

FACILITATING AUDITING'S NEW EARLY WARNING SYSTEM:  
CONTROL DISCLOSURE, AUDITOR LIABILITY AND SAFE HARBORS

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*Abstract*

*This Article considers the interplay between new auditing standards governing audits of internal control over financial reporting and pre-existing legal standards governing auditor liability for audit failure. The interplay produces skewed liability incentives that, if unadjusted, threaten to impair the objective of this new control-audit regime. The regime's objective is, in part, to provide an early warning to financial statement users when current financial statements are reliable but control weaknesses indicate material risk of a company's future inability to produce reliable financial statements. To be meaningful, auditor disclosure of material weaknesses and potential effects is necessary.*

*While liability rules under Section 11 of the Securities Act of 1933 will reinforce auditor incentives to provide this disclosure, liability rules under Section 10(b) of the Securities Exchange Act of 1934 will discourage auditors from providing disclosure because doing so likely makes them primary actors subject to liability rather than secondary actors not subject to liability. To address this skewed interplay between new auditing standards and pre-existing legal liability rules, the Article suggests developing a safe harbor system to protect from Section 10(b) liability auditor disclosure of forward-looking information necessary to give the early warning system meaning.*

*The Article gives a comprehensive account of new auditing standards, noting interpretive questions, and showing a system entirely dependent on extensive auditor disclosure. It then explains how the new system expressly nullifies existing case law under Section 11 by substantially expanding required auditor disclosure of internal control conclusions and how it probably nullifies existing case law under Section 10(b), including the Supreme Court's landmark 1994 case, *Central Bank*, that generally insulated auditors from Section 10(b) liability. These effects, remarkable on their own, pose limits on the early warning system's promise and the Article suggests using safe harbors to overcome them. The Article also offers broader but brief criticism of current preoccupation with control effectiveness as the key to reliable financial reporting evident in auditing's otherwise appealing new early warning system.*

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## INTRODUCTION

Traditional financial statement auditing begins with an auditor assessing a company's internal control environment—the processes used to promote reliability of a company's financial reporting. Relative control effectiveness dictates the scope of substantive testing auditors apply to financial statement assertions. Traditionally, auditing standards did not require auditors to disclose to financial statement users the details of their control assessment process or its effect on the scope of substantive testing they performed. As a matter of law, this meant that auditors faced no liability to financial statement users for failure to disclose control irregularities or those effects. It also meant, when giving an opinion on financial statement assertions, that auditors are secondary actors, not liable to financial statement users defrauded through materially misstated financial statements.

The wave of financial statement frauds of the late 1990s and early 2000s exposed shortcomings of this traditional approach to auditing and related auditor legal liability. Congress responded, in part, by creating a new auditing standard-setter, the Public Company Accounting Oversight Board (PCAOB), and directing it to redefine auditing practice to generate auditor disclosure concerning relative control effectiveness. Under new standards, auditors must perform an audit of internal control and provide opinions for financial statement users. As a matter of law, this means that auditors now face liability for failure to disclose certain control irregularities and their effects on the scope of the auditor's substantive testing. It also means, when giving such opinions on control, that auditors likely become primary actors, exposed to liability to financial statement users when their disclosure concerning control effectiveness is materially misstated.

The theory of this new regime is to provide financial statement users with an early warning system. Control irregularities impair a company's ability to provide reliable financial statements. Auditors may be able to overcome control irregularities by expanded substantive testing and conclude that current financial statements are fair. But those irregularities signal a company's potential inability to provide fair financial statements in the future. Requiring auditors to disclose current control irregularities, despite currently fair financial statements, is intended to provide information to financial statement users to enable them to gauge financial statement reliability rather than effectively entrusting this to auditor judgment. This innovative approach to enhanced transparency in the financial reporting process holds out promise to promote integrity of financial reporting.

As with many innovations in complex processes, however, auditing's new early warning system presents numerous challenges that must be met in order for it to achieve its objectives. This Article considers challenges arising from the interplay between the new early warning system and related legal standards governing auditor liability. It demonstrates that existing legal standards, when applied to this new system, will create skewed liability incentives for auditors when determining whether certain control irregularities should be disclosed. In particular, while Section 11 of the Securities Act of 1933 will encourage auditors to treat close questions as requiring disclosure and facilitate

the early warning system, Section 10(b) of the Securities Exchange Act of 1934 will encourage auditors to treat close questions as not requiring disclosure and impair the early warning system. Because Section 10(b) applies to a broader range of circumstances than Section 11 and carries fewer procedural limits, its effects will be stronger than Section 11's, producing legal incentives that will tend to impair the early warning system's promise.

To meet this challenge, the Article suggests developing safe harbors for auditor disclosure of early warnings concerning control effects on future financial statement reliability. An adjustment such as this seems necessary to relate existing legal doctrines to the new auditing standards in a way that will help the new standards achieve their objectives. The approach is defended, in part, by positioning it in the context of broader reforms recently undertaken that vest auditing standard-setting and auditor oversight in PCAOB rather than the auditing profession and that enhance auditor independence from management in the financial reporting process.

Part I provides a comprehensive account of auditing's new early warning system. It presents the framework for the new exercise of control audits, describes the triggers requiring auditors to disclose information concerning control effectiveness, and interprets new standards defining the content of this disclosure. Particular attention is called to a key distinction in this system between control irregularities constituting significant deficiencies, which auditors need not disclose, and those constituting material weaknesses, which auditors must disclose and explain. Special attention also focuses on disclosure content auditors must provide when facing material weaknesses, distinguishing between auditor explanation of the effect of weaknesses on the auditor's substantive testing of financial statement assertions and auditor explanation of the potential future effects of material weaknesses on financial statements.

Part II shows the interplay between these new auditing/disclosure standards and pre-existing legal standards governing related auditor liability. It explains that the new auditing standards expressly nullify case law under Section 11 that formerly shielded auditors from liability for failure to disclose material weaknesses or their consequences. The combined effect of the new auditing standards and existing Section 11 jurisprudence is to encourage auditor disclosure, including erring in characterizing uncertain control irregularities as material weaknesses rather than significant deficiencies, and providing related disclosure.

It then considers how the new auditing standards nullify case law under Section 10(b) that distinguishes between primary actors who face liability and secondary actors who do not. Auditors providing disclosure under the new auditing standards likely become primary rather than secondary actors, while those not providing such disclosure remain secondary actors. The combined effect of the new auditing standards and this Section 10(b) jurisprudence is to discourage auditor disclosure, including erring in characterizing uncertain control irregularities as significant deficiencies rather than material weaknesses, thereby avoiding disclosure.

This Part concludes by explaining how using safe harbors for auditor disclosure concerning the potential effects of material weaknesses on future financial statements is probably necessary to achieve the early warning system’s objectives. Safe harbors will encourage auditors to err on the side of characterizing uncertain control irregularities as material weaknesses and provide detailed disclosure to explain the particular significance of discrete material weaknesses rather than treat them as significant deficiencies permitting non-disclosure and carrying limited liability risks.

Part III adopts a broader perspective on auditing’s new early warning system. While applauding the system’s goals and main features, it expresses concern that the system shows a misguided preoccupation with internal control as the key to producing reliable financial reporting. It illustrates numerous contexts where control can be effective but financial misstatements still occur. The early warning system may be useful to warn of future financial misstatements due to weak control, but the new auditing standards pay insufficient attention to—and even affirmatively obscure—the possibility that effective control may not be adequate to assure reliability of financial reporting. In addition to the new auditing standards creating need for certain legal adjustments, therefore, the new auditing standards themselves require additional explanation and elaboration in order to develop a coherent and comprehensible system of auditing concerning both control and financial statements.

## I. PCAOB’S EARLY WARNING SYSTEM

The Sarbanes-Oxley Act (SOX) requires a company’s management to assess the effectiveness of its internal control over financial reporting<sup>1</sup> and publicly disclose their conclusions.<sup>2</sup> In turn, SOX requires auditors to attest to managerial assertions and report their conclusions publicly as well.<sup>3</sup> SOX directs the Public Company Accounting

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<sup>1</sup> For convenience, the phrase “internal control over financial reporting” is often abbreviated in this Article as control. The clunky phrase emerged during SEC regulatory development as a way to distinguish this type of control from a wide variety of internal controls corporations use to achieve various purposes. Closely related to internal control over financial reporting (in this technical sense) are controls the SEC dubs “disclosure controls and procedures.” The term is intended to define a somewhat overlapping variety of mechanisms that may be beyond the scope of an auditor’s testing, evaluation and opinion. *See* SECURITIES AND EXCHANGE COMMISSION, MANAGEMENT’S REPORTS ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND CERTIFICATION IN EXCHANGE ACT PERIODIC REPORTS, RELEASE NO. 33-8238 (June 5, 2003) [hereinafter SEC, MANAGEMENT REPORTS ON CONTROL].

<sup>2</sup> Sarbanes-Oxley Act of 2002, § 404(a), Pub. L. No. 107-204, 116 Stat. at \_\_\_\_ ; 15 U.S.C. \_\_\_\_; *see* SEC, MANAGEMENT REPORTS ON CONTROL, *supra* note 1.

<sup>3</sup> Sarbanes-Oxley Act of 2002, § 404(b), Pub. L. No. 107-204, 116 Stat. at \_\_\_\_ ; 15 U.S.C. \_\_\_\_.

Oversight Board (PCAOB) to establish auditing standards for this exercise.<sup>4</sup> PCAOB does so in Auditing Standard No. 2.<sup>5</sup>

### A. Framework

In promulgating Auditing Standard No. 2, PCAOB made several major decisions reflecting an ambitious vision for its new audit system for internal control over financial reporting. They add up to this: the auditor's engagement is a full-fledged *audit* of control, requiring the auditor's *opinion specifically on control* effectiveness, with any material weakness *compelling* the auditor to issue an *adverse* opinion.<sup>6</sup>

This model's strength is seen by comparing its alternative, which PCAOB rejected: the engagement could have been a *review* of control, calling for the auditor's *opinion only on managerial assertions* concerning control effectiveness, with material weaknesses calling for the auditor to determine whether to issue an adverse opinion or various forms of *qualified opinions*. The following explains each choice, showing that Auditing Standard No. 2 is strong brew, not weak tea.

1. *Audit of Control* — Auditing Standard No. 2 denominates the auditing engagement concerning control as an *audit*, not merely a review or other limited exercise. PCAOB solicited public comment as to whether the engagement should be denominates as an audit. Numerous commentators opined that it would be more accurate to describe it as an attestation exercise, suggesting lower levels of work and assurance.<sup>7</sup>

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<sup>4</sup> *Id.*, § 103(a)(2)(A) (calling for auditor opinion on control effectiveness) & § 404(b) (calling for auditor opinion on management's assertions concerning control effectiveness).

<sup>5</sup> PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (March 9, 2004) [hereinafter AUDITING STANDARD NO. 2]. [Note: This is subject to SEC approval, expected easily given SEC's substantial role in the preparation process.]

<sup>6</sup> AUDITING STANDARD NO. 2, ¶¶ 59 & 140. Auditing Standard No. 2's definition of material weakness is excerpted in footnote 15 below.

<sup>7</sup> *E.g.*, *Comment Letters to PCAOB from Prof. McAllister* (PCAOB Rulemaking Docket No. 8, Letter No. 36) (describing using audit designation as potentially problematic and confusing); *Arnall Golden Gregory* (PCAOB Rulemaking Docket No. 8, Letter No. 57) (review of internal control concerns risk of future financial misstatements, entailing lower level of assurance compared to financial statement audit); *Texas Society of Certified Public Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 78) (audit involves testing whereas an attestation involves review); *Fédération des Experts Comptables Européens* (PCAOB Rulemaking Docket No. 8, Letter No. 79) (noting inconsistency with international standards that distinguish between assurance and audit); *Institute of*

PCAOB opined that the concepts of audit and attestation describe engagements of equivalent scope. Despite acknowledging that many treat the concepts as involving different levels of work and assurance, PCAOB emphasized the technical equivalence of the exercises.<sup>8</sup> Even so, PCAOB defended its choice to call the engagement an audit on the grounds that attestation is insufficient to describe the elaborate exercise Auditing Standard No. 2 prescribes.<sup>9</sup>

2. *Direct Opinion on Control* — Auditing Standard No. 2 requires auditors to deliver two control-related opinions: one opinion on management’s assertions concerning control effectiveness and a separate opinion on the auditor’s own assessment of whether a company maintained effective internal control over financial reporting.<sup>10</sup> The separate

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*Chartered Accountants in England and Wales* (PCAOB Rulemaking Docket No. 8, Letter No. 102) (opining that SOX Section 404(b) refers to an attestation or report so denominating it an audit goes beyond mandate and “substantially alter[s] the risk profile of the audit profession”); *Cummins* (PCAOB Rulemaking Docket No. 8, Letter No. 123) (“intent should be to validate the adequacy of management’s process and not to re-perform the assessment.”); *Caterpillar Corp.* (PCAOB Rulemaking Docket No. 8, Letter No. 143) (contending that denominating the exercise as an audit exceeds SOX’s mandate).

Other commentators supported denominating the exercise as an audit, including the AICPA, the Big Four auditing firms, and the mid-sized auditing firms. *See Comment Letters to PCAOB from American Institute of Certified Public Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 105); *Deloitte & Touche LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 71); *Ernst & Young LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 144); *KPMG LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 91); *PriceWaterhouseCoopers LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 82); *BDO Seidman, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 136); *Grant Thornton LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 101); *McGladrey & Pullen, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 142).

<sup>8</sup> AUDITING STANDARD NO. 2, ¶ 18 (“There is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management’s assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting”); *see also* PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 7 (it is “erroneous” to distinguish between attestation and audit; both require same level of work).

<sup>9</sup> PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 6. Even PCAOB, therefore, implicitly recognized some differences in the engagements described as audit versus attestation and clearly emphasizes that the new regime involves a complete rather than partial evaluation.

<sup>10</sup> AUDITING STANDARD NO. 2, ¶ 167. The two opinions can be presented in a single report or in separate reports. *Id.*

opinion on control involves auditors more directly in the disclosure process. That is, if their opinion concerned only management's assertions, auditors could concur or dissent, forcing all detailed disclosure obligations on management. By requiring a separate direct opinion, auditors cannot hide behind management's statements. They must furnish their own disclosure.

PCAOB made this decision based on comments received on its proposed standard. It asked whether the audit report should speak directly to control rather than merely to management's assertions.<sup>11</sup> Its original model proposed an auditor opinion on management's assertions when this was unqualified and an opinion directly on control otherwise. Auditing Standard No. 2 adopts instead the two-opinion approach, which PCAOB explained was necessary to provide greater clarity of disclosure to investors and avoid confusion.<sup>12</sup> PCAOB also opined that this approach is more consistent with SOX Section 404, calling for an opinion on management's assertions, and SOX Section 103, calling for an auditor opinion on control.<sup>13</sup>

The result is that auditors now provide a total of three opinions: one opinion on the financial statements and two opinions concerning control.<sup>14</sup> The three-opinion arrangement poses the possibility of many different combinations of opinions. These include the polar cases of unqualified opinions on all and adverse opinions on all as well

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<sup>11</sup> PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), A PROPOSED STANDARD CONCERNING AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (Oct. 2003) [hereinafter PCAOB, PROPOSED STANDARD], Question. 27.

<sup>12</sup> See AUDITING STANDARD NO. 2, App. E, ¶¶ E27-E28 (approach makes reports easier for users to understand); PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 22-23 (control opinions on management's assessment and on control effectiveness "most clearly communicate[s] to readers the nature and results of the work).

<sup>13</sup> See PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 22-23 (requiring auditor opinions on management's control assessment and on control effectiveness most closely tracks requirements of SOX Sections 103 and 404). The argument runs as follows: SOX Section 404 requires management assessment of control with an auditor attestation; Section 103 directs PCAOB to adopt standards requiring auditors to report on management's Section 404 assertions *and* to present their findings and evaluation of controls.

<sup>14</sup> PCAOB's multiple-opinion decision appears inspired, at least in part, by a comment letter from the German auditing profession. See *Comment Letter to PCAOB from Institut der Wirtschaftsprüfer* (PCAOB Rulemaking Docket No. 8, Letter No. 63) (opining that SOX requires three opinions: on the financial statements, on management's control assessment, and on control directly).



as any combination of adverse or qualified opinions, plus opinions bearing scope limitations or accompanied by disclaimers of opinion.

3. *No Qualified Control Opinion Option* — The key concept in evaluating the effectiveness of internal control over financial reporting is material weakness. PCAOB defines this as control deficiencies resulting in more-than-a-remote likelihood of material misstatements in financial reports.<sup>15</sup> Under Auditing Standard No. 2, the presence of a material weakness requires auditors to deliver an adverse control opinion, without the option of providing a qualified (“except for”) opinion.<sup>16</sup> In traditional financial-statement auditing, “except for” opinions are used to convey an intermediate level of assurance.<sup>17</sup>

Concerning the new control auditing system, an interpretive issue in the financial reporting community appeared to be whether management’s assessments of internal control effectiveness must be adverse when controls are ineffective in any way or whether management could give a qualified assessment—that control is effective “except for” designated disclosed areas. SEC regulations prescribing requirements for management’s assertions about control effectiveness prohibit management from

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<sup>15</sup> Auditing Standard No. 2 defines material weakness as follows:

*A material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

AUDITING STANDARD NO. 2, ¶ 10. In turn, Auditing Standard No. 2 defines significant deficiency as follows:

*A significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.

AUDITING STANDARD NO. 2, ¶ 9.

<sup>16</sup> AUDITING STANDARD NO. 2, ¶ 173(b) & 175.

<sup>17</sup> See VINCENT M. O’REILLY, ET AL., MONTGOMERY’S AUDITING (12<sup>th</sup> ed. 1998), at 28-23

concluding control is effective when a material weakness exists.<sup>18</sup> Some interpreted this to permit management to give a qualified opinion.<sup>19</sup>

PCAOB rejected this interpretation and requires the audit model to follow suit.<sup>20</sup> Accordingly, when a material weakness is identified, auditors must give an adverse

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<sup>18</sup> See SEC, MANAGEMENT REPORTS ON CONTROL, *supra* note 1.

<sup>19</sup> Most commentators on PCAOB's proposed standard opined that its control-audit model should follow the SEC's model for management's control-assessment. Commentators split in interpreting the SEC's management model. The SEC directs that identified material weaknesses prevent management from concluding that control is effective. The issue was whether this meant management could offer a qualified opinion. Support for this view appeared in the SEC's approving citation to AT 501, which permits qualified opinions. See SEC, MANAGEMENT REPORTS ON CONTROL, *supra* note 1, at Part II.B.3, n. 72 (approvingly citing AT § 501, ¶ 37). *E.g.*, *Comment Letters to PCAOB from Association of the Bar of the City of New York* (PCAOB Rulemaking Docket No. 8, Letter No. 68) (recommending that management should disclose nature of weaknesses and corrective actions taken but that auditor should use judgment concerning what opinion to give); *National State Auditors Association* (PCAOB Rulemaking Docket No. 8, Letter No. 113) (agreeing that audit model should follow management model and concluding that since management cannot give qualified conclusions nor can auditor provide qualified opinions); *American Society of Corporate Secretaries, PCAOB Subcommittee of the ASCS Securities Law Committee* (PCAOB Rulemaking Docket No. 8, Letter No. 106) (recommending allowing auditor to use professional judgment as to whether control opinion should be qualified rather than adverse based on materiality of weakness and any scope limitations); *American Bar Association, Section of Business Law* (PCAOB Rulemaking Docket No. 8, Letter No. 185) (qualified opinion "can be useful to convey information to stockholders that would otherwise not be conveyed by a blanket adverse opinion").

The Big Four and mid-sized accounting firms offered split opinions. Opponents of mandatory adverse opinions were Deloitte & Touche, PriceWaterhouseCoopers, Ernst & Young, BDO Seidman and McGladrey & Pullen. See *Comment Letters to PCAOB from Deloitte & Touche LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 71); *Ernst & Young LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 144); *PriceWaterhouseCoopers LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 82); *BDO Seidman, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 136); *McGladrey & Pullen, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 142). Supporting mandatory adverse opinions were KPMG and Grant Thornton. See *Comment Letters to PCOAB from KPMG LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 91); *Grant Thornton LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 101). Some others supported the mandatory adverse opinion as well. *E.g.*, *American Accounting Association* (PCAOB Rulemaking Docket No. 8, Letter No. 31); *National State Auditors Association* (PCAOB Rulemaking Docket No. 8, Letter No. 113).

opinion on control effectiveness.<sup>21</sup> Auditing Standard No. 2 thus departs from traditional financial-statement auditing conventions by prohibiting the intermediate level of assurance signaled by “except for” opinions.<sup>22</sup>

The effect of PCAOB’s framework in Auditing Standard No. 2—requiring full control audits with direct control opinions and without the except-for option—is to render auditors as detectors of control weaknesses in the fullest possible way. This ambitious and rigid framework is designed to generate warnings to financial statement users concerning the reliability of financial statements prepared at companies possessing “leaky” internal control over financial reporting. This early warning system is at the heart of Auditing Standard No. 2, which contains specific triggers requiring auditors to provide such warnings.

### *B. Triggers*

Auditing Standard No. 2 states: “[i]nformation on internal control over financial reporting is intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements . . . .”<sup>23</sup> Those outside the company include investors as well as all gatekeepers.<sup>24</sup> The pressure arises because the early warning system is a signal concerning risks of unreliability of a company’s financial statements, both current and future.

1. *Reports Requiring Auditor Disclosure* — When auditors concur with management’s assessment that control is effective and opine separately that the company maintained effective control, Auditing Standard No. 2 does not specifically require

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<sup>20</sup> See AUDITING STANDARD NO. 2, App. E, ¶¶ E108-E114 (noting that PCAOB’s rejection of this interpretation is based on conversations with SEC staff concerning its interpretation of SEC regulations governing management’s conclusions).

<sup>21</sup> See AUDITING STANDARD NO. 2, App. E, ¶¶ E108-E114. An exception applies for circumstances where an overall opinion cannot be expressed due to scope limitations, but then Auditing Standard No. 2 requires the auditor to explain why. PCAOB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 22 (citing SEC Regulation S-X, Item 2-02(f), that if auditor cannot provide overall attestation opinion, auditor must explain why).

<sup>22</sup> *E.g.*, O’REILLY, MONTGOMERY’S AUDITING, *supra* note 17, at 28-23.

<sup>23</sup> AUDITING STANDARD NO. 2, ¶ 6.

<sup>24</sup> Gatekeepers are “securities professionals,” defined as “accountants, public accounting firms, investment bankers, investment advisors, brokers, dealers, attorneys, and other securities professionals.” Sarbanes-Oxley Act of 2002, § 703, Pub. L. No. 107-204, 116 Stat. at \_\_\_ ; 15 U.S.C. § 7201.

auditors to provide any additional description.<sup>25</sup> However, Auditing Standard No. 2 specifically requires auditors to issue modified reports containing tailored disclosure in numerous circumstances, including the following.

First, auditors must issue an adverse report on control when a material weakness is identified. Audit reports must state PCAOB's definition of the concept of material weakness (essentially a more-than-remote risk of material financial misstatements)<sup>26</sup> and identify its existence. More importantly, the auditor's report must describe the material weakness to provide the report's users "specific information about [its] nature" and "its actual *or potential* effect on the presentation of the company's financial statements issued during [its] existence . . . ."<sup>27</sup>

Second, auditors must issue modified reports when "management's assessment is inadequate."<sup>28</sup> In such cases, auditors must indicate a scope limitation on their report, indicating lack of adequate review.<sup>29</sup> In addition, auditors must issue modified reports when "management's report is inappropriate."<sup>30</sup> In these cases, auditors must "include, at a minimum, an explanatory paragraph describing the reasons for this conclusion."<sup>31</sup>

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<sup>25</sup> AUDITING STANDARD NO. 2, at A-92, Example A-1.

<sup>26</sup> Auditing Standard No. 2's definition of material weakness is excerpted in footnote 15 above.

<sup>27</sup> AUDITING STANDARD NO. 2, ¶ 176 (emphasis added). This description is also to address requirements described in AUDITING STANDARD NO. 2, ¶ 194, noted in the ensuing text. The standard nods at the ridiculous in the following additional requirement: if management makes an adverse assessment of its internal control over financial reporting (and, implicitly, the auditor concurs), then auditors would provide an unqualified opinion as to management's assessment. *Id.*, ¶ 176. Absent some additional auditor role, when management says its company did not maintain effective internal control over financial reporting, users do not need an auditor to attest to this assertion. Including this requirement only makes sense if the auditor is directly charged with explaining the weakness and providing detailed descriptions as to its actual and potential effect on the financial statements. This appears to be PCAOB's intention. *See infra* Part I.C.

<sup>28</sup> AUDITING STANDARD NO. 2, ¶ 173(a).

<sup>29</sup> *Id.*, ¶ 174.

<sup>30</sup> *Id.*, ¶ 173(a).

<sup>31</sup> AUDITING STANDARD NO. 2, ¶ 174. If there is material weakness, management may not conclude control is effective and must disclose all material weaknesses. Although management's report can take many forms, it must "state a direct conclusion about whether the company's [control] is effective." *Id.*, ¶ 163. An auditor's evaluation of

Third, modifications to auditors' control reports are necessary when material weaknesses exist that nevertheless do not prevent giving an unqualified opinion on financial statements.<sup>32</sup> A control opinion "might describe a material weakness . . . while the audit report on the financial statements remains unqualified."<sup>33</sup> If so, control reports are to include, in the paragraph describing material weaknesses, language to the effect that the auditor considered the material weakness in planning substantive audit tests of financial statement assertions and that the adverse control report did not affect the financial statement audit report.<sup>34</sup>

Auditing Standard No. 2 explains: "such disclosure is important to ensure that users of the auditor's report on the financial statements understand why the auditor issued an unqualified opinion on those statements."<sup>35</sup> In addition: "Disclosure is also important when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting."<sup>36</sup> In this case, Auditing Standard No. 2 directs that the auditor's control report include similar language but without the statement that it did not affect the financial statement audit report.<sup>37</sup>

These triggers requiring auditors to provide disclosure concerning internal control effectiveness reflect the theory that effective internal control is an important element in assuring reliable financial statements. Control weaknesses threaten a company's ability to produce reliable financial statements. Investors need to know this, even when a company's current financial statements are deemed reliable. The auditor's audit and opinion, including automatic adverse opinions when material weaknesses exist, are designed to communicate warnings to financial statement users.<sup>38</sup>

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management's report must include an assessment of whether it properly discloses material weaknesses (including those corrected during the period covered). *Id.*, ¶ 166.

<sup>32</sup> AUDITING STANDARD NO. 2, ¶ 193.

<sup>33</sup> *Id.*, ¶ 194.

<sup>34</sup> *Id.*, ¶ 195.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*, ¶ 196.

<sup>37</sup> *Id.*

<sup>38</sup> Several other circumstances also require modified opinions that communicate warnings to financial statement users. Auditors must issue a modified report to disclose any restriction on the engagement's scope. AUDITING STANDARD NO. 2, ¶ 176(c). In this case, auditors can only give unqualified opinions on management's assessment and on internal control over financial reporting if they were able to apply all necessary procedures. *Id.*, ¶ 178. Otherwise, auditors should withdraw from the engagement, disclaim giving any opinion, or provide a qualified opinion. The choice depends on the

2. *Incongruent Opinions* — The salient early warning occurs when an auditor issues an adverse opinion on control effectiveness while providing an unqualified opinion that the financial statements fairly present results and condition in conformity with GAAP.<sup>39</sup> This seeming incongruity is possible because a material weakness discovered in control can be overcome in a financial statement audit by substantive tests that do not rely upon the controls bearing the material weakness.

The key effect of such incongruent opinions as the central element of PCOAB's new early warning system is to enhance transparency of the interior processes of financial reporting, control and audit. This central role is reflected in PCAOB's response to public comment it sought as to whether there are "circumstances where a qualified 'except for' conclusion [in a control audit] would be appropriate" as an alternative to expressing an adverse control-audit opinion when a material weakness exists.<sup>40</sup> Commentators suggested numerous possible circumstances.

The most common suggestion was to permit qualified opinions when a material weakness in control did not prevent giving an unqualified opinion on the financial statements.<sup>41</sup> Some commentators recommended that this should be the case at least

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importance of omitted procedures, but if restrictions are management-imposed then either withdrawing or disclaiming both opinions is required. For example, suppose management found weaknesses and corrected them in a way it believes rendered control effective, but the auditor disagrees that enough time has elapsed to be confident. This would warrant a scope limitation. *Id.*, ¶ 179. If, in this context, the auditor's partial procedures identified a material weakness, then the auditor must provide disclosure along the lines discussed in the foregoing text.

Auditors also must issue modified reports when management includes certain disclosure in its report in addition to its conclusions on whether control is effective. AUDITING STANDARD NO. 2, ¶ 176(f). Examples include information concerning corrective actions, plans to implement new controls, and cost-benefit decisions not to do so. *Id.*, ¶ 190. In this case, auditors must disclaim giving an opinion on the additional information, *id.*, ¶ 191, and, if it contains material misstatements of fact, discuss this with management, possibly report it to the company's audit committee, and perhaps even consult its own counsel concerning further obligations the auditor may have under Section 10A of the Securities Exchange Act. *Id.*, ¶ 192. Auditing Standard No. 2 notes that if management includes such information elsewhere in its securities filing, then no disclaimer is required though the same steps apply. *Id.*

<sup>39</sup> AUDITING STANDARD NO. 2, ¶¶ 193-196.

<sup>40</sup> PCAOB RELEASE ACCOMPANYING THE PROPOSED STANDARD, Question 26.

<sup>41</sup> *E.g.*, *Comment Letters to PCAOB from Credit Suisse* (PCAOB Rulemaking Docket No. 8, Letter No. 74) (excerpt-for opinion "especially in the absence of material misstatements to the financial statements."); *Southern Union* (PCAOB Rulemaking

absent errors or irregularities in the financial statements and the material weakness in control was otherwise isolated.<sup>42</sup> PCAOB rejected these suggestions on the theory that control audits are designed to provide assurance of system capacity to prevent future financial misstatements. An exception for circumstances where current financial statements are unaffected would diminish the utility of the device as an early warning system.<sup>43</sup>

3. *Material Weaknesses* —The key concept in evaluating control effectiveness, material weakness, is closely related to the concept of significant deficiency.<sup>44</sup> Material weakness in control is a particularly severe form of significant deficiency. At bottom, the difference concerns gravity: significant deficiencies pose *consequential* risks for financial statement reliability while material weaknesses pose *material* risks. The characterization has significant implications: auditors must disclose and explain material weaknesses publicly, but need only bring significant deficiencies to the attention of management and audit committees.<sup>45</sup>

Distinguishing significant deficiencies from material weaknesses requires judgment. Whether a significant deficiency amounts to a material weakness depends on the possibility that a financial misstatement could result (not on whether it has—this is

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Docket No. 8, Letter No. 98) (adverse opinion only if material weakness “could impact financials”).

<sup>42</sup> *E.g.*, *Comment Letter to PCAOB from Arnall Golden Gregory* (PCAOB Rulemaking Docket No. 8, Letter No. 57) (suggesting allowing qualified opinions when material weakness is isolated and “no errors or irregularities” appear in the financial statements).

<sup>43</sup> In fact, PCOAB’s rejection of these comments suggest either material weakness in control always prevents giving an unqualified financial statement opinion in future periods or that investors rather than auditors should judge the risk of this eventuality. That is, Auditing Standard No. 2 designs an early warning system intended to empower “those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting.” AUDITING STANDARD NO. 2, ¶ 6. *See infra* Part III.

<sup>44</sup> Auditing Standard No. 2’s definitions of material weakness and significant deficiency are provided above in footnote 15.

<sup>45</sup> *Compare* AUDITING STANDARD NO. 2, ¶¶ 207-214 (required communications to management, audit committees and boards of directors include all significant deficiencies and material weaknesses) *with* AUDITING STANDARD NO. 2, ¶¶ 173(a) & 175-177 (required modifications to audit reports when there is a material weakness).

the essence of the early warning system).<sup>46</sup> This depends on both the likelihood and magnitude, measured using various factors.<sup>47</sup>

Auditing Standard No. 2 defines material weakness using general terms. This breadth captures a wide range of circumstances. These run from inadequate articulation of company policy to noncompliance with it. A material weakness can be a serious infection at a single business segment or involve a single significant account company-wide. Weaknesses can result from changes in applicable GAAP or associated accounting policies or from acquisitions of companies that, in turn, suffered from weak internal control over financial reporting.<sup>48</sup>

Furthermore, a company can be in various stages of addressing any material weakness. Discovery can arise from a variety of sources, including through internal audit or during an external audit. Curative steps may operate effectively within a short period of time (say dismissing a rogue noncompliant employee) or may take multiple accounting periods (retraining the entire finance or accounting department in proper accounting or control).

Auditing Standard No. 2 thus contemplates a wide variety of circumstances requiring auditors to provide explanatory paragraphs in reports. While PCAOB suggests disclosure parameters and provides some specific disclosure requirements, its specific prescriptions include ambiguities and its general directives are deliberately left open-ended as to exactly what disclosure auditors must provide in various circumstances as warnings to financial statement users.

### C. Content

Required auditor disclosure can usefully be divided into two categories. The first concerns the level of detail auditors must provide to explain their conclusions. This chiefly relates to the auditor's explanations concerning identified material weaknesses and their effects on financial statements, as well as why they regard management assertions as inadequate or inappropriate. The second concerns the scope of disclosure auditors must provide to explain the effect of their conclusions on their overall work.

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<sup>46</sup> AUDITING STANDARD NO. 2, ¶ 132 (“The significance of a deficiency in [control] depends on the *potential* for a misstatement, not on whether a misstatement actually has occurred.”).

<sup>47</sup> See AUDITING STANDARD NO. 2, ¶ 133 (illustrating factors affecting the likelihood that a deficiency “could result in a misstatement”); *id.*, ¶ 134 (illustrating factors affecting magnitude).

<sup>48</sup> Auditing Standard No. 2 expressly recognizes a scope limitation when material weaknesses arise from year-end acquisitions. This scope limitation is also available generally for limitations beyond management control. See *supra* note 38.



This chiefly relates to how discovered control deficiencies or weaknesses influenced the scope of the auditor’s substantive testing in performing its financial statement audit.

1. *Auditor Conclusions* — Auditing Standard No. 2 makes clear what auditors must do when facing material weaknesses. They must give an adverse opinion on control, identify the weakness and provide Auditing Standard No. 2’s definition of the concept. It is somewhat less clear concerning exactly what auditors must explain about the consequences of material weaknesses in particular cases.

Auditing Standard No. 2 expressly requires auditors to disclose “specific information about the nature of any material weakness, and its actual *or potential* effect on the presentation of the company’s financial statements issued during the existence of the weakness.”<sup>49</sup> This is an extraordinary statement, requiring auditors to provide forward-looking information concerning potential effects of control weaknesses on future financial statements.

On the other hand, PCAOB provides seemingly different prescriptions in forms of auditor opinions accompanying Auditing Standard No. 2. In giving an adverse opinion on control effectiveness, these forms of opinion direct auditors to “[i]nclude a description of the material weakness and its effect on the achievement of the objectives of the control criteria.”<sup>50</sup> The auditor’s conclusion is to state that “because of the effect of the material weakness . . . on the achievement of the objectives of the control criteria, [the company] has not maintained effective internal control over financial reporting. . . .”<sup>51</sup>

It is possible to reconcile these seemingly different propositions of disclosure concerning actual or potential financial statement effects on the one hand and disclosure concerning effects on achieving control objectives on the other. Control criteria objectives relate ultimately to effects on financial statements. When Auditing Standard No. 2 directs that auditors disclose specific information concerning actual or potential effects of control weaknesses on financial statements, this can be seen as the equivalent of requiring description of the weakness’ effects on control objectives.

While this reconciliation seems reasonable, the two different prescriptions create an ambiguity. Clarifying it will require auditors to provide detailed disclosure as to how

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<sup>49</sup> AUDITING STANDARD NO. 2, ¶ 176 (emphasis added). This description is also to address requirements described in Auditing Standard No. 2, ¶ 194, noted above.

<sup>50</sup> AUDITING STANDARD NO. 2, at A-96, Example A-2.

<sup>51</sup> *Id.* PCAOB’s examples further instruct auditors to state that this weakness was considered in planning the financial statement audit and to state whether it affected the resulting financial statement opinion, and when it does, PCAOB’s examples direct attention to the requirements of AUDITING STANDARD NO. 2, ¶ 194-196, discussed above in Part I.B.1.

the two propositions relate to each other. Summary or boilerplate statements will not provide requisite information to financial statement users.

In addition to this ambiguity that should compel auditors to disclose significant detail, PCAOB's general framework for Auditing Standard No. 2 seems to contemplate extensive auditor disclosure. Detailed auditor disclosure is implied by denominating the exercise an audit, requiring auditor opinions directly on control and, most importantly, mandating adverse opinions when facing material weaknesses.

First, though PCAOB denies any particular significance to denominating Auditing Standard No. 2's control exercise as an audit rather than an attestation, a subtle but important consequence of the audit conception is to designate an exercise of equivalent significance to the financial statement audit. This gives control equal stature with financial statements. Experience with traditional financial statement auditing suggests that making this audit exercise understandable to investors will require education by elaborate disclosure.<sup>52</sup>

Second, requiring separate auditor opinions on control effectiveness creates need for greater disclosure. This is particularly so given the possibility of multiple combinations of the three audit opinions. To avoid investor confusion, auditors will have to provide substantial explanatory disclosure. This would certainly be the case when different sorts of opinions are given, whenever an adverse or other non-standard opinion is given, and even when opinions are unqualified. Otherwise, investors will be misled concerning the relationship between effective internal control and reliable financial statements.<sup>53</sup>

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<sup>52</sup> To take a single, striking, example, between 1932 and 1934, the American Institute of Accounts (successor to the American Association of Public Accountants founded in 1887 and predecessor to the AICPA founded in 1957) engaged in wide-ranging discussion with the New York Stock Exchange (NYSE) concerning the auditing profession's responsibilities. Discussion considered whether a disclaimer in the standard audit report stating that auditors do not perform a comprehensive examination would help the public understand the nature of the audit process; the general consensus was that such a statement probably would not mean much. *See* GARY JOHN PREVITS & BARBARA DUBIS MERINO, *A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING* (1998). By the late 1980s, this consensus changed. Studies indicated widespread public misapprehension about auditing. As a result, the standard audit report was changed effective in 1989, adding specific sentences to clarify that financial statement audits involve examination, on a test basis, and that financial statements are prepared by and are the responsibility of management. *See* LAWRENCE A. CUNNINGHAM, *INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS* (4th ed. 2004).

<sup>53</sup> This point is elaborated more fully in Part III.

Third, mandatory adverse opinions when facing material weaknesses deprive auditors of a standardized signal indicating gradations in severity. Permitting qualified opinions with accompanying explanation is the general approach to financial statement audits. In the case of control audits, PCAOB could have defined in Auditing Standard No. 2 a separate category for material weaknesses that are not pervasive and prescribed issuing qualified opinions in these circumstances. Absent a qualified-opinion option, however, the communication otherwise signaled must be provided by narrative.<sup>54</sup>

In traditional financial statement audits, adverse opinions are a significant penalty.<sup>55</sup> Taken at face value, adverse control opinions could pose consequences disproportionate to the significance of any given material weakness. At the extreme, it could shut off a company's access to capital. Of course, some material weaknesses justify exactly that. To the extent that this result is unjustified in a particular case, it indicates need for detailed specificity in accompanying auditor disclosure.

Adverse opinions that reasonable investors would understand to justify a severe reaction (such as withholding capital investment) would be misleading without specific detail indicating that the defects are not pervasive.<sup>56</sup> Some commentators opining on PCAOB's proposed standard opposed permitting qualified opinions on the grounds that allowing them would require auditors to evaluate the severity of material weakness, leading to more classifications.<sup>57</sup> This result is exactly what Auditing Standard No. 2 contemplates, with the classifications defined by particular auditor disclosure not abstract categories.

Detailed disclosure is likewise necessary to avoid otherwise dilutive effects that mandatory adverse opinions can produce.<sup>58</sup> The more adverse opinions that are issued,

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<sup>54</sup> See *Comment Letters to PCAOB from Deloitte & Touche LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 71) (opining that mandatory adverse opinion for material weakness is inappropriate if weakness is "not pervasive"); *PriceWaterhouseCoopers LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 82) (opining that mandatory adverse opinion for material weakness is "too restrictive" and inappropriate if weakness presents an "isolated impact" as opposed to a "pervasive impact").

<sup>55</sup> E.g., *Comment Letter to PCAOB from Association of the Bar of the City of New York* (PCAOB Rulemaking Docket No. 8, Letter No. 68).

<sup>56</sup> E.g., *Comment Letter to PCAOB from American Institute of Certified Public Accountants* (PCAOB Rulemaking Docket No. 8, Letter No. 105).

<sup>57</sup> *Comment Letter to PCAOB from BDO Seidman, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 136).

<sup>58</sup> E.g., *Comment Letter to PCAOB from BDO Seidman, LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 136) ("excessive use of the adverse opinion . . . will lessen the potential message . . . [The] adverse opinion should provide a signal of the magnitude of a pervasive weakness").

the less information content any particular adverse opinion carries.<sup>59</sup> To make these reports meaningful and not misleading, auditors will have to provide particularized disclosure explaining the consequences of a material weakness in specific contexts.

PCAOB signals its intention to require explanations by concluding that its audit model must follow the management model, ordained by the SEC. There is no compelling logical reason why the audit model must follow the management model, though it may be less confusing. One difference is that while management cannot give its qualified opinion and explanation in its control report it can do so elsewhere in its disclosure filings, such as in the MD&A. Auditors lack such alternative outlets. Under Auditing Standard No. 2, PCAOB is saying they must provide this disclosure in their control-audit reports.

2. *Auditor Processes* — Auditing Standard No. 2 notes that an auditor’s control opinion “might describe a material weakness . . . while the audit report on the financial statements remains unqualified.”<sup>60</sup> If so, Auditing Standard No. 2 requires reports to include, in the paragraph describing material weaknesses, language indicating that the auditor considered the material weakness in planning substantive financial audit tests and that the adverse control report did not affect its financial statement audit report.<sup>61</sup>

It is doubtful whether such a simple statement will provide financial statement users with sufficient information to satisfy obligations that disclosure not mislead. Auditing Standard No. 2 does not literally appear to require disclosure of the auditor’s processes or assessments during the control audit (or the financial statement audit). But since the value of providing an adverse control opinion despite an unqualified financial statement opinion is alerting investors to risk of future financial statement unreliability, logic and completeness indicate that the auditor fully disclose such risk and related processes and assessments.

The reason this incongruent opinion is possible, after all, is that weak controls discovered in a control audit can be compensated for by substantive testing in the

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<sup>59</sup> *E.g., Comment Letters to PCAOB from PriceWaterhouseCoopers LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 82) (“Except for” opinion would be “more useful to readers”); *Ernst & Young LLP* (PCAOB Rulemaking Docket No. 8, Letter No. 144) (supporting qualified opinion option based on assessment of material weakness that “would more clearly communicate to users” and be more meaningful to investors); *Edison Electric Institute* (PCAOB Rulemaking Docket No. 8, Letter No. 117) (supporting option to offer qualified opinions as more useful for investors and that automatic adverse opinions would “create confusion” and “be misleading to investors” because they do “not provide the ability to adequately communicate to the investing public the actual impact of the weakness to the company.”).

<sup>60</sup> AUDITING STANDARD NO. 2, ¶ 194.

<sup>61</sup> *Id.*, ¶ 195.

financial statement audit. Auditors will need to explain this process in some detail to enable investors to understand it. Investors need auditors to explain why, if current financial statement reliability can be vouched for, the auditor also concludes that control is ineffective. Investors will need to know why the financial reporting process cannot simply rely upon auditor testing. Absent explanations of this sort, PCAOB's contemplated early warning system will lack meaningful warnings.

By deepening transparency into the interior of the financing reporting process, PCAOB's new early warning system reflects a view that investors rather than auditors should be the ultimate judges. To achieve this level of informed investors, auditors must provide detailed information as to their methodology. The fundamental argument for meaningful detail is the significant stress and confidence placed on control as the key to fair financial reporting and the decision in SOX and Auditing Standard No. 2 to make this reporting process public.<sup>62</sup>

Finally, since an auditor associates itself with management assertions on control effectiveness, users reasonably will expect auditors to have tested control fully and to explain their testing processes along with their conclusions. Otherwise, an expectations gap arises between what investors believe auditor assurance means and what assurance auditors in fact provide. The potential for an expectations gap raises issues concerning auditor liability. This interplay between Auditing Standard No. 2 and existing auditor liability rules is awkward, suggesting need to adjust related legal standards to make the new early warning system meaningful.

## II. AUDITOR LIABILITY AND CONFLICTING LEGAL INCENTIVES

The early warning system exposes auditors to new liability risks, and PCAOB apparently intends liability risks to promote the system's effectiveness.<sup>63</sup> Whether it will be doubtful, without adjustments to legal rules corresponding to PCAOB's changes in professional auditing standards.

Auditors are subject to civil liability when their work fails to satisfy applicable legal requirements.<sup>64</sup> Applicable legal requirements generally derive from relevant

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<sup>62</sup> Cf. AUDITING STANDARD NO. 2, App. E, ¶ E18 (testing internal control over financial reporting "takes on added importance with the public nature of the internal control reporting"). See *infra* Part III.

<sup>63</sup> Under federal securities law, the SEC cannot promulgate rules extending beyond a statute's scope. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976). However, this restriction does not limit PCAOB in establishing GAAS that imposes obligations on auditors that form the basis of legal standards of negligence, recklessness or fraud.

<sup>64</sup> Auditors are also subject to criminal liability but this topic is beyond the scope of this Article. Criminal liability for auditors can be based on a variety of mostly federal

auditing standards. Numerous federal securities law sections address various wrongs.<sup>65</sup> Principal laws are Section 11 under the Securities Act of 1933 (the 1933 Act) and Section 10(b) under the Securities Exchange Act of 1934 (the 1934 Act).<sup>66</sup> The statutes and associated remedies are generally construed cumulatively.<sup>67</sup> So, for example, a Section 10(b) claim exists even if a Section 11 claim also exists.<sup>68</sup>

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statutes. In addition to the federal securities laws, these include the False Statements Statute, the Mail Fraud Statute, and the Racketeer Influenced and Corrupt Organizations (RICO) Act. Compared to the substantial number of civil cases against auditors, there are relatively few criminal cases against them (though when the latter are brought, the consequences are usually more devastating). Still, Auditing Standard No. 2 may provide additional theories of criminal liability.

<sup>65</sup> State common law also imposes on auditors the standard of care found in traditional tort law applicable to professionals, the breach of which gives rise to claims for ordinary negligence. Gross negligence involves reckless departures from generally accepted auditing standards (GAAS). Auditing engagements routinely are conducted pursuant to a written agreement that can form the basis for state-law breach of contract claims. These topics, including issues relating to which third-parties have standing to bring such claims, are beyond the scope of this Article.

<sup>66</sup> Others include Section 18(a) of the 1934 Act, which creates private rights of action against persons, including accountants, who “make or cause to be made” materially misleading statements in reports or other documents filed with the SEC. 15 U.S.C. § 78r; *see Ernst & Ernst Hochfelder*, 425 U.S. 185, 212 (“Liability extends to persons who, in reliance on such statements, purchased or sold a security whose price was affected by the statements”). Auditors defend such claims by showing good faith and lack of knowledge. *See id.* (defendants are “accorded the defense that [they] acted in ‘good faith’ and had no knowledge that such statement was false or misleading”). Another liability ground is Section 17(a) of the 1933 Act, which imposes on auditors the duties of inquiry and disclosure, the interpretation of which was deferred by the Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Teamsters v. Daniel*, 439 U.S. 551, 557 n. 9 (1979); and *Herman & Maclean* 459 U.S. 375, n. 2 (1983). Open issues included whether the Section authorizes private rights of action. *See, e.g., Maldonado v. Dominguez*, 137 F.3d 1 (1<sup>st</sup> Cir. 1998) (joining four other federal circuit courts in denying that Section 17(a) creates private rights of action).

<sup>67</sup> *Herman & Maclean v. Huddleston*, 459 U.S. 375, 384-86 (1983) (treating as cumulative Section 11 under the 1933 Act and Section 10(b) under the 1934 Act). It is not entirely clear whether all private rights of action under the federal securities laws are cumulative or whether certain express private rights of action are exclusive. *See generally* Barbara Bader Aldave, *Neither Unusual nor Unfortunate? The Overlap of Rule 10b-5 with the Express Liability Provisions of the Securities Acts*, 60 TEX. L. REV. 719 (1982).

<sup>68</sup> *Herman & Maclean v. Huddleston*, 459 U.S. 375, 387.

PCAOB's new early warning system's greatest significance to potential auditor liability is for auditor failure adequately to disclose the existence and meaning of material weaknesses in control. Failure to do so as Auditing Standard No. 2 directs would constitute departure from generally accepted auditing standards (GAAS), which usually amounts to negligence actionable under Section 11 of the 1933 Act.

Additional liability may result because this new auditor duty to disclose is likely to render auditors primary rather than secondary actors when their disclosure is materially misstated or misleading. If so, this strips them of protections under the Supreme Court's opinion in *Central Bank of Denver v. First Interstate Bank of Denver*.<sup>69</sup> That opinion held that, in private actions, Section 10(b) of the 1934 Act does not extend fraud liability to secondary actors for aiding and abetting primary violations.

The interplay is complex between these two legal standards and PCOAB's early warning system. The key pressure point is distinguishing under Auditing Standard No. 2 between significant deficiencies—not requiring public auditor disclosure—and material weaknesses—requiring public auditor disclosure. Minimizing Section 11 liability risk will induce auditors to treat border-line control irregularities as material weaknesses and provide public disclosure; minimizing Section 10(b) liability risk will induce auditors to treat such cases as significant deficiencies and withhold public disclosure. The Section 11 incentive promotes Auditing Standard No. 2's early warning system; the Section 10(b) incentive undermines it. A possible device to overcome this undesirable Section 10(b) bias is safe harbor provisions to protect auditors from liability for forward-looking control statements under Section 10(b).

#### A. *Negligent Failure in the Early Warning System under Section 11*

Section 11 covers registration statements for public offerings of securities.<sup>70</sup> It applies to auditors as to portions of a registration statement for which they are responsible, that they prepared or otherwise “expertised.”<sup>71</sup> Under Auditing Standard No.

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<sup>69</sup> 511 U.S. 164 (1994).

<sup>70</sup> Section 11(a) of the 1933 Act is a long and cumbersome provision but essentially provides for private rights of action by securities purchasers sold using a registration statement containing material misstatements or omissions on its effective date. See 15 U.S.C. § 77k. For auditors, liability attaches as to financial statements in the registration statement when at least one of the material misstatements or omissions appears in the statement the auditor certified.

<sup>71</sup> *Herman & Maclean v. Huddleston*, 459 U.S. 375, 381, n. 11 (1983). See also *id.*, n. 13 (includes “accountants who are named as having prepared or certified the registration statement”, citing 15 U.S.C. § 77k(a), and “only for those matters which purport to have been prepared or certified by them”). Section 11 does not reach “accountants with respect to parts of a registration statement which they are not named as having prepared or certified.” *Id.* at 387, n. 22.

2, auditors give three opinions subject to Section 11. Section 11's standard of care is good faith; its liability basis is negligence.<sup>72</sup> For auditors, standards of performance are generally those fixed by GAAS.<sup>73</sup> Auditors generally discharge their professional and legal obligations by complying with GAAS in good faith.<sup>74</sup>

Plaintiff-purchasers of registered securities need only show a material misstatement or omission to establish a *prima facie* case under Section 11.<sup>75</sup> Accountants have the burden of demonstrating due diligence.<sup>76</sup> Auditing Standard No. 2 does not change these provisions, but it radically expands auditors' professional obligations and

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<sup>72</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207-08:

Section 11 of the 1933 Act unambiguously creates a private right of action for damages when a registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading. . . . [E]xperts such as accountants who have prepared portions of the registration statement are accorded a 'due diligence' defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that 'after reasonable investigation' he had 'reasonable ground[s]' to believe that the statements for which he was responsible were true and there was no omission of a material fact.

See also *Herman & Maclean v. Huddleston*, 459 U.S. 375, 381-82 (1983) (Section 11 is designed to assure compliance using "a stringent standard of liability" on those playing direct roles in registered offerings, including accountants).

<sup>73</sup> See *SEC v. Arthur Young*, 590 F.2d 785, 787-88 (9<sup>th</sup> Cir. 1979) (rejecting alternative standard of "whether the accountant performed . . . audit functions in a manner that would have revealed to an ordinary prudent investor, who examined the accountant's audits or other financial statements, a reasonably accurate reflection of the financial risks such an investor presently bears or might bear in the future [by investing] in the audited endeavor").

<sup>74</sup> See *SEC v. Arthur Young*, 590 F.2d 785, 788 (9<sup>th</sup> Cir. 1979).

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* (citing 15 U.S.C. § 77k(b)). The classic case comprehensively outlining the due diligence defense generally and as applied to external auditors is *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 642 (S.D.N.Y. 1968) (notably announcing that auditors "should not be held to a standard higher than that recognized in their profession").



therefore legal duties concerning what due diligence requires. Auditing Standard No. 2 and Section 11 together create pressure to disclose.<sup>77</sup>

The common scenario Auditing Standard No. 2 expressly addresses involves disclosure of material weaknesses and their effects on substantive audits tests concerning financial statement assertions. Traditionally, auditors had no duty to disclose such weaknesses or to disclose their effects on substantive audit testing. Courts deemed control irregularities not material. Auditing Standard No. 2 clearly reverses these conclusions, imposing duties on auditors to disclose and explain both material weaknesses and their effect on the overall audit process, rendering both material.

This common scenario is epitomized by *Monroe v. Hughes*,<sup>78</sup> a bondholder class action against external auditors of a defunct issuer of securities alleging violations of Section 11.<sup>79</sup> The auditor furnished an unqualified financial statement audit opinion with respect to the issuer's 1987 and 1988 financial statements and furnished a comfort letter with respect to the six-month period immediately prior to the offering.

In its 1988 audit, the auditor found internal control irregularities and conferred with management about them. In light of these control irregularities, the auditor

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<sup>77</sup> Despite Section 11's appeal to GAAS as the standard of an auditor's performance, there is no bright-line test for determining whether an auditor meets its burden of establishing the due diligence defense. At best, a judicial sliding scale evaluates discharge according to factors such as the defendant's "knowledge, expertise, status with regard to the issuer . . . and the degree of the defendant's actual participation in the registration process and in preparing the registration materials." Auditing Standard No. 2 provides specific requirements and general factors that will be relevant to courts, and the SEC, in case-by case evaluations of auditor reasonableness under Section 11. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* (4<sup>th</sup> ed. 2002), § 7.4[3], at 366. SEC Rule 176 provides similar guidance, identifying various factors relevant to the inquiry. 17 C.F.R. § 230.176 (listing the following as relevant circumstances in determining whether a person's conduct constituted a reasonable investigation or a reasonable ground for belief for meeting the Section 11(c) burden: type of issuer, security, person, other relationships, and the reasonableness of any reliance on others). SEC Rule 176 has had a limited effect on judicial opinions applying Section 11. See DONNA M. NAGY *ET AL.*, *SECURITIES LITIGATION AND ENFORCEMENT* (2003), at 285.

<sup>78</sup> 31 F.3d 772 (9<sup>th</sup> Cir. 1994). *Monroe v. Hughes* exemplifies a class of such cases. *E.g.*, *In re SmartTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 524 (S.D. Ohio 2000); *Adams v. Standard Knitting Mills, Inc.*, 623 F. 2d 422, 432 (6<sup>th</sup> Cir. 1980); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1417 (9<sup>th</sup> Cir. 1994).

<sup>79</sup> The opinion centers on Section 11 claims against the auditor, though plaintiffs also made claims against the issuer's officers, claims under state blue sky laws, and Section 10(b) claims against the auditor.

expanded the scope of its 1988 audit by performing more elaborate substantive testing.<sup>80</sup> In its 1989 audit, the auditor found significant deterioration in the internal control and was unable to issue an unqualified financial statement opinion for that fiscal year. The issuer collapsed later that year.

The bondholders' Section 11 claim contended that the auditor should have disclosed in its 1988 audit opinion the internal control irregularities it discovered. The court laid out the Section 11 due diligence defense and the negligence standard governing auditors' liability, observing that good faith compliance with GAAS discharges an auditor's professional obligation to act with reasonable care.<sup>81</sup>

The court noted that the auditor determined the irregularities it discovered to be significant deficiencies but not material weaknesses.<sup>82</sup> At the time, at least, no legal or accounting authority required auditors to disclose those in audit reports. Instead, auditors were to report them to management and, if deemed necessary, expand the scope of the financial audit.<sup>83</sup> In the case, the auditor did both of these things. Even if the control problems had been material weaknesses rather than merely significant deficiencies, the court said that the auditor would only have been required to inform management, as the auditor did. For these reasons, the court concluded that there was no basis or reason to treat control irregularities as material under Section 11.

Auditing Standard No. 2 changes this result for material weaknesses. In effect, the case shows what the U.S. financial reporting system lacked: it boasted no early warning system. In the case, auditors knew of warnings, but had no duty to disclose them publicly and the lack of this duty led the court to conclude that they were not material. Investors were stuck. Auditing Standard No. 2 requires auditors to disclose these early warnings, giving investors aid. Auditor failure to disclose them will constitute a departure from GAAS, the related information will be material, and auditors will be exposed to Section 11 liability.<sup>84</sup>

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<sup>80</sup> Before Auditing Standard No. 2, this was the auditor's key purpose in testing control—a selective testing to determine requisite financial statement audit scope. After Auditing Standard No. 2, the control audit still provides this function but also provides independent information that must be publicly disclosed.

<sup>81</sup> *Monroe v. Hughes*, 31 F.3d 772, \_\_\_ (noting also relevance of good faith compliance with generally accepted accounting principles).

<sup>82</sup> Under auditing standards in effect at the time, the irregularities were called “reportable conditions,” which the court described as significant deficiencies rather than material weaknesses.

<sup>83</sup> AICPA auditing standards adopted at the time but not yet effective also required auditors to report significant deficiencies to the company's board audit committee. *Id.*

<sup>84</sup> The *Monroe v. Hughes* plaintiffs also argued before the lower court that the auditor should have included in its letter either a qualification as to the scope of its audit or a

Consider three other variations on the common scenario epitomized by *Monroe v. Hughes*. First, note that in traditional financial statement auditing, the consequence of a material weakness in control is for auditors to expand substantive audit testing. In the past, allegations concerning auditor failure to follow GAAS relating to control deficiencies and weaknesses required plaintiffs to focus on whether auditors appropriately expanded the scope of substantive audit testing.<sup>85</sup> If auditors did, the plaintiffs' claim failed. Under Auditing Standard No. 2, that is only one obligation auditors have. When facing material weaknesses, at least, auditors must disclose them and their effect on financial-statement audit planning.

Second, consider the effect of control testing and effectiveness on the financial statement audit. Traditionally, plaintiffs asserting control failure needed to show a connection between control weaknesses and the financial statement audit.<sup>86</sup> No longer.

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statement that the issuer might not be able to continue as a going concern. The lower court rejected these claims, and the appellate court observed that professional standards would not require an auditor to include either qualification solely on the grounds that it had discovered reportable conditions (or material weaknesses) in internal control over financial reporting.

<sup>85</sup> See *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1403 (N.D. Cal. 1995). In *Adam*, the complaint satisfied particularity-pleading requirements when alleging that auditors made misrepresentations as to "faulty management practices, such as weak internal controls" and alleged how this violated specific accounting standards as to specific non-performing loans the auditor failed to disclose or, at minimum, which the auditor should have investigated further. The *Adam* court rejected the auditor's argument that allegations concerning a company's weak internal controls are not actionable given that auditors have no independent duty to disclose findings regarding weak internal controls. In *Adam*, the claim was not that the auditor should have disclosed those deficiencies, but that it knew or recklessly disregarded that, as a result of control deficiencies, the company's financial statements (here loan loss reserves) were materially misstated and that the auditor did not expand the scope of its audit.

<sup>86</sup> See *In re IKON Office Solutions, Inc. Sec. Litig.*, 131 F. Sup. 2d 680 (E.D. Pa. 2001). (scienter may not credibly be inferred from auditor's reliance on defective internal controls). Accepting that the company's internal accounting controls may have been unreliable, the *IKON* court found that no evidence indicated a connection between control deficiencies and the financial statement audit. The auditor examined control effectiveness, recommended various control improvements to management, and while the overall internal control environment was effective, the firm did not rely on testing of controls as the primary support for its financial statement audit opinion. Accordingly, the *IKON* court granted the auditor's motion for summary judgment due to the absence of "a genuine issue of material fact from which a jury could conclude that [the auditor] knowingly or blindly adhered to faulty internal controls or accounting practices." (*citing Danis v. USN Comm. Inc.*, 121 F. Supp. 2d 1183, 1995 (N.D. Ill. 2000) ("without more,

Auditing Standard No. 2 defines the exercises as interrelated.<sup>87</sup> When control is ineffective, auditors must so disclose and expand their testing. Failure to do either, whether or not there is a provable connection between the financial statement audit and internal control, exposes auditors to liability for negligent departures from GAAS under Section 11.

Third, suppose an auditor fails to report significant deficiencies to a company's management or audit committee. This has been seen as legally irrelevant to auditor liability under Section 11 in the past.<sup>88</sup> Given the central role of such communications in the new early warning system, however, it is possible that this failure will expose auditors to liability under Section 11. This is especially the case if the audit committee fails to respond adequately to the auditor's communication.

Auditing Standard No. 2 does not require auditors to disclose publicly significant deficiencies, but it specifically provides that ineffective audit committees be treated as a significant deficiency at minimum, and possibly as a material weakness.<sup>89</sup> A good case arises that a significant deficiency plus audit committee failure to respond to an auditor's communication of it together produce a material weakness. When this is the case, auditors who fail to disclose in their public reports that they communicated significant deficiencies to audit committees and received inadequate responses may face Section 11 liability for this failure.

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auditor's knowledge about problems in a client's operational systems could support an inference only of negligence, not recklessness’’)).

<sup>87</sup> AUDITING STANDARD NO. 2, ¶ 27; see PCOAB RELEASE ACCOMPANYING AUDITING STANDARD NO. 2, at 3.

<sup>88</sup> See *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 524 (S.D. Ohio 2000) (treating as irrelevant claims that auditor failed to report control deficiencies to the company's audit committee because the auditor had “no duty to mention in its audit report that it had spoken to the audit committee about such issues’’). The *SmarTalk* case also involved allegations similar to those in *Monroe v. Hughes*. The court accepted the auditor's argument that its failure to disclose a company's “lack of internal controls” did not violate GAAS or federal securities law because auditors have no duty “to disclose [a company's] lack of internal controls.” As a matter of law, the court held, “an auditor is under no duty to disclose in an audit report deficiencies in internal controls.” (citing *Adams v. Standard Knitting Mills, Inc.*, 623 F. 2d 422, 432 (6<sup>th</sup> Cir. 1980) (AICPA imposes no requirement that audit reports disclose internal control weaknesses); *In re Worlds of Wonder Secs. Litig.*, 35 F.3d 1407, 1417 (9<sup>th</sup> Cir. 1994)). Despite these findings, other allegations of misrepresentations in the audit report supported the *SmarTalk* plaintiff's negligent misrepresentation claim.

<sup>89</sup> AUDITING STANDARD NO. 2, ¶ \_\_\_\_.

The common scenario epitomized by *Monroe v. Hughes* and these variations on its theme underscore the likely focus of future litigation: differences between significant deficiency and material weakness. As *Monroe v. Hughes* indicated, before Auditing Standard No. 2, the distinction mattered only for internal purposes, for auditors had no obligation to disclose either publicly. Auditing Standard No. 2 specifically requires auditors to disclose in their reports material weaknesses, but not significant deficiencies.<sup>90</sup>

Under Section 11, auditors unsure of whether a control irregularity is a significant deficiency or a material weakness will have legal incentives to err on the side of material weakness. This inclination serves PCAOB's goal of creating an early warning system through Auditing Standard No. 2. Undercutting this effect and goal, however, are opposite incentives arising under Section 10(b), incentives to resolve uncertainties as significant deficiencies rather than material weaknesses to avoid disclosure.

### *B. Fraudulent Failures as Primary Violations under Section 10(b)*

In cases like *Monroe v. Hughes*, after dismissing the Section 11 claim that the auditor had not committed negligence, Section 10(b) claims for fraud were easy to dismiss. Courts could note that a defendant must have a duty to disclose for a plaintiff to sustain a Section 10(b) claim and that auditors had no such duty. Under Auditing Standard No. 2, auditors have such duties, posing significant legal consequences under Section 10(b) of the 1934 Act.

Section 10(b) addresses all purchases or sales of securities.<sup>91</sup> Anyone making material misstatements (or omissions) on which traders rely faces liability as a primary violator under Section 10(b) when they have a duty of disclosure.<sup>92</sup> The standard is anti-

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<sup>90</sup> See AUDITING STANDARD NO. 2, ¶¶ 173(a) & 175-177 (required modifications to auditor reports when there is a material weakness). Compare AUDITING STANDARD NO. 2, ¶¶ 207-214 (required communications to management, audit committees and boards of directors include all significant deficiencies and material weaknesses).

<sup>91</sup> Section 10 of the 1934 Act makes it “unlawful for any person . . . (b) to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78j. SEC Rule 10(b)(5) encompasses substantially the same matters as Section 10, though using language drawn from Section 17(a) of the 1933 Act by referring to making any untrue statement of material fact or omitting to state material facts necessary to make statements not misleading and specifically prohibiting frauds and deceit using any device, scheme or artifice.

<sup>92</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

fraud; the liability basis is scienter,<sup>93</sup> generally meaning intent to deceive.<sup>94</sup> As with Section 11, Auditing Standard No. 2 does not change these standards, but radically expands auditor responsibilities and therefore legal duties—and, most importantly, in certain circumstances probably redefines auditor status as primary rather than secondary actors.

After deferring in several major decisions to address whether secondary actors face Section 10(b) liability for aiding and abetting fraud,<sup>95</sup> the Supreme Court rejected the possibility squarely in *Central Bank of Denver v. First Interstate Bank of Denver*.<sup>96</sup> Auditors cannot be liable in private actions under Section 10(b) when their roles are simply secondary actors serving as functional accomplices to fraud.<sup>97</sup> However, the Court expressly stated that this does not prevent holding auditors liable as primary actors when the facts indicate sufficient involvement to constitute them as primary actors.<sup>98</sup>

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<sup>93</sup> For private actions, negligence alone does not create liability; for SEC enforcement proceedings, showing negligence may suffice. *See SEC v. Arthur Young* 590 F.2d 785 (9<sup>th</sup> Cir. 1979) (assuming so without deciding).

<sup>94</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, n. 12 (1976) (the statute uses the terms manipulative, device and contrivance). Scienter is from a Latin word meaning knowingly; it generally relates to a state of mind seen as intentional or at least reckless as opposed to negligent or grossly negligent. The Supreme Court has deferred deciding whether it includes recklessness. *Id.*; *Aaron v. SEC*, 446 U.S. 680, 686 n. 5 (1980); *Herman & Maclean v. Huddleston*, 459 U.S. 375, 379, n. 4 (1983). Private Section 10(b) claims are proven by a preponderance of the evidence standard, as in other civil actions, not by any higher standard such as clear and convincing. *Id.* at 387-88 (noting also that the preponderance standard applies to SEC enforcement proceedings under Section 17(a) of the 1933 Act).

<sup>95</sup> The Supreme Court expressly deferred addressing the aiding and abetting issue in both *Ernst & Ernst* 425 U.S. 185, 191-2, n. 7 (1976) and *Herman & Maclean*, 459 U.S. 375, 379, n. 5 (1983).

<sup>96</sup> 511 U.S. 164 (1994).

<sup>97</sup> *Central Bank*'s limitation on aiding and abetting liability applies to private actions; the SEC has separate statutory authority to pursue this theory. *See* 1934 Act, § 20(e) (authorizing SEC actions under Section 21(d) for injunctions and money damages against “any person that knowingly provides substantial assistance to another person in violation of a provision of the [1934 Act]”). The Department of Justice possesses such authority for criminal aiding and abetting generally. *See* 18 U.S.C. § 2.

<sup>98</sup> *Central Bank*, 511 U.S. 164, at 191.

Consequently, in post-*Central Bank* private actions, plaintiffs alleged that auditors acted as primary violators of Section 10(b) not mere accomplices.<sup>99</sup>

Courts wrestled with distinguishing between primary and secondary actors. Most courts considering the question applied a bright-linerule.<sup>100</sup> The bright-line provided that a secondary defendant, such as an auditor, must make a false or misleading statement (or omission) to the public to be liable under Section 10(b).<sup>101</sup> Absent such a statement (or

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<sup>99</sup> See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* (4<sup>th</sup> ed. 2002), § 12.25, at 690.

<sup>100</sup> Scholars struggled too. *E.g.*, Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999); Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691 (1997); Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325 (1997); Donald C. Langevoort, *Words on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865 (1995).

<sup>101</sup> *E.g.*, *Wright v. Ernst & Young, L.L.P.*, 152 F.3d 169, 175 (2d Cir. 1998) ("a secondary actor cannot incur primary liability . . . for a statement not attributed to that actor at the time of its dissemination"); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997); *In re MTC Elec. Techs. S'holder Litig.*, 898 F. Supp. 974, 986 (E.D.N.Y. 1995); *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1255-56 (S.D.N.Y. 1996); *In re Leslie Fay Co. Sec. Litig.*, 871 F. Supp. 686 (S.D.N.Y. 1995); *Klein v. Boyd*, Fed. Sec. L. Rep. P 90,136, 90,317 (3d Cir. Feb. 12, 1998) (panel holding secondary actor potentially liable as primary actor when creating fraudulent statements spoken by another, but circuit *en banc* vacated decision and parties subsequently settled); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226, 1227 (10th Cir. 1996) (accountants not liable despite providing significant or substantial assistance to primary fraudsters because liability requires that they "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors"); *Ziamba v. Cascade Int'l Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Lycan v. Walters*, 904 F. Supp. 884, 901 n.12 (S.D. Ind. 1995) (stating that, after *Central Bank*, plaintiffs' claims cannot survive motions for summary judgment by asserting that auditors "assisted in the perpetration of a fraud"); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28, 28 n.1 (D. Mass. 1994) (denying liability for accounting firm that reviewed and approved fraudulent financial statements because by not actually engaging in reporting of statements, statements were not attributable to firm, and further stating that "[w]hile participation in the 'structuring' of transactions may be evidence of [auditor's] knowledge at the time it provided its audit opinion, the participation in the 'structuring' does not constitute the making of a material misstatement.... [I]t is clear that after *Central Bank*, only the making of material misstatements (or omissions) will be actionable under Section 10(b)."); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (auditor advice and guidance to person making fraudulent misrepresentations do not render auditor a primary actor).

omission), the actor was at best an aider and abettor, outside Section 10(b)'s liability reach.

Some courts favored a substantial-participation approach, exposing to Section 10(b) liability auditors whose involvement was not clearly secondary but sufficiently substantial to render it primary.<sup>102</sup> Under this approach, for example, auditor silence is not enough to prevent auditor liability as a primary actor. Another person's misstatement could be attributed to a silent auditor if the auditor significantly participated in the activity where the misstatement was made.<sup>103</sup>

Auditing Standard No. 2 dramatically changes this legal landscape. Under it, auditors are required to speak directly in furnishing their opinions on internal control over financial reporting. If they conclude that control is effective when it is not, the situation may be akin to that occurring when they conclude financial statements are fair and conform to GAAP when this is false. In this case, they may be seen as secondary actors, insulated from Section 10(b) liability.

However, unlike an adverse financial statement opinion, an adverse control opinion requires additional auditor disclosure. Auditors must describe material weaknesses, their actual or potential effects on financial statements and on related control objectives, and their effects on the auditor's financial statement audit. When this disclosure is false or misleading, its speaker is a primary actor under any of the various formulations interpreting *Central Bank*. They are certainly within Section 10(b)'s reach

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<sup>102</sup> *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n. 3 (9th Cir. 1994) (primary liability possible for "significant role" in preparing letter to the SEC); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (primary liability when auditor is "intricately involved" in creating false documents); *Employers Ins. of Wausau v. Musick, Peeler, & Garrett*, 871 F. Supp. 381, 389-90 (S.D. Cal. 1994) (attorneys and accountants); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432 (N.D. Ill. 1995).

<sup>103</sup> A position arose between these extremes of the bright-line and substantial participation tests. This approach imposed liability but only so long as the secondary actor originated the fraud as by preparing documentation constituting misrepresentations. Courts were split on this variation, though it famously provided the basis for claims against those aiding in the Enron fraud case *See Newby v. Enron Corp. (In re Enron Corp. Sec. Derivative & ERISA Litig.)*, 235 F. Supp. 2d 549 (S.D. Tex. 2002). In *Newby*, the court denied an auditor's motion to dismiss, announcing that auditors can be primary violators of Section 10(b) when they design transactions knowing of their propensity to confuse and mislead investors. In the case, the SEC argued that primary liability attaches to secondary actors when they create fraudulent documents. This is the case whether or not they make public statements or have public statements of other actors attributed to them. *See also Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998); *but see Ziembra v. Cascade Int'l Inc.*, 256 F.3d 1194, 1205 (9<sup>th</sup> Cir. 2001) (rejecting this standard in suit against law firm, adopting instead the bright line approach).



under the substantial participation approach and likely render auditors primary actors under the bright-line rule favored by most courts.

To this extent, Auditing Standard No. 2 may be seen to nullify *Central Bank* as to control audits. Of course, it only nullifies it through indirect means, by changing the nature of an auditor's professional obligations, not by changing the text of Section 10(b) or the Supreme Court's interpretation of it. But the effect is equally significant for auditors. The interplay between this result of Auditing Standard No. 2 and *Central Bank* raises a complexity, however, that PCAOB probably neither foresaw nor intended.

If an auditor issuing an unqualified control opinion is a secondary actor insulated from Section 10(b) liability while an auditor issuing an adverse opinion explaining material weaknesses is a primary actor subject to Section 10(b) liability, then auditors have a clear legal incentive to prefer the former. For control irregularities at the border, this will induce auditors to characterize them as significant deficiencies rather than control weaknesses. But this bias undermines PCAOB's goal to provide early warnings of future financial statement unreliability. It also conflicts with the opposite effect arising under Section 11, which induces auditors to err on the side of designating close cases as material weaknesses.

The two effects of Section 10(b) and Section 11 cannot be counted on to offset each other. The statutory Sections address different circumstances and provide different legal standards and procedures, though they are cumulative and both often apply to a particular set of facts. Section 11 covers only registration statements, whereas Section 10(b) covers all matters in connection with the purchase and sale of securities.<sup>104</sup> Moreover, for disclosure outside registered offerings, where Section 11 does not apply, Section 10(b) effects are not offset by the opposite Section 11 incentives. Thus Section 10(b)'s incentives are strong to resolve uncertain cases as significant deficiencies rather than material weaknesses.

A fact pattern from a classic Supreme Court case, *Ernst & Ernst v. Hochfelder*,<sup>105</sup> illustrates. For 21 years, a brokerage firm's president sold fraudulent securities and converted investor funds to his own use. The transactions were conducted outside the firm's usual dealings with customers, between investors and the president. Transactions did not appear in the firm's records or reports, which auditors audited. The firm's

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<sup>104</sup> In addition, Section 11 imposes a tough standard of obligation (negligence) compared to Section 10(b) (fraud); and Section 11 contains numerous procedural requirements for plaintiffs not faced in Section 10(b). Thus compared to Section 10(b), Section 11 is a stringent standard of obligation but applies to a narrower class of persons and transactions and carries various procedural protections the statute provides, such as posting bonds for costs and a one-year statute of limitations. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209-10 (1976).

<sup>105</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

auditors failed to discover strange internal control practices, however, including a rule that no one but the president could open his mail, even when he was away.

Plaintiffs alleged that if auditors had conducted a proper audit, they would have discovered this, and would have had to disclose it as an irregular procedure.<sup>106</sup> The Supreme Court rejected these claims. However, the facts appear to be precisely the kind of control irregularity Auditing Standard No. 2 directs auditors to detect and disclose if detected. But if the call is close whether the irregularity is a significant deficiency or a material weakness, *Central Bank's* primary/secondary actor distinction creates incentives for auditors to choose the significant deficiency characterization and withhold disclosure. This mutes the potential power of the early warning system.

The skewed liability incentives this interplay creates will reinforce other biases the new early warning system contains, independent of legal rules. Auditing Standard No. 2 contemplates that auditors evaluate the existence of material weaknesses and disclose them if identified. In practice, auditors will understand the potentially severe consequences for issuers of the material weakness characterization. The automatic adverse opinion required by Auditing Standard No. 2 in such cases risks discouraging auditors from elevating significant deficiencies to the material weakness level.<sup>107</sup>

This bias may lead auditors to approach the question as whether the potential for misstated financials is pervasive or overwhelmingly material to the financial statements taken as a whole. If not, they may conclude no material weakness exists—even if under the more direct approach an objective audit would indicate that a material weakness exists. Auditors indulging this bias risk allowing the early warning system to fail; when it does, and subsequent financials cannot be given unqualified opinions, however, they will not face Section 10(b) liability given that such opinions position them as secondary not primary actors. Though Section 11 will offset this bias somewhat for registered offerings, some additional adjustment to relevant legal standards seems necessary to help promote the effectiveness of Auditing Standard No. 2 as an early warning system.

### *C. Promoting the Ideal*

The ideal early warning system will produce auditor disclosure accurately reflecting calibrated risk of future financial misstatements. That is, it should point out

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<sup>106</sup> *Id.*, at 191-92. The lower court rejected the auditor's defense that it could not be held liable for aiding and abetting under 10(b) on negligence claims alone. It referenced Section 17a-5, requiring auditors to inquire of and provide disclosure concerning the brokerage firm's "internal control system." In this pre-*Central Bank* era, such failure exposed the auditor to liability in damages for aiding and abetting. In the case, genuine issues of material fact arose as to whether the auditor's failure to discover the mail rule breached the duty and whether its discovery would have prevented the fraud.

<sup>107</sup> *E.g.*, *Comment Letter to PCAOB from Association of the Bar of the City of New York* (PCAOB Rulemaking Docket No. 8, Letter No. 68).

both areas where misstatements are more than remote as well as areas where they are less than remote. Liability threats could help direct disclosure toward the optimal balance. But the conflicting incentives created by the interplay between Auditing Standard No. 2 and legal rules governing auditor liability impair this capability.

How can legal rules be adjusted to facilitate the early warning system's objective of providing meaningful content to financial statement users? One way to address this issue would be to provide that auditor statements concerning control material weaknesses do not expose them to Section 10(b) claims as primary actors. This likely would better position auditors to provide the early warnings Auditing Standard No. 2 contemplates. However, it would also threaten doctrinal incoherence in Section 10(b) case law, which applies not only to auditors but to all actors from issuers to attorneys, underwriters and others.

Nor would it be appropriate simply to unite liability effects under Sections 10(b) and 11. The standards address different circumstances, apply different legal standards, and employ differing procedural directives. If Section 10(b) risks were increased to match those under Section 11, moreover, excessive material weakness conclusions could result, producing too many warnings, which are no warnings at all.<sup>108</sup> If Section 11 risks were reduced to match those under Section 10(b), this could neutralize the directive power of liability risks.

A more tailored doctrinal possibility is to develop safe harbor protections for auditor statements under Section 10(b) about control having a forward-looking nature, paralleling existing safe harbors for issuer statements. Though doing so may neutralize some incentives that liability threats create, additional pressures on auditors from new auditor independence rules and new PCAOB oversight should offer sufficient counterbalancing effects to generate a system likely to optimize disclosure in the early warning system.

1. *Forward-Looking Disclosure* — In traditional financial statement audits, auditors speak as of a moment in time about financial statements prepared as of a prior date and for a prior period, providing hard facts. Some required control-audit disclosure is also historical or factual in this sense, including providing PCAOB's definition of material weakness, stating the existence of a material weakness, and what auditors did about it in their substantive testing. But in describing material weaknesses as early warnings, disclosure becomes inherently forward-looking. The concept of material weakness is forward-looking, defined as risk that material misstatements will not be detected or prevented. Auditing Standard No. 2 requires auditors to describe material weaknesses along with their actual or *potential* future effects on the financial statements.

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<sup>108</sup> Cf. Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417 (2003) (offering tentative assessment of risks of prevailing inclinations towards generating increasing volumes of information in light of emerging empirical studies concerning investor psychology and behavioral finance).

Consider, for example, a material weakness in control governing the creation of invoices—say company policy requires a supervisor to approve invoices prepared by shipping clerks and an audit indicates this policy is not closely followed. Auditor disclosure of this situation will include historical/factual information plus forward-looking/potential information. The former includes auditor disclosure defining the concept of material weakness, identifying this invoice-control weakness and explaining how it led the auditor to expand the scope of its substantive audit tests (in this example, as by contacting a larger sampling of customers to verify the existence of purchases from the company).

To make related disclosure meaningful, however, auditors must disclose information of a more forward-looking nature. Auditors should disclose how this weakness increases risk of material misstatements in the company's accounts receivable line item and how this has the potential to inflate sales and earnings. Auditors should also disclose steps being taken or that could be taken to cure this weakness, such as enhanced employee training, and the potential effect these have on neutralizing such risks.

In certain cases, disclosure should explain how a particular material weakness relates to the company's overall control environment and overall financial reporting efficacy, all of which are likely to be forward-looking. In the invoice-control example, if this is the only control weakness detected, disclosure indicating that this weakness should have no effect on other financial statement line items such as inventory would be useful to investors. Auditors should also be encouraged to indicate the likelihood of designated potential effects and to indicate that other potential effects are less likely or not likely at all.

The list of examples of the kind of forward-looking information thus generated is limitless. Disclosure granularity is necessary to enable financial statement users to reasonably accurately calibrate the significance of control weaknesses in a potentially infinite variety of contexts. Such particularization is necessary to make the early warning system effective. But since much of the requisite disclosure is inherently forward-looking, real risks exist that the auditor's best judgment and guidance will, with hindsight, be incorrect. Absent some legal adjustments, this risk, coupled with Section 10(b)'s incentives to treat such control irregularities as significant deficiencies and keep quiet, will discourage auditors from providing optimal disclosure and render the early warning system substantially inert.

This illustration suggests that the early warning system for control audits is akin to a parallel system of forward-looking disclosure that requires and/or encourages issuers to provide information concerning trends and uncertainties in their businesses.<sup>109</sup> Whereas that forward-looking disclosure system focuses on generating early views of

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<sup>109</sup> SECURITIES AND EXCHANGE COMMISSION, REGULATION S-K, ITEM 303, 17 C.F.R. § 229.303; *see generally* Quinton F. Seamons, *Requirements and Pitfalls of MD&A Disclosure*, 25 SEC. REG. L. J. 239 (1997).

business substance, PCAOB's new early warning system focuses on generating early views of financial reporting processes. A key lesson from the development of the substantive forward-looking disclosure regime for the process early warning system is the need to provide incentives and protections for those making statements about the future.

In the case of issuer forward-looking disclosure, as this system evolved in the 1980s, the SEC, Congress and courts all offered safe harbors. These were doctrines insulating issuers from liability in private actions arising from forward-looking statements when accompanied by requisite cautionary language and other conditions met.<sup>110</sup> Evidence indicates that this system has enhanced the overall quality of information and its interpretation.<sup>111</sup> Similar doctrines developed for auditing's new early warning system should promote achieving ideal auditor disclosure.

Existing safe harbors governing forward-looking information do not generally apply to auditors.<sup>112</sup> Despite the revolution in auditing that Congress and the SEC have

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<sup>110</sup> The SEC does so in Securities Act Rule 175 and Exchange Act Rule 3b-6; Congress did so in provisions of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 77z-2 (Section 27A of the 1933 Act) and 15 U.S.C. § 78u-5(c) (Section 21E of the 1934 Act); and courts did so using the judicially-created bespeaks caution doctrine, *see, e.g., In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993); *Rubenstein v. Collins*, 20 F.3d 164, 167 (5<sup>th</sup> Cir. 1994); *Mayer v. Mylod*, 988 F.2d 635 (6<sup>th</sup> Cir. 1993), including interpretations of the SEC and Congressional systems and safe harbors, *e.g., See, e.g., Harris v. Ivax Corp.*, 182 F.3d 799 (11<sup>th</sup> Cir. 1999).

<sup>111</sup> JOHN C. COFFEE, JR. & JOEL SELIGMAN, *SECURITIES REGULATION: CASES AND MATERIALS* (9<sup>th</sup> ed. 2003), at 6 (citing Artyom Durnev *et al.*, *Law, Share Price Accuracy and Economic Performance: The New Evidence*, PRESENTATION AT THE AMERICAN LAW AND ECONOMICS ASSOCIATION ANNUAL MEETING (May 12, 2001) (examining impact of mandatory forward-looking disclosure in MD&A on share prices).

<sup>112</sup> For example, statutory safe harbors define forward looking statements to mean:

(A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

(B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;

(C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the commission;

(D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);

(E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or

set off, neither body created any auditor safe harbors; and PCAOB lacks authority to do so.<sup>113</sup> It may be desirable for Congress or the SEC to adopt requisite protections, *ex ante*, as this would provide greater certainty to auditors and help to develop uniform disclosure in this new system.<sup>114</sup> As with the development of forward-looking disclosure system, however, it will likely be necessary for the judiciary to participate in shaping the exact contours of this system. Ultimately, it may be ideal for all three sources of authority to participate in providing requisite boundaries, just as all three participated in developing safe harbor provisions and conditions in the forward-looking disclosure system.

Absent Congressional or SEC action, moreover, courts should be encouraged to develop such a system independently. Courts did this for issuer forward-looking disclosure by developing protections under the bespeaks-caution doctrine.<sup>115</sup> This

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(F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the commission.

Securities Exchange Act, § 21E(a).

<sup>113</sup> *Cf.* AUDITING STANDARD NO. 2 ¶ 212 (“Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no significant deficiencies were noted during an audit of internal control over financial reporting the auditor should not issue such representations”).

<sup>114</sup> The SEC has power to do so. *See* Securities Exchange Act, § 21E(c)(4); Securities Act, § 27A(g)-(h). For example, statutory safe harbors define forward looking statements relating to auditor control opinions might define these by piggybacking on existing standards quoted in note 112 above, as follows:

(A) a statement containing an opinion as to the potential effects of material weaknesses in internal control over financial reporting relating to effects on projections in revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

(B) a statement of recommendations, and proposed plans and objectives for future improvements in internal control over financial reporting, including plans or objectives relating to material weaknesses; and

(C) any statement of the assumptions underlying or relating to any statement described in subparagraph (A) or (B).

This suggestion is for illustration only; additional refinement would likely be required. Partly for this reason, it is probably just as well to recognize authority to develop this doctrine within federal courts.

<sup>115</sup> While the SEC was the real engine of the forward-looking disclosure regime, and it and Congress both furnished safe harbors, ultimate interpretation and development of the

provided a case-by-case evaluation of whether forward looking information was accompanied by sufficient cautionary language to alert a reasonable investor to the tentative quality of the information.<sup>116</sup>

When developing safe harbors for issuer forward-looking control disclosure, a standardized fact pattern emerged. Issuer forward-looking disclosure often included optimistic projections that were subsequently disappointed, with stock price drops leading to lawsuits by security-holders who purchased or held securities during the relevant period.<sup>117</sup> The opposite situation sometimes arose—issuers offering gloomy forecasts that turned out to be wrong and produced opposite results.<sup>118</sup> Courts ultimately used substantially similar tools in evaluating both types of disclosure and related claims.

In auditing's new early warning system, most cases may involve warnings of risks that ultimately are not realized. That is, auditor warnings based on material weaknesses signal material risks of future financial misstatements. When the risks are subsequently not realized, stock price will rise, leading to lawsuits by security holders who sold during the relevant period. Safe harbors should certainly be provided for such statements.

More important for auditing's new early warning system, however, are safe harbors for assuring statements. A key virtue of the safe harbor protections of auditor early warnings would be to encourage auditors to calibrate the significance of particular control weaknesses. This means describing not only the potential risks but also singling out issues that a particular material weakness does not implicate. This granular disclosure is necessary to enable financial statement users to rank material weaknesses according to their gravity.

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doctrine's contours, fell to the courts using the bespeaks caution doctrine. *See generally* Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW. 481 (1994).

<sup>116</sup> Courts provided varying formulations of the doctrine, though generally they applied to both misstatements and omissions, solely to prospective information, with particularized cautionary language related directly to the relevant disclosure. COFFEE & SELIGMAN, *supra* note 111, at 1017-20 (summarizing cases and positions by circuit). In general, however, it is a pragmatic application of basic principles of securities law, chiefly designed to balance generating useful but contingent information against dangers that issuers could hide behind bad news by cloaking it in cautionary garb. *See Rubenstein v. Collins*, 20 F.3d 164, 167 (5<sup>th</sup> Cir. 1994). Some courts even hinted at using it to protect from liability disclosure concerning the effectiveness of internal control. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9<sup>th</sup> Cir. 1994) (issuer's warning of ongoing attempts to improve control implicitly seen as forward-looking).

<sup>117</sup> *E.g.*, *Grossman v. Novell, Inc.*, 120 F.3d 1112 (10<sup>th</sup> Cir. 1997).

<sup>118</sup> An example of this in the case of issuers is *Walker v. Action Indus., Inc.*, 802 F.2d 703, *cert. denied* 479 U.S. 1065 (1987).

The need for such textured disclosure to make early warnings meaningful calls for balancing. While legislative or regulatory doctrines could be developed to provide guidance, it will likely fall to judges to adapt the bespeaks-caution doctrine for application to auditor early warnings. Traditional jurisprudence concerning the relation between federal securities law and GAAS provides judges with necessary grounds for this innovation.

Federal securities case law routinely acknowledges that auditors discharge their legal duties by complying with professional standards articulated as GAAS. But they also recognize that compliance with GAAS does not alone satisfy legal obligations;<sup>119</sup> more importantly, meeting legal obligations does not always depend on compliance with GAAS.<sup>120</sup> Legal standards supercede auditing standards. In the case of Auditing Standard No. 2 as GAAS, judges could accept its content as specifying applicable professional standards, but also adjust applicable legal standards as necessary to fulfill the overall objectives of the early warning system. An adapted bespeaks-caution doctrine can promote these objectives while sustaining the doctrinal coherence of Section 10(b) jurisprudence.

2. *Recovering Trust* — It may seem strange to offer safe harbors to a profession whose diminished trustworthiness prompted Auditing Standard No. 2. But other changes in requirements applicable to the auditing profession may, when coupled with such safe harbors, operate to provide a system geared toward providing optimal auditor disclosure as contemplated by Auditing Standard No. 2's early warning system.

SOX and PCAOB are motivated to provide control-transparency due, in part, to diminished public confidence in the integrity of financial reporting caused by financial reporting debacles of the late 1990s and early 2000s. As groups, auditing-standard setters, managers and auditors lost public trust necessary to vest them with discretion that they previously enjoyed. Congress reflected public disgust with these groups in SOX, the catalyst for PCAOB and its reforms. PCAOB-mandated control transparency is a way to curtail the need for that discretion, by requiring deeper disclosure of the processes by which managers and auditors reach their conclusions in financial reports.

As for auditing standard-setters, SOX created and anointed PCAOB, the first attempt consciously to insulate audit standard-setting from auditor lobbying. For generations, establishing generally accepted auditing standards (GAAS) had been the

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<sup>119</sup> *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) (Friendly, J.), *cert. denied*, 397 U.S. 1006 (1970) (concerning GAAP); *SEC v. Arthur Young*, 590 F.2d 785, 788-89 (9<sup>th</sup> Cir. 1979) (concerning GAAS) (dicta).

<sup>120</sup> *E.g.*, *Bradford-White Corp. v. Ernst & Whinney*, 872 F.2d 1153 (3d Cir. 1989); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153 (2d Cir. 1998); *Chill v. General Electric Co.*, 101 F.3d 263, 270 (2d Cir. 1996); *see also In re First Union Corp. Sec. Litig.*, 128 F. Supp. 871 (W.D.N.C. 2001); *In re E. Spire Comm., Inc., Sec. Litig.* 127 F. Supp. 2d 734 (D. Md. 2001).



province of the AICPA. The AICPA used various structures to exercise this authority, all of which were subject to rent-seeking pressures from the profession. SOX created PCAOB<sup>121</sup> as a self-regulatory organization,<sup>122</sup> with the SEC appointing and overseeing its five-member board.<sup>123</sup> Structural features are intended to strengthen PCAOB's independence from the auditing profession.<sup>124</sup>

Reflecting managerial mistrust, PCAOB announced that SOX's Section 404 auditor attestation is intended to give shareholders and the public "an independent reason to rely on management's description of the company's internal control over financial reporting."<sup>125</sup> Reflecting mistrust of auditors, the early warning system denies that their final word is acceptable, at least when material weaknesses are present. Auditors must disclose their conclusions and explain what they mean, leaving investors to make more informed judgments about the reliability of the auditor's opinion.

SOX was accompanied by rhetoric announcing its revolutionary quality; careful textual study indicates that the statute itself created no revolution.<sup>126</sup> The one silver bullet concerned creation of PCAOB and its mandate.<sup>127</sup> In Auditing Standard No. 2, PCAOB lives up to the rhetoric.<sup>128</sup> Critics contended that PCAOB exceeded SOX's

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<sup>121</sup> Sarbanes-Oxley Act of 2002, § 101, Pub. L. No. 107-204, 116 Stat. at \_\_\_\_ ; 15 U.S.C. \_\_\_\_.

<sup>122</sup> Sarbanes-Oxley Act of 2002, § 107, Pub. L. No. 107-204, 116 Stat. at \_\_\_\_ ; 15 U.S.C. \_\_\_\_.

<sup>123</sup> Monitoring duties include reviewing audit procedures and policies, registering public accounting firms, maintaining standards concerning audit reports, and the conduct of oversight, disciplining and sanctioning of public accounting firms.

<sup>124</sup> Several structural differences stand out: PCAOB is a creature of statute, not grace; a majority of its five members must be non-CPAs and its chair cannot have practiced public accounting during the year before becoming chair; it is funded by public company shareholders, not the AICPA; and members must be full-time and serve 5-year terms (with a two-term limit) and are subject to removal for cause by the SEC.

<sup>125</sup> PCAOB RELEASE ACCOMPANYING AS NO. 2, at 3.

<sup>126</sup> See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 U. CONN. L. REV. 915 (2003).

<sup>127</sup> *Id.* at 919 & 945-946.

<sup>128</sup> One PCAOB Board member opined that the new regime of internal control certification and attestation "revolutionizes" managerial and auditor attention to internal control. *Statement of Daniel L. Goelzer, PCAOB, on THE PROPOSED STANDARD FOR AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS* (Oct. 7, 2003).

mandates in promulgating Auditing Standard No. 2 and questioned the enlarged scope of legal liability risk the early warning system engenders.<sup>129</sup>

PCAOB dismissed these criticisms. It is created to set standards on an ongoing basis and its authorization is open-ended, not constrained by particular SOX provisions or SEC regulations.<sup>130</sup> Unlike the SEC, whose power is constrained by Congressional legislation granting it, PCAOB articulates generally accepted auditing standards *carte blanche*, unchecked by Congressional grants of power.<sup>131</sup> Its actions in developing Auditing Standard No. 2 show determination to provide firm leadership, in the public interest not beholden to the auditing profession. For example, it responded to the profession's comments mostly by rejecting their opinions; it provides a hard-driven program imposing substantial duties on auditors, significantly restricting their discretion and compelling new disclosure directly from auditors.

These systemic forces suggest an intention to define a new control disclosure regime in which auditors provide direct and full disclosure unlike that they have historically provided concerning financial statements. But for PCAOB's early warning system under Auditing Standard No. 2 to meet its objectives likely requires legal adjustments. Judicial adjustments using safe harbors for forward-looking disclosure can do so, backstopped by PCAOB's ongoing enhanced auditor oversight role.

3. *Auditor Independence* — The new control audit regime addresses the tension between competition and independence in the auditing profession in ways calculated to move auditor control disclosure towards the ideal. Competition among auditing firms has provided the financial reporting system with mixed results. Critics contend that zealous competition for clients drove auditors headlong into consulting practices, thereby

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<sup>129</sup> *E.g.*, *Comment Letters to PCAOB from Kimball* (PCAOB Rulemaking Docket No. 8, Letter No. 38) (noting also that it had written to Indiana Senators and Congressmen protesting and seeking help); *GlaxoSmithKline* (PCAOB Rulemaking Docket No. 8, Letter No. 62); *Pfizer* (PCAOB Rulemaking Docket No. 8, Letter No. 69); *Institute of Chartered Accountants in England and Wales* (PCAOB Rulemaking Docket No. 8, Letter No. 102); *Cummins* (PCAOB Rulemaking Docket No. 8, Letter No. 123); *Caterpillar* (PCAOB Rulemaking Docket No. 8, Letter No. 143); *supra* note 7 (providing additional examples).

<sup>130</sup> *See, e.g.*, AUDITING STANDARD NO. 2 ¶ \_\_\_\_.

<sup>131</sup> This is an important feature making it attractive to the SEC to use organizations such as PCAOB, as well as self-regulatory organizations like the New York Stock Exchange to assist the SEC's development and enforcement of corporate governance and related regulations. *See* Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 968-69 (2003). The complex interplay between Auditing Standard No. 2 and legal rules under Sections 10(b) and 11 show the limits of this method of regulatory production.

compromising their independence.<sup>132</sup> More nuanced observers contend that the move to consulting was a consequence, not a cause, of pressures on auditing firms arising from governmental policies that encouraged them to compete in markets other than traditional auditing.<sup>133</sup>

Whichever view is more accurate, the high-visibility audit failures that began in the late 1990s led the SEC to restrict this competition, shutting auditors out of most consulting markets.<sup>134</sup> SOX elevated the regulatory restrictions to federal law.<sup>135</sup> Thus, accompanying the control-disclosure innovation are regulations intended to reinforce auditor independence. These include empowering audit committees rather than managers to hire, supervise and terminate auditors,<sup>136</sup> as well as restrictions on the kinds of non-audit services auditors can perform to assure their independence from management.<sup>137</sup>

The new model for auditors now ideally should focus not on lucrative consulting business, but more effective attestation services including forward-looking disclosure concerning material weaknesses in control. At stake in this new regime is whether auditors will produce optimal or sub-optimal information. Risks include auditor biases to err on the side of treating control irregularities as significant deficiencies not material weaknesses or to provide perfunctory boilerplate disclosure.

Given Auditing Standard No. 2's limited and somewhat ambiguous guidance,<sup>138</sup> auditor disclosure will develop by custom and best practices. Auditors will consider peer disclosure in shaping their own. A competition will arise. Disclosure competition among auditors may lead auditors to provide disclosure better suited to the tastes of managers (financial statement preparers) rather than of shareholders and the public (financial statement users). Whether this competition will produce superior or inferior disclosure

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<sup>132</sup> See e.g., SECURITIES AND EXCHANGE COMMISSION, REVISION OF THE COMMISSION'S AUDITOR INDEPENDENCE REQUIREMENTS (Nov. 21, 2000).

<sup>133</sup> See e.g., Shyam Sunder, *Rethinking the Structure of Accounting and Auditing* (SSRN.COM, June 16, 2003).

<sup>134</sup> AMENDMENT OF RULE 2-01 OF REGULATION S-X (Reg. § 210.2-01, Qualifications of Accountants).

<sup>135</sup> Sarbanes-Oxley Act of 2002, § 201, Pub. L. No. 107-204, 116 Stat. at \_\_\_ ; 15 U.S.C. \_\_\_ (amending 15 U.S.C. § 78j-1) see also S.E.C. Reg. S-X, 17 C.F.R. § 210.2-01(c) (4)(i)-(ix).

<sup>136</sup> Sarbanes-Oxley Act of 2002, § 301, Pub. L. No. 107-204, 116 Stat. at \_\_\_ ; 15 U.S.C. \_\_\_.

<sup>137</sup> However, not all non-audit services are restricted, and may be performed with audit committee pre-approval.

<sup>138</sup> See *supra* Part I.C.

depends on whether auditors remain beholden to management or are in fact independent of them.

Developing a regime of forward-looking disclosure protected by safe harbor provisions can help reorient auditor alignment more towards investors and away from managers. Auditors could more readily see themselves as partners with shareholders in warning of control difficulties rather than adversaries aligned with management in seeking to keep the financial reporting process opaque. Thus an early warning system using forward-looking disclosure and safe harbors can help to reinforce the new regime of enhanced auditor independence. This is particularly likely if developed by judges on a case-by-case basis that enables attending to an auditor's relative independence from management in a particular case.

### III. A DIFFERENT WARNING: CONTROL WORSHIP

The early-warning system model is rational. The system attempts to offer deeper transparency about control when a company's financial statements fairly present results in accordance with GAAP, but at the same time it uses weak control. The weak control may impair that ability in future periods. A warning is appropriate.

Consider other possible scenarios: the financials are materially misstated, but control is effective; or both are uncertifiable (misstated financials and ineffective control) but the financials are misstated due to factors other than ineffective control; or both are fine but there is no link between them. Making transparency meaningful in these contexts requires greater explanation than Auditing Standard No. 2 requires auditors to provide.<sup>139</sup>

Auditing Standard No. 2's conceit is that effective control will catch accidental mistakes and irregularities and, possibly, fraud. Auditing Standard No. 2 correctly emphasizes inherent limitations of control and the contrast between reasonable assurance, which is possible, and absolute assurance, which is not.<sup>140</sup> It likewise notes that the same limits of financial statement audits apply to control audits.<sup>141</sup> Auditing Standard No. 2 also rightly describes these limits as known features of the financial reporting process and expresses the hope that installing safeguards will "reduce, though not eliminate, the risk" of material financial misstatements.<sup>142</sup>

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<sup>139</sup> See *supra* note 25 (noting that when unqualified opinions are provided Auditing Standard No. 2 requires no special disclosure).

<sup>140</sup> AUDITING STANDARD NO. 2, ¶¶ 16-18.

<sup>141</sup> *Id.*, ¶¶ 16-18.

<sup>142</sup> *Id.*, ¶ 16.

However, Auditing Standard No. 2 never mentions the case of an adverse financial audit opinion despite an unqualified control audit opinion.<sup>143</sup> But control cannot catch aggressive judgments. The new auditing system will convey this point when an auditor provides an unqualified opinion on control but an adverse or qualified opinion on financial statements. When an auditor does so without explanation, however, financial statement users will be confused. In effect, Auditing Standard No. 2 and its early warning system assume that controls are the foundation of reliable financial statements.

But consider the variety of circumstances that can lead an auditor to provide an unqualified opinion on control while providing an adverse or qualified opinion on financial statements. These involve all matters of accounting judgment, ranging from allowance for doubtful accounts to off-balance sheet financing to stock option valuation. Any of these and scores of other accounting judgments may be aggressive. This can be the case even though a company otherwise uses air-tight control over matters such as transaction recording, classification and aggregation.

This class of incongruent opinions can arise for innocuous reasons such as disagreements over accounting judgments. A simple illustration occurs when managers—and auditors—thoroughly review all reporting and controls and find both to be air-tight. Yet the SEC disagrees with an accounting judgment and compels the company to restate the financials.<sup>144</sup> There is no control weakness or even deficiency, but no doubt that the financial statements were not fairly stated in conformity with GAAP.

Disagreements concerning accounting judgment can also arise between management and auditors. Suppose FASB adopts a new accounting standard. Its interpretation in application is untested. Management may take one position and the auditor another and they cannot resolve the difference but the auditor does not feel constrained to resign from the engagement. If controls are air-tight, the auditor would provide an unqualified opinion on control but a non-standard opinion on the financial statements—adverse or qualified.

At the other extreme, managerial judgments can be simply out of bounds and the auditor cannot concur with them. Suppose an auditor assesses managerial judgments as too aggressive, whether as to reserving for doubtful accounts, assessing inventory

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<sup>143</sup> As matters of logic and probability, it may be more likely that a company will boast ineffective internal control over financial reporting and yet be in a position to present fair financial statements than the other way around. But of greater concern is the situation in which effective control nevertheless yields materially misstated financial statements.

<sup>144</sup> See *Comment Letter to PCAOB from BDO Seidman, LLP* (PCAOB Rulemaking Docket No. 8, Letter No.136) (commenting on Proposed Standard, ¶ 126: “There are often cases where a restatement of financial statements is not due to any weakness in internal control (*e.g.*, cases where accounting or disclosure is responsibly reviewed at all levels of the company and at the highest levels of the auditing firm, but a restatement is still required due to the insistence of the SEC staff based upon differing judgment.”)).

obsolescence, depreciating fixed assets, accounting for leases, stock options, derivatives or any of numerous other areas demanding judgment over which control puts no limits. Auditors can say control is effective, but cannot concur that the financial statements fairly present condition and results in conformity with GAAP.<sup>145</sup>

Between the extremes of innocuous and manipulative are circumstances generating scope limitations on auditor reports. Circumstances may prevent an auditor from concluding that financial statements warrant an unqualified opinion; but it may yet be able to give an unqualified opinion on control.

In many of these contexts, the incongruent opinions might signal to reasonable and prudent investors not merely a yellow flag of caution but a red flag concerning a management's integrity in the financial reporting process. But not all such cases will deserve such an interpretation. They could be explained as reasonable.

Despite these complex realities, PCAOB and its pronouncements never mention such situations. On the contrary, all express ultimate confidence in control as the key to reliable financial reporting. As a result, PCAOB's new early warning system imposes no explanatory disclosure obligation on auditors in these situations as it does when control is weak but financials are reliable. This asymmetry can create undue emphasis on control and insufficient emphasis on matters that must be valued using judgment.

After all, everything about internal control over financial reporting should be geared to fairly-presented financial statements, for present and future periods, not as ends in themselves. The new deepened transparency concerning control over financial reporting is not really what investors care about; if auditors had retained investor trust it would not be necessary to deepen disclosure in this way. Investors only care about control because auditors violated that trust.

Absent auditor—or PCAOB—explanation of the variety of opinion combinations and meanings, the new system of yellow (and red) flags will include no green flags. For example, in this system what is the significance of an unqualified opinion as to both control and financial statements? The alignment may tend to create in the investment community a sense that control is working to the end of promoting fair financial statements. But this sense may be false.<sup>146</sup> Opposite congruent opinions can likewise

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<sup>145</sup> Cf. *Comment Letter to PCAOB from Texas Instruments Corporation* (PCAOB Rulemaking Docket No. 8, Letter No. 114) (“Recent major frauds occurred at management level, so responding with enhanced testing of computer controls would not have prevented and is wrong medicine; focus should be on high-risk areas”).

<sup>146</sup> This raises a curiosity in Auditing Standard No. 2 that would remain a curiosity but for the planned broad disclosure regime. Auditing Standard No. 2 provides that when management gives its controls an adverse opinion, and the auditor concurs, it must concur with management (offer an unqualified opinion on their adverse assessment). See *supra* note 27.

mislead unless explained: For joint adverse opinions, the alignment may signal to investors and others that control weaknesses are to blame for noncompliant financial statements. But this may not be the case.

Without clear explanation of these incongruities, PCAOB's new early warning system is a partial step. Failing to address these matters contradicts its premises. It reflects diminished trust in auditors and enriched appetite for information concerning the interior of the financial reporting process. Auditing Standard No. 2 delivers this for the early warning system, but then relies on opposite premises when failing to deliver for the bewildering variety of other combinations of opinions its new regime sponsors.

The purpose of effective control is to facilitate preparation of fairly-presented financial statements, current and future. But the possibility of incongruent audit opinions shows that there is no necessary connection between the two. In fact, the recognized possibility of incongruent opinions suggests reason to be concerned that control can become an end in itself rather than the means to the ultimate objective of fair financial reporting.

## CONCLUSION

Revolutions invariably bring unintended consequences. Second-order effects are especially likely for processes with multiple components driven by numerous actors operating separately and without coordination. For revolution to yield coherent results, other components must make corresponding adjustments. The complex financial reporting process illustrates. In the case of PCAOB's new early warning system, Congress directed its creation and provided a skeletal instruction for implementation. PCAOB provides an elaborate program. Laws that interplay with this feature require adjustment to move the overall process towards greater coherence. PCAOB itself also has more work to do, particularly providing greater clarity to aspects of its new system as likely to mislead and confuse investors as to provide meaningful early warnings.