (or some other desired figure in their company's financial statements).[18]

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12. *See Markets*, L.A. TIMES, Dec. 2, 2003 at C4 (noting that Sarbanes-Oxley was passed "after the Enron and WorldCom scandals eroded confidence in Wall Street"); *see also* Andrew Parker, *Firms Await Audit Crackdown—Regulator to Unveil Tough Rules on Fees and Additional Work for Clients*, FINANCIAL TIMES, Nov. 22, 2003, at 1 ("US business scandals such as Enron and WorldCom undermined confidence in companies' accounts partly because of allegations of poor work by auditors.").

13. *See* Scott Kilman, *Rite Aid Ex-Officials Charged in Accounting Fraud Probe*, WALL ST. J., June 24, 2002, at A2 (describing the scheme that resulted in what was then the largest U.S. corporate earnings restatement to date (approximately $258 million)).

14. *See* Jared Sandberg & Deborah Solomon, *WorldCom Board to Begin Search for New CEO*, WALL ST. J., Sept. 11, 2002, at A3 (describing the market downturn that resulted from the discovery of WorldCom's $3.8 billion financial overstatement, later to total more than $7 billion).

15. *See* Carrick Mollenkamp & Chad Terhune, *HealthSouth Puts False Accounting at $2.5 Billion*, WALL ST. J., July 8, 2003, at A3 (reporting the results of the auditor's cumulative investigation—$2.5 billion in fraudulent or improper accounting designed to manipulate earnings and meet Wall Street expectations).

16. *See* Jerry Useem, *In Corporate America It's Cleanup Time*, FORTUNE, Sept. 16, 2002, at 62 (noting that companies who meet analyst estimates exactly or beat them by a penny face a presumption that they have been cooking their books); Carol J. Loomis, *Lies, Damned Lies, and Managed Earnings*, FORTUNE, Aug. 2, 1999 at 74 (equating the term "cooking the books" with criminal accounting fraud).

17. GAAP are the principles that govern how financial information is to be presented in financial statements. They are set forth in Statements of Financial Accounting Standards (SFAS) promulgated by the Financial Standards Accounting Board (FASB), as well as by similar standards promulgated by predecessors to the FASB that have not been superceded by SFAS, and by authoritative statements in the accounting literature that address issues not addressed by such standards. DONALD E. KEISO & JERRY J. WEIGANDT, INTERMEDIATE ACCOUNTING, 6, 13–14 (9th ed. 1998).

18. Patricia M. Dechow & Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators*, 14 ACCT. HORIZONS 235, 238

- The failure of public companies and their accountants to make clear to the public the extent to which critical entries in those companies' financial statements are based on highly subjective judgments, the accuracy of which cannot be measured objectively. Inevitably, with the passage of time, some of those judgments prove inaccurate. Even if those judgments were made in good faith, investors who do not appreciate the amount of subjectivity involved in preparing financial statements may suspect that the disparity between what was reported and "economic reality" is a product of earnings management, if not of outright fraud.

Professor Don Langevoort argues that the best way to address these problems is for the Securities and Exchange Commission (SEC) again to overhaul its approach to Management's Discussion and Analysis (the MD&A).[19] I disagree. The SEC has been pushing that particular string with little success for many years now,[20] which leads me to question whether any new approach the SEC is likely to adopt will be much more successful in eliciting meaningful, forward

(2000). Professors Dechow and Skinner point out that it is difficult to measure "earnings management" because it turns on managers' subjective intent, which cannot be observed directly. *Id*.

19. Langevoort, *supra* note 2, at 1155. The SEC requires every public company to include an MD&A in its annual reports on Form 10-K and its quarterly reports on Form 10-Q. Regulation S-K, 17 C.F.R. § 229.303 (2003) (commonly known as Regulation S-K, Instruction 3, Item 303). According to the SEC, the purpose of the MD&A is to provide (i) a narrative explanation of the company's financial statements that enable investors to see the company through the eyes of management; (ii) a context within which the company's financial statements should be analyzed; and (iii) information about the quality of, and potential variability of, the company's earnings and cash flow, so that investors can better assess the company's likely future performance. Analysis of Financial Condition and Operations, Securities Act Release No. 6711, 52 Fed. Reg. 13,715, 13,717 (Apr. 24, 1987).

20. For those unfamiliar with this expression, it refers to the fact that a string can be pulled but cannot be pushed. Recent evidence of the SEC's lack of success is provided by a report from the Division of Corporation Finance, which reviewed the annual reports for 2001 filed by all Fortune 500 companies and noted significant deficiencies in 350 of them. U.S. Sec. & Exch. Comm'n, Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of Fortune 500 Companies, *at* http://www.sec.gov/divisions/corpfin/fortune500rep.htm (last modified Feb. 27, 2003) (on file with the *Duke Law Journal*). The Division noted that although the SEC had indicated in FR-60 that companies should provide more information in their MD&A about their critical accounting policies, "a substantial number of companies did not provide *any* critical accounting policy disclosure[;] . . . the critical accounting policy disclosures of many companies did not adequately respond to the guidance provided in FR-60 [and] many companies failed to provide the sensitivity analysis the Commission encouraged in FR-60." *Id.* (emphasis added.). In 2001 10-K reporting, the SEC identified little quantified sensitivity analysis. Linda C. Quinn & Ottilie L. Jarmel, *MD&A 2003: Linchpin of SEC Post-Enron Disclosure Reform*, 1395 PLI/Corp 487, 495 (Nov. 2003).

looking disclosures from corporate managers than have the SEC's past, failed efforts.

A major conceptual problem with the SEC's approach, in my view, is that the Commission has persisted in treating "historical" financial information as if it is fixed in nature, rather than inherently uncertain. Thus, in its guidance concerning preparation of the MD&A, the SEC advises issuers to focus "on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or future financial conditions."[21] The SEC ignores—or treats as nonexistent—the possibility that as a consequence of "material [future] events and uncertainties," reported financial results will prove not to reflect accurately *past* operating results or *past* financial conditions. Yet, as every sophisticated user of financial reports knows, this almost always is a distinct possibility.[22]

The SEC has a tradition of viewing historical information as fixed and certain—so long as it is not tainted by fraud.[23] The PCAOB is not bound by this tradition and thus is well positioned both to limit earnings management and to help investors better appreciate the uncertainties inherent in all financial statements, including those prepared in good faith. If the Board does so, investors will have greater confidence in the integrity of public companies' financial

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21. Regulation S-K, 17 C.F.R. § 229.303.

22. To illustrate, when a company that sells on credit establishes an allowance for doubtful accounts receivable, it must make assumptions about whether those customers who now owe it money are more likely, less likely, or as likely to pay their bills as the customers to whom the company has sold its products in prior periods, as well as whether a significant shift in overall economic conditions or conditions within a particular industry or locale are likely to lead to substantial changes in its customers' bill-paying habits. Even assumptions made in good faith may prove to be wrong. If they are, the company's real economic results and financial position may vary considerably from the results and financial position it reported in its filing with the SEC.

23. *See* Paul H. Dawes et al., *The Sarbanes-Oxley Act of 2002 and SEC Rulemaking*, 1378 PLI/Corp 245, 256 (2003) (noting that Sarbanes-Oxley's encouragement of qualitative information disclosures could result in "a reappraisal of the Commission's traditional emphasis on historical information as the basis on which investment decisions are made," but whether this will be more effective against fraud "remains to be seen"); Jeanne Calderon & Rachel Kowal, *Safe Harbors: Historical and Current Approaches to Future Forecasting*, 22 J. CORP. L. 661, 662 (1997) (describing the Commission's preference for historical ("hard") information in company disclosures); Carl W. Schneider, *Nits, Grits and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 258 (1972) ("The Commission tries to confine [SEC filings] to hard information to assure a continued high degree of reliability. . . [which also] makes it easier to establish accountability for inadequate disclosures.").

statements and should be better able to appreciate the risks involved in buying and selling the securities those companies have issued.

Although the PCAOB lacks the authority to prescribe or amend GAAP, this should not impair its ability to achieve these goals if the Board makes creative use of its authority (i) to establish and amend Generally Accepted Auditing Standards (GAAS),[24] (ii) to inspect the operations of public accounting firms, and (iii) to discipline those firms and their associated personnel where they do not follow the auditing standards the Board has prescribed. More specifically, the PCAOB should be able to decrease earnings management and increase investors' understanding of public companies' financial statements by embarking on a three-part program that includes the following:[25]

- <u>Independence</u>: The PCAOB should seek to ensure that public accountants approach audit assignments at public companies as independent professionals committed to ensuring that the financial statements they audit and certify reflect economic reality as closely as reasonably possible.

- <u>Accuracy</u>: The PCAOB should amend GAAS to require auditors to be more sensitive to the possibility of "earnings management" and, where circumstances suggest earnings management is likely, to scrutinize closely all important judgments and assumptions that GAAP permit or require managers to make.

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24. GAAS are the principles that govern the procedures an accountant should use to verify the accuracy of the information in a financial statement it is auditing. Prior to the creation of the PCAOB, GAAS were promulgated by the American Institute of Certified Public Accountants (AICPA), the professional organization to which most certified public accountants belong. GAAS issued by the AICPA can be found in the Codification of Statements on Auditing Standards (AICPA 2002).

25. The Board, of course, also must address a number of major organizational and administrative issues, especially during the early years of its existence. These include staffing a major new regulatory organization from the ground up and developing policies and procedures to govern that organization's operations. The Board also must issue regulations to implement a number of specific legislative mandates. For example, section 103(a)(1) of Sarbanes-Oxley requires the Board to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports. The Board is also granted the power to establish rules to implement the auditor independence requirements in Title II of the Act. PCAOB Rel. No. 2003–009, *Compliance with Auditing and Related Professional Practice Standards: Advisory Groups*, PCAOB Rulemaking Docket Matter No. 004 (June 30, 2003). As evidenced by the Board's website, which lists all of its regulatory initiatives, that process seems to be well under way. *See* http://www.pcaob.com (last visited Jan. 26, 2003).

- Transparency: The PCAOB should also endeavor to ensure that investors better understand the inherent subjectivity of public companies' financial statements by requiring auditors to explain why they believe a public company's financial statements *present fairly*, in conformity with GAAP, the results of its operations and its financial position.[26]

As explained below, to achieve these objectives the PCAOB will need to think outside the box and promulgate auditing and ethical standards that address the very issues the accounting profession traditionally has chosen not to address.[27] In addition, the Board will need to use its authority to review the performance of registered public auditing firms and to discipline firms and auditors in order to promote a high level of compliance with whatever new standards it chooses to promulgate.

I. INDEPENDENCE

One major concern that led to the passage of Sarbanes-Oxley was that, as accounting firms began to derive an increasing portion of their revenues from nonaudit services, they faced increasing conflicts of interest. Title II of Sarbanes-Oxley[28] addresses the issue of auditor independence, which, according to the relevant Senate report, "is at the center of this legislation."[29] Title II includes a

26. This is the key language in the opinions public accountants now issue with respect to the financial statements of public companies they have audited. *See* Am. Inst. of Certified Pub. Accountants, Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements* (1988) (as amended).

27. Observers have pointed out that the auditing standards promulgated by the AICPA, which had authority to promulgate such standards prior to the creation of the PCAOB, were written largely with a view to protecting auditing firms from possible liability for faulty audits. *See, e.g.*, *Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. 6 (2002) [hereinafter *Hearings*] (statement of Lynn E. Turner, Chief Accountant, Securities and Exchange Commission) ("Simply put, auditing standards today, which are often reviewed and edited by the legal counsels of the [major public accounting] firms, are written to protect the interests of the firms, not ensure quality audits that will protect investors."). PCAOB has taken the critical first step of deciding to strip the AICPA of its authority to set auditing standards for registered public accounting firms. The Board has asserted that it alone will have the authority to establish such standards and to amend existing standards. Statement Regarding the Establishment of Auditing and Other Professional Standards, PCAOB Release No. 2003–005, 68 Fed. Reg. 55,667 (Apr. 18, 2003).

28. Sarbanes-Oxley Act of 2002 §§ 201–209, 15 U.S.C.A. § 78j–1 (West Supp. 2003).

29. S. REP. NO. 107–205, at 14 (2002).

number of explicit prohibitions and requirements directed at promoting auditors' independence.

Section 201, the most important of these provisions, makes it unlawful for accounting firms to provide audit clients with any of eight categories of nonaudit services that Congress determined create "a fundamental conflict of interest for the accounting firms."[30] Section 201 also authorizes the Board to designate additional nonaudit services that accounting firms would then be prohibited from providing to audit clients.[31] Further, section 201 stipulates that before an accounting firm can provide an audit client with any nonaudit services, including tax services, that activity must be "approved in advance by the audit committee of the issuer."[32]

Several other Title II provisions promote auditor independence. Section 203 requires accounting firms to change the lead and reviewing partners assigned to an audit client every five years.[33] Section 207 directs the Comptroller General to conduct a study of "the potential effects of requiring the mandatory rotation of registered public accounting firms" and report the results to Congress.[34] To deal with the conflicts of interest inherent in the "revolving door" situation—in which a partner or employee of an accounting firm that has audited a client company becomes a senior executive or financial officer of that company—section 206 imposes a one-year "cooling off period" during which it is unlawful for an accounting firm to audit a company that is so employing one of its former partners or employees.[35]

Finally, Title II seeks to further bolster accounting firms' and audit committees' independence by strengthening their relationship with each other. Section 202 makes public companies' audit committees responsible for preapproving all audit (and nonaudit) services provided by their auditors.[36] Section 204 directs every registered public accounting firm to report in a timely fashion to the audit committee of every public audit client (1) the client company's

30. *Id.* at 18; *see* Sarbanes-Oxley Act of 2002 § 201(a), 15 U.S.C.A. § 78j–1(g).

31. Sarbanes-Oxley Act of 2002 § 201(a), 15 U.S.C.A. § 78j–1(g)(9).

32. *Id.* § 201(a), 15 U.S.C.A. § 78j–1(h) (adding section 10A(h) to the Securities Exchange Act of 1934, 15 U.S.C.A. § 78a et seq.). Section 201(b) grants the PCAOB authority to exempt issuers and firms from these prohibitions on a case-by-case basis. 15 U.S.C.A. § 78j–1(m)(3)(c).

33. 15 U.S.C.A. § 78j–1(j) (adding section 10A(j) to the Securities Exchange Act of 1934).

34. 15 U.S.C.A. § 7232.

35. 15 U.S.C.A. § 78j–1(c) (adding section 10A(l) to the Securities Exchange Act of 1934).

36. 15 U.S.C.A. § 78j–1(i).

"critical accounting policies and practices"; (2) "all alternative treatments of financial information" it has discussed with the management of that company, the ramifications of alternative disclosures and accounting treatments, and the treatment the accounting firm prefers; and (3) all other "material written communications" between the accounting firm and the management of the issuer.[37]

Given the range of statutory prohibitions and requirements directed at promoting auditors' independence, one might well ask whether it is necessary for the PCAOB to take additional action in this area. My answer is yes. Several years ago, Judge Frank Easterbrook argued that it would be "irrational" for a large public accounting firm or any of its partners to acquiesce in a client's fraud because they had little to gain and much to lose by doing so.[38] Few now accept his observation, and recent events make clear that, at least during the 1990s, many accountants were prepared to overlook their clients' financial frauds or to acquiesce in them.[39] Of course, acquiescence—and even assistance—is considerably more likely when the client is engaged not in fraud but in manipulating GAAP so as to produce some desired level of earnings or to influence some given balance sheet account.[40]

Much of the problem relates to the reward structure within public accounting firms. There is a good bit of evidence that public accounting firms, especially when they were providing multiple

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37. 15 U.S.C.A. § 78j–1(k) (adding section 10A(k) to the Securities Exchange Act of 1934). Professor Jim Cox argues that promoting a meaningful dialogue between accounting professionals and audit committees should be a "core consideration" for the PCAOB. James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurement*, 81 WASH. U. L.Q. 301, 327 (2003).

38. DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990).

39. *See supra* notes 11–16 and accompanying text; *see also* AUSA Life v. Ernst & Young, 206 F.3d 202, 205 (2d Cir. 2000) (commenting on the "spinelessness" of the Ernst & Young partner in charge of the audit in question).

40. *See* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Regulation*, 95 NW. U. L. REV. 133, 209 (2000) (noting that the "predominant problem is that of clients inducing their auditors to accept an inappropriate treatment of a financial reporting issue" and that studies find an auditor is more likely to "cave in" when dealing with a large client). Moreover, the earnings management problem persists. A financial analyst recently adjusted the reported earnings of all companies in the S&P 500 to reflect what he viewed as (i) questionable special charges, (ii) the cost of stock option grants, and (iii) overly rosy assumptions relating to their pension plans. He found that, on average, in 1991 adjusted earnings were 18 percent less than those the companies reported, while in 2002 they were 41 percent less. *See* Gretchen Morgenson, *Earnings Are Worse Without the Icing*, N.Y. TIMES, July 13, 2003, at C1.

services to audit clients, tended to name as senior engagement partners accountants who had demonstrated good sales skills or the ability to "manage" relationships with clients. Such accountants, however, are likely to be more flexible when interpreting accounting and auditing standards than are skilled accounting technicians. As former SEC Commissioner Bevis Longstreth testified:

> Audit account partners are expected by their firms to establish close relationships with the managements they serve. They are expected to cross-market to management as full a range of non-audit services as possible. And, they are compensated by their firms on the basis, among others, of how much revenue they produce from their audit clients. Their stake in maximizing revenue from these clients . . . is as natural and compelling as any financial reward could be. To claim these incentives have no adverse impact on both the fact and appearance of independence is a fiction, pure and simple.[41]

The role of salesperson is fundamentally inconsistent with that of auditor, whose "ultimate allegiance [is] to the corporation's creditors and stockholders, as well as to the investing public."[42] Partners in accounting firms, if compensated primarily on the basis of the volume of services they sell, are unlikely to question rigorously dubious accounting judgments made by audit clients, when to do so may jeopardize the potential sale of audit and other services to those clients. It is far more likely that the partner in charge of an engagement, if she views an audit client primarily as a valued customer, will seek to secure the good will of that "customer" by acquiescing in all arguably reasonable accounting judgments it makes—and even by using her expertise to help the audit client understand how GAAP can be "gamed" to produce the financial results the client wants to report. A sense of realism also suggests that more junior members of accounting firms' audit teams will be reluctant to risk alienating these valued "customers" by challenging their accounting judgments if they fear that by doing so they will negatively affect their compensation or prospects for advancement.

Sarbanes-Oxley's prohibition on auditing firms providing many nonaudit services should help alleviate these problems, but it will not eliminate them. The Act clearly assumes both that public companies will continue to hire—and have the power to fire—their public

41. *Hearings*, supra note 27, at 7 (statement of Bevis Longstreth, former Commissioner of Securities and Exchange Commission).

42. United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984).

accountants, and that those firms will remain free to provide certain nonaudit services.[43] Moreover, even if one assumes that registered public accounting firms will only provide audit clients with audit services, the nature of the auditor-auditee relationship is such that those firms and their partners will continue to find their independence threatened by "pressures and other factors that [may] impair [their] objectivity."[44] Furthermore, although Sarbanes-Oxley will reduce the pressures that accountants must have felt when their firms were generating most of their profits from the provision of nonaudit services,[45] if audit services now become profit centers for large public accounting firms (as knowledgeable observers predict will be the case), the pressures on objectivity arising from the auditor-auditee relationship may well become more intense.

How, then, should the PCAOB address the problem of auditor independence? It should begin by abandoning the notion—now implicit in the accounting profession's ethical standards and rules on independence—that it is appropriate to view each accounting firm as a "black box" that can and should be regulated as an entity. For at least two decades, students of the public corporation have recognized that this is not the case, and have devoted most of their efforts to addressing principal-agent tensions that exist within the firm.[46] The

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43. Most worrisome may be tax counseling services. Accounting firms that provide such services generally will act as advocates for their clients vis-à-vis the Internal Revenue Service. In addition, they will be required to verify the validity of their clients' accruals for tax liabilities, and thus the validity of their tax advice, when auditing those clients' books.

44. *See* William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L.Q. 519, 528 (2002) (quoting INDEPENDENCE STANDARDS BD., STAFF REPORT: A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE (2001), *at* http://www.cpaindependence.org, and listing five "sources of threats to objectivity," all of which are present in the standard auditor-auditee relationship); *see also* Cox, *supra* note 37, at 315 ("[A] good deal of the auditor's independence is compromised by the sheer magnitude of the audit fees associated with a client, especially if they view these fees as a perpetuity."); Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* 2–3, *at* http://papers.ssrn.com/toptens/tt_jrnl_296306.html (University of Pittsburgh School of Law, Working Paper, 2002) (on file with the *Duke Law Journal*) (making a similar argument).

45. *See* John C. Coffee, *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and Governance of Accounting* 14–16 (Columbia Law School, Center for Law and Economic Studies, Working Paper No. 191, 2001), *available at* http://www2.law.columbia.edu/law-economicstudies/papers/wp191.pdf (performing a seminal analysis of these pressures); *see also* Richard M. Frankel et al., *The Relation Between Auditors' Fees for Nonaudit Services and Earnings Management*, 77 ACCT. REV., 71 (Supp. 2002) (finding "a positive association between nonaudit fees and the likelihood of reporting a small earnings surprise").

46. *See* Michael Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305 (1976) (setting forth agency

accounting profession's rules and standards relating to auditor independence have, however, continued to view accounting firms as "black boxes" and have focused almost exclusively on regulating conflicts of interest between those firms, their partners and employees, on the one hand, and audit clients on the other.[47]

The Board should recognize that the incentives firms provide, whether monetary or nonmonetary, undoubtedly exert as strong an influence on the partners and employees of accounting firms as they do on the executives and employees of public corporations. Consequently, the Board should revise GAAS and the accounting profession's ethical standards and rules on independence to reflect this reality. More specifically, 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.[48]

Section 501 of Sarbanes-Oxley, which addresses conflicts of interest involving securities analysts, suggests one approach the PCAOB should consider.[49] That section instructs the SEC or the National Association of Securities Dealers to adopt rules designed

> to establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.[50]

As such, section 501 reflects Congress's recognition that regulating broker-dealer firms' incentive structures is necessary to safeguard the independence of securities analysts, another group of professionals

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cost theory of the firm); Joseph E. Stiglitz, *Symposium on Organization and Economics*, 5 J. ECON. PERSP. 15, 15–19 (1991) (reviewing shift in economic analysis from viewing the firm as a "black box" to considering carefully what occurs within the firm).

47. *See* 1–1 Applying GAAP and GAAS Section 1.09, PROFESSIONAL ETHICS CONSIDERATIONS IN ACCOUNTING AND AUDITING ENGAGEMENTS (Matthew Bender 2004) (listing AICPA Rules of Professional Conduct and Interpretations of those rules, which focus heavily on regulating specific relationships between the firm, its employees, and audit clients).

48. *See* Sarbanes-Oxley Act of 2002 § 103, 15 U.S.C.A. § 7213 (West Supp. 2003) (clearly authorizing the Board to adopt such standards).

49. Section 501 also suggests that an initiative along the lines suggested would be entirely consistent with congressional intent. 15 U.S.C.A. § 78o–6.

50. 15 U.S.C.A. § 78o–6(a)(3) (adding section 15D(a)(3) to the Securities Exchange Act of 1934).

charged with acting in the interest of investors. The PCAOB could similarly require that registered public accounting firms establish structural and institutional safeguards designed to ensure that they do not provide their partners or employees with incentives or subject their partners or employees to pressures—financial or nonfinancial—that are likely to jeopardize their independent performance of their responsibilities.

In a more affirmative vein, the PCAOB also should consider the regulatory implications of Professor Robert Prentice's observation that public accounting firms generally do not appropriately reward partners and employees for astute and rigorous auditing.[51] That might lead the Board to consider issuing rules or standards that would require registered public accounting firms to adopt structural and institutional policies directed at rewarding, and thus encouraging, high-quality auditor performance.[52]

II. ACCURACY

A large part of the impetus for Sarbanes-Oxley's passage derived from public and congressional concern about widespread "management" of public companies' earnings.[53] This form of data manipulation results when managers intentionally make accounting judgments and assumptions with a view to enabling their firms to report some given level of earnings—most frequently, earnings that meet or narrowly exceed investors' expectations.[54] Every person with

51. Prentice, *supra* note 40, at 195–98.

52. For example, the PCAOB might encourage accounting firms to adopt policies that provide bonuses or accelerated promotion to auditors who detect fraud or persuade clients to modify questionable accounting estimates. Precisely how the PCAOB should frame its rules in this area best awaits discussion between the Board and appropriate expert advisory groups. Section 103(a)(4) of the Act anticipates that the Board often will find it desirable to consult with such groups before promulgating new rules and standards. 15 U.S.C.A. § 7213(a)(4). Whatever form any such rules take, the PCAOB then will be in a position to ensure at least a reasonable level of compliance by exercising its authority to conduct inspections of registered public accounting firms and to discipline firms that fail to meet regulatory requirements. *See* Sarbanes-Oxley Act of 2002 §§ 104–105, 15 U.S.C.A. §§ 7214–7215.

53. *See* Matthew S. Mokwa, *Enron, Sarbanes-Oxley, and the End of Earnings Management*, 39 TEX. J. BUS. L. 325, 348–49 (citing earnings management as a primary culprit behind the frauds the Act was designed to prevent).

54. Note 18, *supra*, discusses the issues involved in defining "earnings management." However, Professors David Burgstahler and Ilia Dichev provide compelling statistical evidence that earnings are in some sense "managed." *See* David Burgstahler & Ilia Dichev, *Earnings Management to Avoid Earnings Decreases and Losses*, 24 J. ACCT. & ECON. 99, 99–101 (1997). In a random sample, one would expect roughly equal numbers of firms to report earnings just

a reasonable grasp of financial accounting knows that financial statements prepared in accordance with GAAP may or may not be objectively accurate because they always reflect a variety of subjective judgments:

- What portion of accounts receivable will a company be able to collect?

- What portion of the loans it has made will not be repaid?

- What portion of goods sold subject to rights to return will in fact be returned?

- What costs will the company have to incur to meet warranty obligations related to goods or services it has sold?

- Have changes in consumer tastes or technology caused the fair market value of items in inventory to drop below cost or the value of fixed assets to drop below book value?

- What actuarial assumptions and rates of return should the company use to determine pension expenses and liabilities?

- How much should the company accrue to reflect the income tax it would have to pay if its taxable income was the same as its GAAP income?

- How much should it accrue to meet its obligations under various environmental protection laws?

- What costs will the company incur in closing down a line of business it has decided to discontinue or integrating a business it has agreed to acquire?

Most people familiar with financial accounting also realize that managers' subjective judgments have had a steadily increasing impact on public companies' financial statements in recent years. This is a

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above and just below their previous year's earnings. The authors found, however, that reported earnings form "a striking, nonrandom pattern," with very few firms falling just short of previous year's earnings and many more firms matching or barely exceeding previous year's earnings. *Id.* at 103–06. Their findings suggest one reason a company's stock price often falls sharply when it reports earnings just short of the market's expectations: investors may interpret such results as indicating not a minor shortfall, but that the company, even after taking advantage of all the opportunities to manage earnings that GAAP provides, still could not hit its earnings target.

consequence of two developments: the proliferation of complex financial instruments that GAAP require be "marked to market," and the tendency of public companies to reorganize their operations with increasing frequency, which generates a need to create reserves to cover anticipated costs.[55]

These developments create the potential for an increase in "earnings management," but the principal cause of problems in this area, in my view, is the focus on market expectations. When making the subjective judgments required by GAAP, managers of public companies have increasingly disregarded the objective of generating as accurate a picture as possible of the results of their companies' operations. Instead, the goal has moved toward structuring these results such that their companies can report whatever level of earnings the managers themselves have led investors—i.e., the market—to expect.[56] Moreover, the problem probably has been exacerbated by the willingness of at least some accountants to advise audit clients about how they can "game the system"—i.e., how they can report the earnings they wish to report

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55. As concerns accounting for derivatives, Warren Buffett recently observed:

> Errors will usually be honest, reflecting only the human tendency to take an optimistic view of one's commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them. Those who trade derivatives are usually paid (in whole or in part) on "earnings" calculated by mark-to-market accounting. But often there is no real market . . . and "mark-to-model" is utilized. This substitution can bring on large-scale mischief. . . . In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.

BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 13 (2003).

56. Warren Buffett noted some time ago that "many managements view GAAP not as a standard to be met, but as an obstacle to be overcome. Too often their accountants assist them. . . . Even honest and well-intentioned managements sometimes stretch GAAP a bit . . . ." BERKSHIRE HATHAWAY INC., 1988 SHAREHOLDER LETTER 2–3 (1988). More recently—but well in advance of the accounting scandals brought to light in the early 2000s—he observed that corporate norms had shifted to the point where "stretch[ing] GAAP a bit" had become a pervasive problem:

> What bothers me . . . is that people of generally high integrity who you would trust in any situation—you could make them the trustee under your will—but it has now become the norm to feel that as the manager of a major company it is up to [them] to play the accounting game, particularly the ones suggested to [them] by [their] very own auditor.
>
> It is the degree to which the high grade people have either been co-opted or acquiesced or whatever word you want to pick. And that's very tough to cleanse the system of because you don't have good guys and bad guys anymore.

Conversations from the Warren Buffett Symposium, 19 CARDOZO L. REV. 719, 799 (1997) (quoting Warren E. Buffett).

by making accounting judgments that the auditors have indicated they will be prepared to accept.[57]

Some have suggested that the best approach to the problem of earnings management would be to revise GAAP so as to make them less rule-based and more principled.[58] That approach may have some merit, but given the complexity and unpredictability of business, subjective judgments by corporate managers will continue to play a major role in the preparation of public companies' financial statements no matter how principle-based GAAP become.[59] Thus, to improve the accuracy of public companies' financial statements by reducing earnings management (and fraud), the PCAOB should instead consider amending GAAS to require registered accounting firms to do a better job of identifying the companies most likely to engage in earnings management (and fraud), to question vigorously all important accounting judgments and estimates made by the managers of those companies, and to bring to the attention of the audit committees of client companies any estimates or judgments about which the accountants continue to be concerned.[60]

It is my understanding that every large public accounting firm already has in place systems that can identify higher risk audit clients. What is unclear to me, though, is whether those firms' risk assessment systems take adequate account of factors that recent events suggest often are associated with aggressive earnings management (and sometimes are associated with fraud). Those factors include

- Large amounts of stock options (or other incentive compensation arrangements) that have—or are likely to have—

57. As noted in the above discussion of independence issues, *see supra* notes 41–42 and accompanying text, accounting firms' incentive structures may well encourage audit partners to engage in such behavior.

58. *See, e.g.*, *Hearings*, supra note 27, at 12 (statement of Robert E. Litan, Director, Economic Studies Program, The Brookings Institute).

59. Professor Cox points out that a principle-based system invites more discretion and judgment, by both reporting companies and their auditors, and thus may exacerbate problems in this area. Cox, *supra* note 37, at 315.

60. The Panel on Audit Effectiveness made a similar general recommendation, directed primarily at the detection of fraud. *See* PANEL ON AUDIT EFFECTIVENESS, REPORT AND RECOMMENDATIONS 87, *at* http://www.pobauditpanel.org (Aug. 31, 2000) (on file with the *Duke Law Journal*). Their focus, however, is on strengthening what might best be termed "traditional" audit procedures. *Id.* at 87–92. Of course, requiring registered public accounting firms to change their incentive structures, *see supra* notes 46–52 and accompanying text, also should make it less likely that auditors will help the managers of audit clients to figure out "acceptable" techniques for "managing" their companies' earnings.

value only so long as the company reports steadily increasing revenues or earnings;[61]

- Earnings "guidance" or estimates that appear aggressive when considered in light of the line(s) of business in which a company is engaged;

- A history of reporting smooth and steady earnings growth when the company's primary line(s) of business tend to be volatile or cyclical; and

- An audit committee that lacks independence or, perhaps more importantly, that appears to have little interest in understanding the important accounting issues the company faces or in reviewing the important accounting judgments embedded in its financial reports.[62]

There is an early step the PCAOB could take to address concerns about earnings management and to improve the accuracy of public companies' financial reports. It would entail amending GAAS to require registered public accounting firms to incorporate these and similar risk factors into their risk assessment matrices.[63]

Another step the Board should consider would be revising GAAS to require accounting firms, especially when auditing higher

61. A related factor may be what portion of managers' compensation is fixed and what portion is dependent on either the price of the company's stock or reported financial results (which usually will affect the price of its stock). By 1999, chief executives were receiving some 60 percent of their annual pay in stock and options. Daniel Altman, *How to Tie Pay to Goals, Instead of the Stock Price*, N.Y. TIMES, Sept. 8, 2002, at C4.

62. This listing is meant to be illustrative, not comprehensive. Although the risk factors listed are suggested by recent events, it is worth noting that the Treadway Report, issued in 1987, suggested that auditors take account of similar factors in considering the risk of fraudulent financial reporting. NAT'L COMM'N ON FRAUDULENT FIN. REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 155–64 (1987), *available at* http://bear.cba.ufl.edu/hackenbrack/acg5637/PDF/NCFFR.pdf (on file with the *Duke Law Journal*) (commonly known as the Treadway Report).

63. The auditing standard currently directed at audit risk, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS NO. 47; AUDIT RISK AND MATERIALITY IN CONDUCTING AN AUDIT (1983) [hereinafter SAS NO. 47], focuses much more heavily on the risks associated with an auditor not sampling sufficient transactions to detect material discrepancies. SAS No. 47 does not effectively address the risk that the managers of firms with certain characteristics are more likely to make accounting judgments directed at achieving some desired level of reported earnings. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS NO. 82; CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT (1997) [hereinafter SAS NO. 82], does require auditors to consider similar factors, but only in relation to risks associated with "cooking the books."

risk clients, to obtain a reasonable understanding of the dynamics of those clients' businesses, including an understanding of external economic factors likely to have a significant impact on earnings. The results of a study Janet Moser and I conducted of the accounting fraud allegedly perpetrated by Green Tree Financial Corporation.[64] suggest that had Green Tree's auditors focused on external data that made clear dramatic changes had occurred in the economic and competitive environment in which Green Tree was operating, they would—or at least should—have realized the need to question the key assumptions underlying Green Tree's reports that its earnings were steadily increasing.[65]

Similarly, three accounting professors recently studied the audit failure at Lincoln Savings and Loan and concluded that consideration of readily available data about the Phoenix real estate market should have led Lincoln's auditors to question the profits Lincoln reported on several fraudulent real estate transactions.[66] The authors note that SAS No. 82, which is directed at increasing auditors' sensitivity to the possibility of fraud, does not require auditors to consider such external data.[67] Absent such a requirement, the authors argue, auditors following traditional procedures often fail to question fraudulent transactions similar to those in which Lincoln was involved.[68]

64. The alleged fraud is described in *Florida State Board of Administration v. Green Tree Financial Corp.*, 270 F.3d 645, 648–51 (8th Cir. 2001) (reversing decision dismissing complaint alleging Green Tree and various insiders violated section 10(b) and Rule 10b-5).

65. *See* Elliott Weiss & Janet Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457, 481–97 (1998). Green Tree used "gain on sale" accounting to record profits from its securitization and resale of subprime mortgages secured by liens on manufactured housing. A key component in Green Tree's calculation of its gains on such resales was its estimate of the rate at which those mortgages would be prepaid. *Id.* at 475–78. Increased competition in the subprime lending business and declining interest rates made it highly likely that prepayments would accelerate, which would reduce the gains Green Tree realized on the resales of those mortgages. *Id.* at 481–92. Notably, Green Tree also involved a risk factor of the kind discussed earlier. *See supra* notes 61–62 and accompanying text. Its CEO was employed under a contract with a unique and potentially very lucrative bonus arrangement, keyed to Green Tree's reported earnings, that expired at the end of Fiscal Year 1996. Weiss & Moser, *supra*, at 492–93; *see also Green Tree*, 270 F.3d at 661 (holding that Green Tree's bonus arrangement provided its CEO with the motive to misreport earnings).

66. Merle Erickson et al., *Why Do Audits Fail? Evidence from Lincoln Savings and Loan*, 38 J. ACCT. RES. 165, 168 (2000).

67. *Id.* at 191–92.

68. *Id.* at 192.

Turning to more recent events, consideration of relevant industry data might well have led auditors to question more vigorously how certain companies accounted for various transactions that have been much in the news. For example, had Global Crossing's or Qwest's auditors[69] been required to consider data on industry trends, they probably would have become aware of the growing glut in fiber optics cable capacity;[70] thus, they would have been better positioned to question whether it was appropriate for those companies to recognize current revenues from transactions in which they simply swapped excess cable capacity with other, similarly burdened, fiber optics companies.[71] In like fashion, had Arthur Andersen been required to consider relevant external data, it might have examined more closely Enron's claim that it realized a $110.9 million gain on its sale to a purportedly independent special purpose entity of its interest in a joint venture with Blockbuster Inc.—a venture that had only recently been created, had virtually no customers, and had not even negotiated arrangements with any of the major movie studios that were the only possible sources for the motion pictures that were to be the venture's principal product.[72]

Of course, requiring that registered accounting firms pay attention to a broader range of risk factors and consider relevant external data will not guarantee that those firms will ask the right questions about suspicious estimates and transactions.[73] To make it more likely that they will, a third step is required—one that clearly is

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69. *See* Dennis K. Berman, *House Panel Issues Subpoenas to Global, Qwest Executives*, WALL ST. J., Sept. 13, 2002, at B4 ("Both companies face myriad investigations into whether their swaps of hundreds of millions of dollars of telecom capacity were used to inflate revenue.").

70. *See* Henny Sender & Dennis K. Berman, *SEC Rules Against Capacity Swaps*, WALL ST. J., Aug. 21, 2002, at B3 (characterizing the telecommunications sector as an industry "grappling with a massive glut of capacity").

71. *See* Dennis K. Berman & Deborah Solomon, *Optical Illusion? Accounting Questions Swirl Around Pioneer in the Telecom World*, WALL ST. J., Feb. 13, 2002, at A1 (describing use of "swaps" by Global Crossing and Qwest); *Global Crossing Discussed Using Swaps with Qwest*, WALL ST. J., Sept. 24, 2002, at B3 (reporting on emails showing "that executives at both companies used the [swap] deals as a way of bolstering their revenue figures and making the companies' growth prospects look better than they actually were").

72. *See* Rebecca Smith, *Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand*, WALL ST. J., Jan. 17, 2002, at A1.

73. *See, e.g.*, In the Matter of Arthur Andersen LLP, Securities Exchange Release No. 44,444 (June 19, 2001) (describing how Arthur Andersen identified Waste Management, Inc. as a high risk audit client but then allowed Waste Management to continue to engage in accounting practices that Andersen knew were improper).

within the PCAOB's authority and should be within its capacity. Recall that Sarbanes-Oxley requires the PCAOB to conduct annual or triennial inspections of registered public accounting firms.[74] When it does, the Board, through its staff, should review whether each firm being inspected is complying with whatever new auditing standards the Board promulgates in these areas. As concerns situations where risk factors were present or where external data gave rise to suspicions about the validity of otherwise seemingly legitimate transactions or estimates, the Board should review whether the auditors questioned those transactions or estimates with appropriate vigor. The Board should not find it unduly burdensome to determine whether the appropriate inquiries were made; they can do so by examining the auditors' work papers, which should record all such inquiries if they were made.

The prospect of such inspections, in turn, is likely to lead to a reasonably high degree of auditor compliance with whatever new auditing standards the Board adopts. Registered accounting firms, their partners, and their employees will all be on notice of the possibility that the Board will review their work on any given audit—and of the even greater likelihood that the Board will focus its review on audits that, with the benefit of hindsight, appear problematic. The firms also will appreciate the possibility that disciplinary action will result if the Board finds that an audit was conducted negligently or recklessly. A decrease in earnings management and fraud and an increase in the accuracy of public companies' financial reports should result.

III. TRANSPARENCY

Even if accuracy improves and earnings management is reduced, issues relating to the transparency of public companies' financial reports will persist.[75] At the end of the day, accountants have no real choice but to accept accounting estimates and assumptions that the managers of audit clients insist are reasonable and for which those

74. Sarbanes-Oxley Act of 2002 § 104, 15 U.S.C.A. § 7214 (West Supp. 2003).

75. In a recent paper, Professors Healy and Palepu argue that a priority for corporate audit committees should be to "focus on the broader issue of transparency." Paul M. Healy & Krisha Palepu, *Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron* 39 (Harvard Business School, Negotiations, Organizations, and Markets Unit, Research Paper No. 02–27, 2002). It seems to me that public companies' auditors are better situated than their audit committees to understand and address transparency issues.

managers can offer cogent justifications. Moreover, this is as it should be; a company's managers, if acting honestly, will almost always be better positioned than its auditors to assess how potential future developments are likely to affect that company's business.

The transparency problem, in a nutshell, derives from the statement in the standard auditor's opinion that the reporting company's financial statements "present fairly . . . in conformity with generally accepted accounting principles" the company's financial position as of a given date and the results of its operations for a given period. That statement leaves a great deal unsaid. Even financially sophisticated readers of most companies' financial statements often find it somewhere between difficult and impossible to ascertain, first, what critical accounting estimates, assumptions, and judgments the reporting company's managers have made (and its auditors have accepted) and, second, how sensitive the company's reported results and financial position are to those estimates, assumptions, and judgments.[76]

Sarbanes-Oxley section 204 reflects an awareness of this issue through its requirement that every registered public accounting firm report to the audit committee of every audit client about the client company's "critical accounting policies and practices" and "all alternative treatments of financial information" it has discussed with that company's management.[77] But Sarbanes-Oxley does not require the audit committee to express publicly its opinion about the reasonableness of the choices management has made and, as is pointed out above, the SEC's efforts to require managers to do so in their companies' MD&A to date have borne very little fruit.[78]

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76. In Release No. 8040 the SEC states:

> Reported financial position and results often imply a degree of precision, continuity and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures. As a result, even a technically accurate application of generally accepted accounting principles ("GAAP") may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating status.

Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Securities Act Release No. 8404, Exchange Act Release No. 45,149, 66 Fed. Reg. 65,013 (Dec. 17, 2001).

77. 15 U.S.C.A. § 78j–1(k); *see also supra* note 37 and accompanying text.

78. *See supra* notes 19–20 and accompanying text (pointing out that even though the SEC has begun pressing public companies to disclose more about their critical accounting judgments, very few companies have responded satisfactorily to the SEC's efforts).

The PCAOB is well situated—perhaps more so than the SEC—to make a constructive contribution here. It could do so by amending GAAS to make two changes in the standard auditors' opinion. First, it could require the standard opinion to include the phrase "as explained in the attached statement" just before the "present fairly" statement. Second, it could require that the firm rendering that opinion also prepare what might be called a Presents Fairly Explanation (PFE). Therein, the audit firm would (1) identify what in its view are the most critical accounting judgments management had made, (2) describe the factors the auditors took into account when reviewing those judgments, and (3) discuss the sensitivity of the reporting company's balance sheet or income statement to those judgments.[79]

To illustrate, assume a situation in which a large portion of Bank's loans outstanding are mortgages on homes in the area in which Bank operates. Real estate prices in that area have recently begun to soften, the local economy is not growing, and delinquencies in mortgage payments have begun to inch up.[80] Bank's managers assert that Bank's allowance for bad debts should be 2 percent of loans outstanding, which is in line with Banks' experience for the past five years. The auditors point out that, in light of the developments noted above, a higher allowance might be appropriate, especially because each 0.5 percent increase in Bank's allowance for bad debts would reduce its reported earnings by 6 percent. Management responds that it does not believe any increase is necessary because, in anticipation of a likely economic downturn, Bank recently tightened its mortgage lending standards. Consequently, management does not believe any significant increase in defaults by Bank's borrowers is likely.

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79. The standard I have in mind would go well beyond Statement on Standards of Attestation Engagements No. 8 (SSAE No. 8), which sets forth the current obligations of an accountant retained to review a client company's MD&A. *See* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON STANDARDS OF ATTESTATION ENGAGEMENTS NO. 8; MANAGEMENT'S DISCUSSION AND ANALYSIS (1998). SSAE No. 8 largely limits the accountant's obligations to making sure that the client (a) has satisfied the minimum requirements set forth in SEC rules and (b) has computed correctly its comparison of year-to-year differences. *Id.* § 700.05. The requirement that the accountant also review management's estimates and assumptions adds little because those estimates and assumptions are likely to be identical to the estimates and assumptions the accountant reviewed when auditing the company's financial statements.

80. A situation similar to that allegedly involved in *Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992). *See id.* at 275–76.

In these circumstances, the auditors probably have no choice but to demur to the judgment of Bank's managers. However, if the auditors, in their professional judgment, identify Bank's allowance for bad debts as reflecting a critical accounting judgment likely to have a significant impact on Bank's financial statements, they then might include in their PFE a statement along the following lines:

> One critical accounting judgment made by Bank's management concerns the size of Bank's allowance for bad debts, which management has set at 2 percent of loans outstanding. Each 0.5 percent increase (or decrease) in that allowance would have caused Bank's reported earnings for the most recent year to decrease (or increase) by 6 percent. We have discussed with management the factors that, in our opinion, could make an increase in defaults on mortgage loan repayments more likely. Management has assured us that it has considered those factors and that, in light of Bank's lending policies, management believes the 2 percent allowance, which also is consistent with Bank's recent experience, is reasonable.[81]

It would be both reasonable and desirable for the PCAOB to require registered public accounting firms—which, after all, are comprised of professionals who possess a great deal of specialized expertise—to include PFEs in the reports they issue on public companies' financial statements. Such explanatory statements have the potential to enhance considerably investors' and other users' qualitative appreciation of the quantitative information included in financial statements.[82] Moreover, an effort by the PCAOB along these lines is more likely to succeed in promoting disclosure of meaningful explanatory information about financial statements than have the MD&A-related efforts of the SEC, because the PCAOB—through its periodic inspection of accounting firms and review of their work papers—will be in a better position than the SEC to determine what

81. The PCAOB could either provide auditing firms with a benchmark as to what constitutes a "critical accounting judgment" or could leave that determination to those firms' professional judgment. Were it to adopt the former approach, it might establish as a benchmark that a judgment presumptively is critical if reported income would increase or decrease by at least 5 percent were the judgment to vary by an amount that the auditors considered to be within the range of reasonable possibilities.

82. In a comment on this Article, Professor Jim Cox suggested that if large public accounting firms are genuinely concerned about the inherent limitations of the accounting process, as their recent public comments suggest, they might welcome a requirement that they explain those limitations in a PFE. Professor Jim Cox, Speech at the *Duke Law Journal*/ILEP Conference on Complex Litigation (Apr. 5, 2003).

accounting issues have been discussed by accounting firms with their audit clients and to make sure that they have also addressed the most important issues in their PFEs.[83]

However, the PCAOB also should recognize that registered accounting firms have legitimate grounds to be concerned that requiring them to prepare PFEs will increase dramatically their exposure to liability, especially when situations arise (as they inevitably will) in which an accounting firm fails to discuss in a PFE some important accounting judgment, assumption, or estimate an audit client made that later proves to be inaccurate.[84] The PCAOB might best respond to this concern by conditioning any requirement that auditors prepare PFEs on the adoption by the SEC of a rule that brings the PFE within the existing statutory safe harbor for forward-looking statements.[85]

CONCLUSION

After a rocky start, caused by a flawed appointment process, the PCAOB is now up and running. The SEC has approved its organizational structure[86] and has appointed a highly qualified person to serve as its permanent chairman.[87] The Board itself has begun hiring staff and, perhaps most importantly, has decided to assume the

83. Here, too, accounting firms' awareness that they will be inspected should lead to increased compliance. In addition, requiring accountants to prepare a PFE may give them welcome additional leverage in negotiating with clients about accounting estimates that they believe may be unsound. A public company that knows its accountants plan to discuss an issue in their PFE may be willing to modify estimates its accountants question if by doing so it can avoid having the accountants issue a PFE that makes those estimates the focus of investors' attention.

84. The danger here, as in other areas of securities law, is that the auditors will be vulnerable to charges of "fraud by hindsight." *See* Elliott J. Weiss, *Pleading Securities Fraud*, 64 LAW & CONTEMP. PROBS. 1, 6–7, 48–52 (Spring/Summer 2001) (discussing the ease with which a skilled plaintiffs' attorney, benefiting from hindsight, can frame a seemingly convincing charge of fraud).

85. *See* Securities Exchange Act of 1934 § 21E, 15 U.S.C. § 77u–5 (2000). Although one could argue that the statutory safe harbor does not include "a forward-looking statement . . . that is . . . included in a financial statement prepared in accordance with generally accepted accounting principles," *id.* § 21E(b)(2)(A), 15 U.S.C. § 77u–5(b)(2)(A), the PCAOB and the SEC might be able to finesse this issue by defining the PFE as a document that supplements, but is not "included in," the financial statement to which it relates.

86. See Deborah Solomon & Cassell Bryan-Low, *Questioning the Books: Accounting Board to Give Chairman Additional Power*, WALL ST. J., Apr. 28, 2003, at C7 (reporting that the SEC formally signed off on the PCAOB).

87. *See McDonough to Head*, WALL ST. J., May 22, 2003, at C9 (stating that the SEC approved the appointment of William McDonough to head the PCAOB).

responsibility, previously exercised by the AICPA, of establishing professional auditing standards.

Much remains to be done, and it no doubt will take considerable time before the PCAOB becomes a fully effective regulator of the firms that audit public companies' financial reports. However, Congress appears to have given the Board the powers it needs to do that job and created an organizational structure that will allow the Board to operate with considerable autonomy.[88] In this Article, I make some suggestions about how, once the PCAOB begins to consider new auditing standards, it might use its rulemaking authority to improve the integrity, accuracy, and transparency of the financial reporting process. Perhaps the Board will find them to be of interest.

88. *See* Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C.A. § 7211 (West Supp. 2003) (providing that the SEC, an independent regulatory agency, shall appoint the members of the Board); *id.* § 107, 15 U.S.C.A. § 7217 (charging the SEC with responsibility for overseeing the activities of the Board); *id.* § 109, 15 U.S.C.A. § 7219 (authorizing the Board to assess auditing firms and public companies annual fees to support the Board's activities).