

# The Case for Individual Audit Partner Accountability

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*Despite repeated regulatory interventions, accounting failures continue to persist in companies around the world. In this Article, I explain why regulatory oversight, private enforcement, and firm-level reputational sanctions are unlikely to induce accountants to take optimal levels of care when auditing corporate financials. Instead, our best chance for improving audit quality lies in establishing a market for individual audit partners' brands—a market that can hold individual auditors responsible for their mistakes.*

*The Article begins by identifying four key benefits to this approach. First, forcing auditors to be publicly associated with any audit failures occurring on their watch will induce them to increase their effort in order to avoid the stigma of failure. Second, now that a significant portion—frequently more than half—of audit hours are performed overseas, holding a single individual publicly accountable for any audit failures will improve monitoring of auditors in other jurisdictions. Third, in light of significant evidence of variation in the quality of audit partners—even partners within the same firm—exposing that heterogeneity will empower members of audit committees and investors to choose auditors more carefully. Finally, commoditizing individual auditors could increase industry competition without the need for aggressive regulatory action.*

*The Article then argues that, in order to spur the development of a market in auditor reputation, lawmakers should encourage the development of Auditor Scorecards. To do so, regulators should require the disclosure of additional auditor-level information and ensure useful information is provided through enforcement actions. Although there are costs to these changes, those costs are likely to be outweighed by giving investors the information they need to develop a common Scorecard for auditor quality. Such Scorecards will help*

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*boards and investors make better use of the legal tools already at their disposal to hold auditors accountable when they fail in their gatekeeping function.*

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## INTRODUCTION

Nearly two decades ago, Congress adopted the Sarbanes-Oxley Act of 2002 to improve the quality of financial reporting. Yet 2018 provided evidence that accounting scandals remain all too common. From the United States,<sup>1</sup> to the United Kingdom,<sup>2</sup> to South Africa,<sup>3</sup> the accounting profession saw a series of high-profile audit failures. Perhaps even more damaging to the integrity of the profession, it was revealed that KPMG cheated on its regulatory inspections by obtaining confidential information from its primary U.S. regulator, the Public Company Accounting Oversight Board (“PCAOB”), leading to a criminal

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1. See Chris Dolmetsch, *PwC Ordered to Pay \$625 Million in Damages Over Bank’s Audit*, BLOOMBERG (July 2, 2018), <https://www.bloomberg.com/news/articles/2018-07-02/pwc-ordered-to-pay-625-million-to-fdic-over-alabama-bank-audit> [https://perma.cc/HE7L-NN8V]; see also Press Release, U.S. Dep’t of Justice, *Deloitte & Touche Agrees to Pay \$149.5 Million to Settle Claims Arising From Its Audits of Failed Mortgage Lender Taylor, Bean & Whitaker* (Feb. 28, 2018), <https://www.justice.gov/opa/pr/deloitte-touche-agrees-pay-1495-million-settle-claims-arising-its-audits-failed-mortgage> [https://perma.cc/P2NC-9SK7].

2. See Caitlin Morrison, *Carillion Collapse: Who Was Behind the ‘Recklessness, Hubris and Greed’ that Led to the Demise of the Government Contractor?*, INDEPENDENT (May 16, 2018), <https://www.independent.co.uk/news/business/analysis-and-features/carillion-collapse-latest-who-responsible-richard-adam-howson-philip-green-mp-report-a8353921.html> [https://perma.cc/6X4L-HGJ5] (describing the failure of Carillion and KPMG’s failure to exercise professional scrutiny); see also Madison Marriage, *UK Watchdog Issues Damning Report on PwC’s Work for BHS*, FIN. TIMES (Aug. 15, 2018), <https://www.ft.com/content/85e00736-a072-11e8-85da-eeb7a9ce36e4> [https://perma.cc/668Q-R9JL] (describing the governmental report issued on PwC’s audit of BHS).

3. See *KPMG South Africa Appeals for Second Chance After Corruption Scandals*, REUTERS (Dec. 10, 2018), <https://www.reuters.com/article/safrica-kpmg/kpmg-south-africa-appeals-for-second-chance-after-corruption-scandals-idUSL8N1YF1AT> [https://perma.cc/R7E-5YTJ] (describing KPMG’s faulty audits for VBS Mutual Bank and the Gupta family).

investigation.<sup>4</sup> And these are hardly isolated incidents: from 2005 to 2016, the PCAOB has found that anywhere from 14 to 33% of the audit opinions it inspected should not have been issued.<sup>5</sup> It is time to ask: Despite the best efforts of Congress, regulators, corporate directors, and investors, why do significant audit failures persist?

In this Article, I argue that the answer to this question lies in part in the lack of accountability the law currently provides for individual auditors. I explain that the incentives provided by regulatory oversight, private enforcement, and firm-level reputational sanctions are unlikely to induce socially optimal levels of audit quality. Instead, individual reputational sanctions are more likely to give audit partners optimal incentives for care. Thus, lawmakers, corporate fiduciaries, and investors seeking to improve audit quality should focus on developing a market in the reputational brands of individual audit partners.

Individual brands are common in financial markets.<sup>6</sup> Broker-dealers, for example, provide significant individual disclosure in an online database known as Brokercheck, and prior work shows that financial advisors' career outcomes are profoundly affected by these disclosures.<sup>7</sup> Securities analysts—commonly grouped together with auditors as gatekeepers—disclose the name of the lead analyst(s) writing the report, again leading to significant reputational consequences for individual analysts.<sup>8</sup> By contrast, accounting firms have fought mightily to resist providing market participants with information about individual auditors.

This Article argues that focusing on individual accountability would provide four important benefits. First, individual reputation markets for auditors would cause audit partners to more fully internalize the costs of an audit failure. Allowing audit partners to remain anonymous permits them to enjoy a disproportionate portion of the financial benefits provided by an audit client but share the costs of failure jointly with other partners of the firm—and those partners are imperfect monitors of one another's conduct. Requiring individual partners to take responsibility for their work will better align incentives and induce greater levels of effort.

Second, individual accountability will help mitigate a particular audit risk that has increased over the past decade: the reliance on

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4. See *infra* Part II.

5. See Appendix A.

6. Individual accountability underscores many required disclosures. For a literature review in this area, see Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675 (2005).

7. See *infra* Part II.

8. See *infra* Part I.

overseas auditors. The limited research on the use of overseas audit participants suggests that they are associated with increased risk of audit failure.<sup>9</sup> But studies also suggest that holding the lead partner to a higher level of accountability can, at least in part, counteract the increased risk by giving domestic partners strong incentives to monitor overseas work.<sup>10</sup>

Third, a robust market for individual auditors' reputation would make it easier for audit committees and investors to choose higher-quality auditors. The evidence shows that there is significant variation in audit partner quality, even among partners at the same firm. Knowing this information would allow market participants to demand higher-quality auditors—while also imposing a penalty on audit partners who fail to protect investors.

Finally, building individual auditor reputation markets could increase competition without the need for aggressive regulatory action. Over 99% of the S&P 500 select one of the Big Four accounting firms,<sup>11</sup> and commentators have increasingly taken aim at the oligopolistic structure of the industry.<sup>12</sup> Based on lessons from similar industries, such as credit and risk analysts, there is reason to believe that individual reputation markets could increase competition and mobility.

To help market participants develop a robust market for individual auditor reputation, this Article proposes the use of Auditor Scorecards that describe publicly available information on the lead auditor and the audit design for each public company. Such Scorecards would provide valuable information to the market—but they would be more informative if regulators mandated disclosure of additional information that is currently unavailable. First, PCAOB disciplinary proceedings are not publicly available until years after the infraction, minimizing their utility. These should be disclosed in a timelier manner. Second, the current disclosures regarding overseas auditors are incomplete and should be supplemented. Finally, some enforcement actions regarding poor audit practices name the auditor, but others do not. When possible and equitable, the auditor should be named so that the information can be incorporated in individual reputation markets.

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9. See *infra* notes 133–134 and accompanying text.

10. See *infra* Part II.

11. John Pakaluk, *Auditor Market Share of the S&P 500*, AUDIT ANALYTICS (Feb. 27, 2017), <https://blog.auditanalytics.com/auditor-market-share-of-the-sp-500/> [https://perma.cc/55D3-7UEN].

12. See *infra* note 162 and accompanying text.

## I. THE LAW AND ECONOMICS OF AUDIT OVERSIGHT

Financial misconduct has serious consequences that reverberate throughout the economy. At a broad economic level, fraud distorts the allocation of assets, as fraudulent companies receive funding that would be better allocated elsewhere.<sup>13</sup> And companies associated with the fraudulent company suffer economic setbacks, even if those companies played no role in the misconduct.<sup>14</sup>

At an individual level, fraud has serious consequences for employees and investors. Employees of firms that commit fraud are more likely to lose their jobs and to receive lower wages if they do retain their jobs.<sup>15</sup> Employees may also lose their retirement savings. Investors suffer, too. In addition to financial hardship, investors may suffer from broken relationships, psychological effects, and mental and physical health problems.<sup>16</sup>

For these reasons, current law devotes considerable resources to preventing fraud. A substantial portion of these resources are devoted to ensuring a strong audit function. Public companies are required to employ independent auditors, and these auditors are induced to perform high-quality work through regulatory oversight, private enforcement, and reputational sanctions. In this Part, I describe the structural market that provides these incentives.

*A. Regulatory Oversight*

The PCAOB is the primary audit regulator, but the Securities and Exchange Commission (“SEC”) also plays a key role. Both regulators have a multipronged regulatory approach that includes ex ante monitoring and ex post enforcement. Of the two, the PCAOB plays a larger monitoring role. Not only does the PCAOB establish auditing standards, but it ensures compliance with those standards through

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13. Simi Kedia & Thomas Philippon, *The Economics of Fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2195 (2009). As an example, consider Theranos, the fraudulent blood-testing company that received hundreds of millions of dollars from investors. See Reed Abelson, *Theranos Founder Elizabeth Holmes Indicted on Fraud Charges*, N.Y. TIMES (June 15, 2018), <https://www.nytimes.com/2018/06/15/health/theranos-elizabeth-holmes-fraud.html> [<https://perma.cc/MZP6-U4HZ>].

14. See Umit G. Gurun, Noah Stoffman & Scott E. Yonker, *Trust Busting: The Effect of Fraud on Investor Behavior*, 31 REV. FIN. STUD. 1341, 1344–45 (2018).

15. Jung Ho Choi & Brandon Gipper, *Fraudulent Financial Reporting and the Consequences for Employees* 38–39 (Stanford Univ. Graduate Sch. of Bus., Research Paper No. 19-19, 2009), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3346759](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3346759) [<https://perma.cc/7TPN-9WHU>].

16. Mark Button, Chris Lewis & Jacki Tapley, *Not a Victimless Crime: The Impact of Fraud on Individual Victims and Their Families*, 27 SECURITY J. 36, 42–43 (2014).

annual inspections of accounting firms.<sup>17</sup> In effect, the PCAOB audits the audit firms. Further, because the PCAOB's mission is to protect investors more broadly, the PCAOB also mandates new disclosures relating to the auditing process that should, in theory, allow investors to play a greater monitoring role.<sup>18</sup>

By contrast, although the SEC's Office of the Chief Accountant also plays a role in monitoring auditors, the SEC's regulation of auditors is generally better known for its ex post enforcement.<sup>19</sup> The SEC can sanction accountants or, in severe cases, bar them from serving as public company auditors.<sup>20</sup> The PCAOB can bring disciplinary orders as well, but the PCAOB orders tend to concern inspection-related infractions while SEC actions are more likely to be brought in instances of fraud.<sup>21</sup> Further, PCAOB disciplinary orders can be appealed to the SEC,<sup>22</sup> meaning that the SEC has significant control over the PCAOB's enforcement mechanism.

### *B. Private Enforcement*

Under the traditional framework in corporate law, shareholders (the principal) hire firm managers (the agents). Auditing adds additional complexity to this model. The shareholders elect the board of directors, and the board of directors acts through the audit committee to hire and fire the auditor. Like the board of directors, the auditor works for the benefit of shareholders. In effect, shareholders are subject to two agency relationships: one with the audit committee and another

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17. *Fast Answers: Public Company Accounting Oversight Board*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/fast-answers/answerspcaobhtm.html> (last modified Jan. 16, 2013) [<https://perma.cc/MA9R-DF7E>].

18. *Id.*; see also Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 107, 116 Stat. 745, 765–66 (codified at 15 U.S.C. § 7217) (new disclosures are subject to SEC approval).

19. *Fast Answers*, *supra* note 17. The SEC also oversees the PCAOB. It approves the PCAOB's budget, appoints the board members, and must approve certain disciplinary measures, meaning that the SEC has significant control over the PCAOB. Although the PCAOB and SEC are the primary auditing regulators, auditors can be targeted by any number of government actors. For example, the Department of Justice and Federal Deposit Insurance Corporation also bring cases against auditors.

20. See, e.g., Simcha Baer, CPA, Exchange Act Release No. 82736, 2018 WL 922498 (Feb. 16, 2018) (barring an accountant from appearing or practicing before the Commission as an accountant).

21. Simi Kedia, Urooj Khan & Shivaram Rajgopal, The SEC's Enforcement Record Against Auditors 23 (Feb. 16, 2017) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2947469](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2947469) [<https://perma.cc/WJ5Y-8S2H>]; see also Joshua Nichols, *Examining Sanctions for Accountants Under SEC Rule of Practice 102(e)(1)*, VEDDER PRICE 10, 11–12 (2016), <https://www.vedderprice.com/-/media/files/vedder-thinking/publications/2016/12/securities-litigation-and-government-enforcement-t.pdf> [<https://perma.cc/782K-SMNG>].

22. *Fast Answers*, *supra* note 17.

with the auditor. This means the shareholders can discipline the auditor directly (either through litigation or shareholder voting) or indirectly through the audit committee (through termination).

### 1. Litigation Against Audit Firms

In theory, the risk of shareholder litigation provides auditors with a strong incentive to perform high-quality audits. Although auditors can be sued by any number of parties,<sup>23</sup> the incentives created by shareholder litigation—and the payouts from these cases—are typically considered most influential.<sup>24</sup>

In recent years, however, the Supreme Court has increasingly restricted shareholders' ability to sue auditors.<sup>25</sup> Shareholder litigation against auditors occurs primarily under the federal securities laws—typically Rule 10b-5.<sup>26</sup> Broadly stated, under Rule 10b-5, actors can be liable as “primary actors” (those who performed the bad act themselves) or “secondary actors” (those who assisted the primary actor in her bad act). Traditionally, secondary actor liability provided a realistic threat that a poor audit could lead to liability, but auditors were rarely held liable as primary violators because they typically did not commit the fraud themselves.

However, beginning with *Central Bank of Denver v. First Interstate Bank of Denver* in 1994<sup>27</sup> and extending through *Janus Capital Group, Inc. v. First Derivative Traders* in 2011, the Court has

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23. In addition to shareholders, auditors are frequently sued by, for example, clients, banks, and insurance companies. Jennifer J. Gaver, Jeffrey S. Paterson & Carl J. Pacini, *The Influence of Auditor State-Level Legal Liability on Conservative Financial Reporting in the Property-Casualty Insurance Industry*, 31 AUDITING, Aug. 2012, at 95, 120; see also Divya Anantharaman, Jeffrey A. Pittman & Nader Wans, *State Liability Regimes Within the United States and Auditor Reporting*, 91 ACCT. REV. 1545, 1545–46 (2016).

24. See, e.g., John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* 6 (Columbia Law Sch. Ctr. for Law & Econ. Studies Working Paper No. 191, 2001), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=270944](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=270944) [<https://perma.cc/CC4N-FYVK>]; see also Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 370 (2004).

25. *Private Securities Fraud Claims Under Section 10(b) Based on False or Misleading Statements*, SULLIVAN & CROMWELL LLP 3 (2011), [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Private\\_Securities\\_Fraud\\_Claims\\_Under\\_Section\\_10b.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Private_Securities_Fraud_Claims_Under_Section_10b.pdf) [<https://perma.cc/G386-FWJA>].

26. 17 C.F.R. § 240.10b-5 (2019). Rule 10b-5, promulgated under Section 10(b) of the Exchange Act, is the broadest antifraud rule under federal securities law. It is the most frequent shareholder claim brought against auditors. See Colleen Honigsberg et al., *The Changing Landscape of Auditor Litigation* 22 (Stanford Law and Econ. Olin Working Paper No. 512, 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3074923](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3074923) [<https://perma.cc/PM2B-269W>]. Common law notions of privity prevent most state law claims. See Gaver, *supra* note 23, at 96.

27. 511 U.S. 164 (1994).

increasingly restricted the scope of secondary actor liability under Rule 10b-5.<sup>28</sup> The law now requires shareholder plaintiffs to argue that the auditor should be liable as a primary actor—a far more difficult feat than arguing the auditor should be liable as a secondary actor. Although the Court appeared to step back from the most extreme limitations of its *Janus* decision in the more recent *Lorenzo v. SEC*,<sup>29</sup> even a lenient interpretation of *Janus* imposes significant limitations on auditor liability.

Perhaps in response to the narrowing of secondary actor liability under Rule 10b-5, Section 11 of the Securities and Exchange Act of 1933 has begun to play an increasing role in shareholder litigation against auditors.<sup>30</sup> However, Section 11 is an imperfect substitute. Not only does it have a shorter statute of limitations than Rule 10b-5,<sup>31</sup> but it applies only to registration statements (and documents incorporated by reference).<sup>32</sup> By contrast, Rule 10b-5 applies more broadly.

## 2. Shareholder Voting

Shareholder voting can also provide a check on auditors' work. An estimated 80 to 95% of companies request that their shareholders ratify the company's auditor.<sup>33</sup> These votes are routinely favorable. According to Audit Analytics, 98% of votes cast from January 1, 2014

28. 564 U.S. 135 (2011); see Honigsberg et al., *supra* note 26, at 13; *infra* notes 86–98 and accompanying text.

29. 139 S. Ct. 1094, 1103 (2019). Justice Clarence Thomas, the author of *Janus*, wrote a forceful dissent in *Lorenzo*, arguing that the majority opinion made no real effort to reconcile its opinion with *Janus*. See *id.* at 1105–11 (Thomas, J., dissenting). However, even if *Lorenzo* is more lenient than *Janus*, it does not seem sufficiently lenient to roll back established precedent for pleading Rule 10b-5 claims against auditors.

30. 15 U.S.C. § 77k (2012). See Honigsberg et al., *supra* note 26, at 21–22, 53. From 1996–1998, 91% of securities cases against auditors alleged a violation of Rule 10b-5, and only 28% alleged a violation of Section 11. By contrast, from 2014–2016, 69% of securities cases against auditors alleged a violation of Rule 10b-5, and 54% alleged a violation of Section 11. *Id.*

31. SOX's extension of the statute of limitations for Rule 10b-5 does not apply to Section 11. See *In re WorldCom, Inc. Sec. Litig.*, Nos. 02 Civ.3288 (DLC), 03 Civ.9499 (DLC), 2004 WL 1435356, at \*3 (S.D.N.Y. June 28, 2004); see also *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003).

32. See 15 U.S.C. § 77k.

33. Cory A. Cassell, Tyler Kleppe & Jonathan E. Shipman, Uninformed Shareholders and the Efficacy of Proxy Voting 8 (Apr. 6, 2019) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3113807](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3113807) [<https://perma.cc/422Z-VYYT>]. Many companies hold a vote on the auditor because it is a “routine” matter supported by management, meaning that brokers can vote shares without their customers' direction; as long as there is at least one such “routine” vote, broker non-votes can be counted towards a quorum. John Pakaluk, *Auditor Ratification: Shareholders Appear Content*, AUDIT ANALYTICS BLOG (Oct. 21, 2013), <https://blog.auditanalytics.com/auditor-ratification-shareholders-appear-content/> [<https://perma.cc/4MDU-8FTZ>].

through December 31, 2016 were cast in favor of auditor ratification.<sup>34</sup> Although such high favorability could indicate satisfaction with the auditor, these votes are usually considered perfunctory and uninformed.<sup>35</sup>

### 3. Termination

Although the shareholders cannot directly fire the auditor, their agent (the audit committee) can do so. In theory, the risk of termination should incentivize auditors to perform high-quality work to keep their job.<sup>36</sup> However, there are significant costs to firing an auditor.<sup>37</sup> Indeed, issuers and auditors tend to have very sticky relationships. For example, over 175 firms in the S&P 500 have had the same auditor for over twenty-five years.<sup>38</sup> For large public companies, terminating the company's auditor is a rare event.

#### *C. Reputational Risk*

Alongside regulatory oversight and private enforcement, reputational risk is thought to provide audit firms—especially large,

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34. Jessica McKeon, *Auditor Ratification: A Closer Look at Votes Against*, AUDIT ANALYTICS BLOG (Jan. 17, 2017), <https://blog.auditanalytics.com/auditor-ratification-a-closer-look-at-votes-against/> [<https://perma.cc/A7JP-AM23>].

35. See Cassell, Kleppe & Shipman, *supra* note 33, at 7.

36. Financial intermediaries usually push companies to hire one of the Big Four/Big Five auditors, where these are the big audit firms considered to be part of the oligopoly. These firms are PricewaterhouseCoopers, Ernst & Young, KPMG, Deloitte & Touche, and prior to its demise, Arthur Andersen (this group is frequently referred to as the Big N because its size was reduced from the Big Five to the Big Four after the demise of Arthur Andersen). See, e.g., Sadok El Ghouli, Omrane Guedhami & Jeffrey Pittman, *Cross-Country Evidence on the Importance of Big Four Auditors to Equity Pricing: The Mediating Role of Legal Institutions*, 54 ACCT., ORGS. & SOC'Y 60, 68 (2016) (finding that the cost of equity is reduced when an issuer hires a Big N auditor); Krishnagopal Menon & David D. Williams, *Auditor Credibility and Initial Public Offerings*, 66 ACCT. REV. 313, 330 (1991) (finding that investment banks push new firms to the large auditors); Vivien Beattie & Stella Fearnley, *Audit Market Competition: Auditor Changes and the Impact of Tendering*, 30 BRITISH ACCT. REV. 261, 276–77 (1998) (finding, based on interviews in the United Kingdom, that firms switch into the Big N because of the influence of banks or underwriters, the influence of equity or loan providers, the need for more capacity, the need for a multinational capability, and just generally the need for a Big N firm (listed in order of descending frequency of response)). Note that the audit market for issuers is heavily concentrated, but that this contrasts with the broker-dealer market, where there are thousands of audit firms. See Jonathan Aaron Cook et al., *Auditors Are Known by the Companies They Keep* (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 19-12, 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3326595](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3326595) [<https://perma.cc/U2JE-FL39>].

37. See *infra* Part II.

38. See David Ingram & Dena Aubin, *Insight: Big 4 Auditors Spend More Than Ever on US Lobbying*, REUTERS (Mar. 13, 2012), <https://www.reuters.com/article/us-usa-accounting-big4/insight-big-4-auditors-spend-more-than-ever-on-u-s-lobbying-idUSBRES2C0JQ20120313> [<https://perma.cc/KX6M-M4Q2>].

successful audit firms—with significant incentives to perform high-quality work. Auditors sell their reputation, and theory suggests that high-quality clients would be unwilling to hire an auditor with a tarnished reputation.

### 1. Firm Reputation

Prior research has provided evidence consistent with the intuition that high-quality clients do not want to be associated with a low-quality audit firm. For example, large public companies overwhelmingly employ one of the Big Four audit firms, which are commonly perceived to be of higher quality. Theoretically, these firms have more to lose in litigation (they are thought to be attractive litigation targets because they have relatively deep pockets), and a sufficiently large client base to resist pressure from a single client. Some empirical evidence supports the contention that these firms are, in fact, of higher quality.<sup>39</sup>

An interesting feature of firm-level auditor reputation in the United States, however, is that the Big Four appear to enjoy such an established brand advantage that their reputation is relatively unaffected by typical audit failures. Although there is some evidence from abroad that public companies may drop an affiliate of a Big Four auditor after a high-profile failure,<sup>40</sup> this pattern is not present in the United States.<sup>41</sup> As described in Section II.A.2, there are many possible explanations for the Big Four's seeming immunity from competition,

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39. *E.g.*, Mark DeFond & Jieying Zhang, *A Review of Archival Auditing Research*, 58 J. ACCT. & ECON. 275, 299 (2014); Jere R. Francis, Matthew L. Pinnuck & Olena Watanabe, *Auditor Style and Financial Statement Comparability*, 89 ACCT. REV. 605, 628 (2014); Denise Dickins et al., *ICYMI | Not All PCAOB Inspections Are Created Equal*, CPA J. (2018), <https://www.cpajournal.com/2018/08/30/icymi-not-all-pcaob-inspections-are-created-equal/> [https://perma.cc/Q7GC-XFW6].

40. *See, e.g.*, Douglas J. Skinner & Suraj Srinivasan, *Audit Quality and Auditor Reputation: Evidence from Japan*, 87 ACCT. REV. 1737, 1738–39 (2012) (finding that, following a short suspension, the Japanese affiliate of PwC lost approximately one-quarter of its clients); Joseph Weber, Michael Willenborg & Jieying Zhang, *Does Auditor Reputation Matter? The Case of KPMG Germany and ComROAD AG*, 46 J. ACCT. RES. 941, 944 (2008) (finding an increase in the number of clients dropping KPMG following a scandal in Germany); Loni Prinsloo & John Bowker, *KPMG Loses More South African Staff from Gupta Fallout*, BLOOMBERG (Sept. 26, 2018), <https://www.bloomberg.com/news/articles/2018-09-25/kpmg-is-said-to-lose-more-south-african-staff-from-gupta-fallout> [https://perma.cc/Y8HM-S4W8] (describing KPMG's loss of clients after the recent Gupta scandal in South Africa).

41. *See* Kedia, Khan & Rajgopal, *supra* note 21, at 29. *See also* Matthew Baugh et al., *Did the 2005 Deferred Prosecution Agreement Adversely Impact KPMG's Tax and/or Audit Practices?*, 38 AUDITING, Feb. 2019, at 77, 95 (finding that KPMG's audit practice was not affected by the legal challenges its tax practice faced).

including market pressures, the costs required to get a new auditor up to speed, and a lack of other options.<sup>42</sup>

## 2. Individual Reputation

Finally, in theory, individual reputational risk could induce high-quality audits. However, to date, auditors have had limited individual reputational constraints in American markets. With that being said, research in other securities contexts suggests that individual reputational constraints can provide powerful incentives to perform high-quality work.

### *a. Reputation in Capital Markets*

Prior work has shown, for example, that managers who are present when a firm commits financial misconduct and fail to prevent it suffer adverse career consequences. Directors are more likely to depart a firm following earnings restatements or financial fraud,<sup>43</sup> and CEOs have difficulty finding new management roles when they leave after regulatory enforcement actions are revealed.<sup>44</sup> Similarly, financial advisors, for whom individual detail on prior misconduct is available in online regulatory databases, suffer negative career consequences upon committing misconduct.<sup>45</sup>

Financial analysts, too, are subject to reputation markets. Beginning in the early 1990s, the Wall Street Journal published a list of “All-Star Analysts,”<sup>46</sup> and significant research has shown that being

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42. See *infra* Section II.A.2.c.

43. Suraj Srinivasan, *Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members*, 43 J. ACCT. RES. 291, 331 (2005); see also Hemang Desai, Chris E. Hogan & Michael S. Wilkins, *The Reputational Penalty for Aggressive Accounting: Earnings Restatements and Management Turnover*, 81 ACCT. REV. 83, 108 (2006); Karen M. Hennes, Andrew J. Leone & Brian P. Miller, *The Importance of Distinguishing Errors from Irregularities in Restatement Research: The Case of Restatements and CEO/CFO Turnover*, 83 ACCT. REV. 1487, 1515, 1517 (2008).

44. Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 J. FIN. ECON. 306, 307 (Nov. 2007).

45. See Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct*, 127 J. POL. ECON. 233, 261–71 (2019) (showing that advisors are more likely to depart their firm after misconduct and have a slightly worse prospect of reemployment than advisors with no instances of misconduct; and those who find employment with a new firm are, on average, likely to land a less prestigious employment); see also Colleen Honigsberg & Matthew Jacob, *Deleting Misconduct: The Expungement of Brokercheck Records* (Nov. 14, 2018) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3284738](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3284738) [<https://perma.cc/87ES-2QNQ>] (showing that brokers with successful expungements have better career outcomes).

46. *Looking Back at the Best on the Street*, WALL ST. J. (May 9, 2012, 11:51 AM), <https://www.wsj.com/articles/SB10001424052702304811304577370093584392220#7> [<https://perma.cc/Y999-AD3H>]; see also John R. Dorfman, *Sixteen All-Stars Excel for the Fifth*

on that list is associated with substantial professional rewards. One study found that Star Analysts were more likely to move to the buy side following industry turmoil.<sup>47</sup> Another found that Star Analysts earn 61% more than unrated peers.<sup>48</sup> And another found that Star Analysts enjoyed increased job mobility following regulatory reform.<sup>49</sup> Because analysts, like auditors, are commonly considered gatekeepers, research on analyst reputation markets may be especially relevant for lawmakers considering how to improve audit outcomes.<sup>50</sup>

### *b. Reputation Markets in the Auditing Industry*

By comparison, accounting firms have successfully resisted rules that would produce public disclosure of individual auditor information, allowing audit partners to hide behind their firms' reputations.<sup>51</sup> The resulting incentives have a concerning implication for investors: each individual partner is incentivized to accommodate firm managers, even at the expense of audit quality.

To see why, consider the following. Audit partners' compensation is significantly determined by whether they maintain or increase their client base.<sup>52</sup> Further, many Big Four partners leave to work in industry.<sup>53</sup> Therefore, each partner's principal objectives are to keep her clients and to appease potential future clients and employers. Relative to the firm, each partner will receive a disproportionate share

*Time*, WALL ST. J. (June 19, 1997), <https://www.wsj.com/public/current/articles/SB866661569251491500.htm> [<https://perma.cc/EXK8-ML6C>].

47. Yuyan Guan, Hai Lu & M.H. Franco Wong, *Regulations and Brain Drain: Evidence from the Wall Street Star Analysts' Career Choices* 24 (Jan. 2013) (unpublished manuscript), [http://www-2.rotman.utoronto.ca/facbios/file/GLW\\_Jan28\\_2013\\_fullversion.pdf](http://www-2.rotman.utoronto.ca/facbios/file/GLW_Jan28_2013_fullversion.pdf) [<https://perma.cc/65KZ-PF35>].

48. Boris Groysberg, Paul M. Healy & David A. Maber, *What Drives Sell-Side Analyst Compensation at High-Status Investment Banks?*, 49 J. ACCT. RES. 969, 971 (2011).

49. See Yuyan Guan et al., *Regulations and Brain Drain: Evidence from Wall Street Star Analysts' Career Choices*, MGMT. SCI. (forthcoming) (manuscript at 27), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3243135](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3243135) [<https://perma.cc/8GHA-Q9X9>].

50. Of course, the comparison is not identical—analysts succeed by making accurate predictions; auditors succeed by preventing failure (a relatively binary outcome).

51. Barring relatively infrequent instances, the name of the partner conducting the audit has historically been confidential, so the reputational focus is on the firm or firm office.

52. W. Robert Knechel, Lasse Niemi & Mikko Zerni, *Empirical Evidence on the Implicit Determinants of Compensation in Big 4 Audit Partnerships*, 51 J. ACCT. RES. 349, 350, 376–78 (2013) (analyzing Big Four compensation in Sweden); see also Paul J. Coram & Matthew J. Robinson, *Professionalism and Performance Incentives in Accounting Firms*, 31 ACCT. HORIZONS 103, 105, 118–19 (2017) (examining Big Four compensation in Australia).

53. See Anne Albrecht, Elaine G. Mauldin & Nathan J. Newton, *Do Auditors Recognize the Potential Dark Side of Executives' Accounting Competence?*, ACCT. REV., Nov. 2018, at 1, 9 (finding that 18.2% of firms between 2004 and 2013 had at least one executive with either audit manager or audit partner experience).

of the fees paid by that client—and other potential benefits in the form of non–Big Four employment. However, because the market will not know the partner’s identity—only that of her firm and perhaps her associated office—she will share the risk of an audit failure jointly with other partners at her same firm.

Recognizing this problem, in 2009 the PCAOB proposed mandating disclosure of the individual audit partner leading public company audits.<sup>54</sup> The accounting industry strongly opposed the disclosure, arguing that it would significantly increase their risk of litigation for little benefit.<sup>55</sup> For example, they argued that the disclosure could increase their risk of Section 11 liability (a claim the SEC disputed).<sup>56</sup> The firms also argued that the disclosure could increase their risk of Rule 10b-5 liability and/or cause individual auditors to be named in lawsuits.<sup>57</sup>

In response to concerns of increased litigation risk, in December 2015, the PCAOB adopted a new rule that required disclosure of the audit partner in a different format.<sup>58</sup> The new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, would be filed on the PCAOB’s website rather than with the issuer’s filings—that is, the name of the engagement partner would not be disclosed in the audit report, but in an entirely separate location. The SEC approved the rules requiring Form AP in May 2016,<sup>59</sup> and audit firms became required to file the form in conjunction with audit reports issued on or after January 31, 2017.<sup>60</sup>

It is too soon to know the effect of the disclosure (if any). The initial research is split on its effect, with some studies suggesting that

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54. PUB. CO. ACCOUNTING OVERSIGHT BD., RELEASE NO. 2009-005, CONCEPT RELEASE ON REQUIRING THE ENGAGEMENT PARTNER TO SIGN THE AUDIT REPORT 7–8 (2009), [https://pcaobus.org/Rulemaking/Docket029/2009-07-28\\_Release\\_No\\_2009-005.pdf](https://pcaobus.org/Rulemaking/Docket029/2009-07-28_Release_No_2009-005.pdf) [<https://perma.cc/L6GN-JX6J>].

55. PUB. CO. ACCOUNTING OVERSIGHT BD., RELEASE NO. 2015-004, SUPPLEMENTAL REQUEST FOR COMMENT: RULES TO REQUIRE DISCLOSURE OF CERTAIN AUDIT PARTICIPANTS ON A NEW PCAOB FORM 4 (2015), [https://pcaobus.org/Rulemaking/Docket029/Release\\_2015\\_004.pdf](https://pcaobus.org/Rulemaking/Docket029/Release_2015_004.pdf) [<https://perma.cc/P34J-F4F7>].

56. See Order Granting Approval of Proposed Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards, Exchange Act Release No. 34-77787, at 6–7 (May 9, 2016), <https://www.sec.gov/rules/pcaob/2016/34-77787.pdf> [<https://perma.cc/FMK4-TMXR>] [hereinafter Order Granting Approval of Proposed Rules] (discussing the concern over increased liability and the PCAOB’s response).

57. PUB. CO. ACCOUNTING OVERSIGHT BD., *supra* note 55, at 4–5.

58. News Release, Pub. Co. Accounting Oversight Bd., PCAOB Adopts Rules Requiring Disclosure of the Engagement Partner (Dec. 15, 2015), <https://pcaobus.org/News/Releases/Pages/PCAOB-adopts-disclosure-rules-Form-AP-12-15-15.aspx> [<https://perma.cc/N8V6-UWD3>].

59. See Order Granting Approval of Proposed Rules, *supra* note 56.

60. *Id.*

it may have increased audit quality (and audit fees), and other work finding no effect.<sup>61</sup> As a practical matter, however, the name of the audit partner seems unlikely to provide investors with significant information until those investors know more about that individual through, for example, Auditor Scorecards.

## II. THE CASE FOR INDIVIDUAL AUDITOR REPUTATION

In this Part, I note that existing deterrence mechanisms have failed to produce optimal audit quality. Then, I describe the arguments for and against individual auditor reputation markets. In favor, I note that the existing deterrence mechanisms are ineffective, and that individual brands would improve audit quality by realigning the incentives of the auditor, improving the ability of audit committees and investors to select a high-quality auditor, and arguably increasing competition. However, I note potential objections such as the possibilities of increased audit fees, litigation, and/or risk aversion.

### *A. Existing Deterrence Mechanisms*

In evaluating the effectiveness of existing mechanisms, it is important to distinguish the optimal failure rate for audit “outcomes” (for example, restatements) from the optimal failure rate for audit “inputs” (for example, failing to perform the audit in accordance with auditing standards). The optimal failure of inputs should be far lower than the optimal failure of outcomes and close to zero. After all, auditing standards are adopted after a rigorous review process and are designed to balance the need for cost-effective audits with the need to prevent audit failure outcomes.

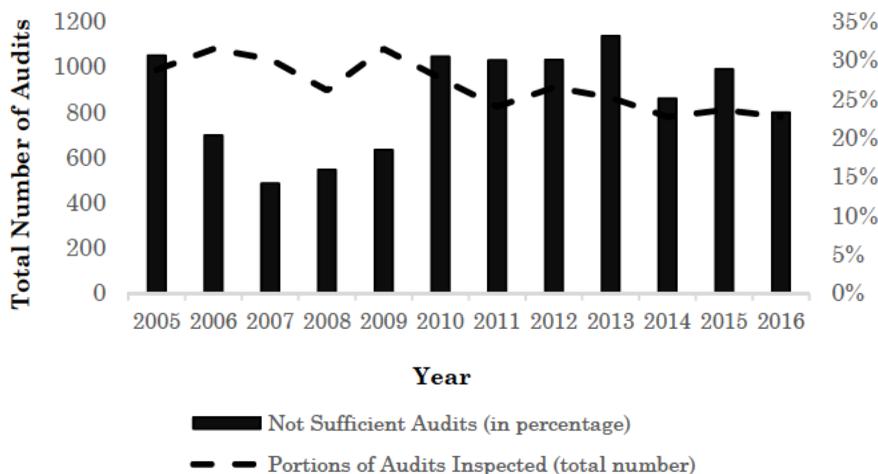
The best evidence of the quality of audit inputs comes from PCAOB inspections. Figure 1 shows the frequency of “not sufficient” audits uncovered by the PCAOB during their inspections. An audit is deemed not sufficient if the PCAOB believed the auditor lacked sufficient evidence to issue an opinion (stated simply, an audit is deemed not sufficient if the PCAOB believes the auditor did not follow

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61. Compare Lauren Cunningham, Chan Li, Sarah E. Stein & Nicole Wright, *What's in a Name? Initial Evidence of U.S. Audit Partner Identification Using Difference-in-Differences Analyses*, 94 ACCT. REV. 139 (2019) (finding no significant increase in audit fees and/or audit quality on average), with Jenna Burke, Rani Hoitash & Udi Hoitash, *Audit Partner Identification and Characteristics: Evidence from U.S. Form AP Filings*, 38 AUDITING, Aug. 2019 (finding a significant increase in audit fees and audit quality in the first year after adoption). See also *infra* Part II (discussing other recent research).

auditing standards). From 2005 to 2016, the number of “not sufficient” audits ranged from 14 to 33% with no discernable trend.<sup>62</sup>

FIGURE 1: PCAOB INSPECTIONS, 2005 TO 2016



These are striking statistics. Although the sample of audits selected for inspection is not randomly chosen and likely to be more problematic than the full set of audits,<sup>63</sup> a finding that, on average, 25% of audit opinions inspected should not have been issued cannot be optimal. Further, the lack of a decline is notable, as it suggests that firms are not learning from the PCAOB’s inspection process.<sup>64</sup> These

62. See Appendix A. As an example of an audit lacking sufficient evidence, consider the PCAOB’s 2014 inspection report for MaloneBailey. The issuer in question recognized full revenue upon the customer’s acceptance of delivery despite the fact that the contracts indicated the issuer had ongoing obligations beyond delivery. Under basic accounting principles, revenue should be recognized when earned. If the issuer has not fulfilled all obligations of the contract, it cannot recognize full revenue. This basic tenet was not followed, and the PCAOB noted there was no evidence in the audit documentation that the auditor had performed standard procedures to determine whether the issuer’s revenue recognition was correct. PUB. CO. ACCOUNTING OVERSIGHT BD., 2013 INSPECTION OF MALONEBAILEY, LLP 5–6 (2014), [https://pcaobus.org/Inspections/Reports/Documents/2015\\_MaloneBailey\\_LL.pdf](https://pcaobus.org/Inspections/Reports/Documents/2015_MaloneBailey_LL.pdf) [<https://perma.cc/QNS9-CMWF>].

63. The PCAOB conducts risk-based inspections, meaning that it uses internally developed factors to predict audit failure and weighs the predicted failure rates when selecting audits to inspect. However, the PCAOB must inspect the eleven accounting firms with more than one hundred issuers annually, while accounting firms with fewer than one hundred issuers are generally inspected triennially. As such, the inspections are risk-based, conditional on the firms subject to inspection. Therefore, the audits inspected are often considered to disproportionately represent large issuers in complex industries that have experienced prior accounting failures.

64. These trends are not limited to the United States. European regulators also find high failure rates in the audits they inspect. See John C. Coffee, *Why Do Auditors Fail? What Might Work? What Won’t?* (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 597,

findings lead us to question why the existing deterrence methods described above do not induce better behavior.

## 1. Regulatory Authorities

Despite the reforms imposed by the Sarbanes-Oxley Act of 2002 (“SOX”), there remain several reasons to expect regulation to provide suboptimal levels of deterrence. First, there is evidence that accounting regulators suffer from regulatory capture. Second, lobbying by accounting firms has successfully deterred and/or eliminated regulation meant to incentivize high-quality audits. Third, following the collapse of Arthur Andersen, regulators have been reluctant to impose penalties that could further reduce the size of the accounting market.

### *a. Regulatory Capture at the PCAOB*

Stated broadly, regulatory capture is the process through which special interests infiltrate the regulatory process and advance their own interests at the public’s expense.<sup>65</sup> When capture occurs, the regulatory process is upended and becomes ineffective.

Capture can occur for many reasons. However, in financial services, a common explanation for capture is that regulators cater to the entities they are supposed to regulate in order to receive lucrative job offers from those entities upon leaving the regulatory organization.<sup>66</sup> To mitigate these concerns, the PCAOB is limited to two CPAs on its board of five members.<sup>67</sup>

Nonetheless, capture remains a concern. A recent study found that accounting firms with worse PCAOB inspection results hire more

2019), [https://scholarship.law.columbia.edu/faculty\\_scholarship/2293/](https://scholarship.law.columbia.edu/faculty_scholarship/2293/) [<https://perma.cc/V2T5-3WXM>].

65. For example, an industry might propose rules that restrict entrance into a market, thus benefitting the existing players. See, e.g., Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089 (1991); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

66. For example, “between 2006 and 2010, 219 former SEC employees filed 789 post-employment statements indicating their intent to represent an outside client before the Commission.” PROJECT ON GOV’T OVERSIGHT, REVOLVING REGULATORS: SEC FACES ETHICS CHALLENGES WITH REVOLVING DOOR 2 (2011), <http://pogoarchives.org/m/fo/revolving-regulators-20110513.pdf> [<https://perma.cc/3NBJ-QRS9>].

67. Lewis H. Ferguson, Board Member, Pub. Co. Accounting Oversight Bd., Remarks on Investor Protection Through Audit Oversight (Sept. 21, 2012), [https://pcaobus.org/News/Speech/Pages/09212012\\_FergusonCalState.aspx](https://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx) [<https://perma.cc/4UJR-299G>].

PCAOB employees into senior-level positions<sup>68</sup>—after which inspection results improve. Although this could reflect an improvement in audit quality, the authors found no change in the frequency of restatements or SEC enforcement actions; the improvement was limited to inspection findings.<sup>69</sup>

With this in mind, the facts cited in the Department of Justice (“DOJ”) indictment against former KPMG and PCAOB employees bear mention.<sup>70</sup> Relative to the other Big Four firms, KPMG scored poorly on its PCAOB audit inspections. To improve its performance, it hired former PCAOB employees and demanded that these employees provide confidential PCAOB data detailing the audits to be inspected. These newly hired KPMG employees complied, stealing confidential information on their way out the door and wringing further confidential information out of a former colleague at the PCAOB after they had exited.

The result was that KPMG cheated on its PCAOB inspections for years. By obtaining the list of audits to be inspected, KPMG essentially had the answers to the exam in advance. Two defendants have already pled guilty, two were convicted at trial, and two still face ongoing charges.<sup>71</sup>

### *b. Lobbying Efforts of the Big Four*

Lobbying, too, has limited the effectiveness of regulatory authorities. A Reuters report found that the Big Four spent \$9.4 million on in-house and outside lobbyists in 2012<sup>72</sup>—a figure that has steadily

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68. Bradley E. Hendricks, Wayne R. Landsman & F. Dimas Pena-Romera, *The Revolving Door Between the PCAOB and Large Audit Firms* 2, 5 (May 2018) (unpublished manuscript), [https://www.gsb.stanford.edu/sites/gsb/files/acct\\_05\\_18\\_hendricks.pdf](https://www.gsb.stanford.edu/sites/gsb/files/acct_05_18_hendricks.pdf) [https://perma.cc/WBG8-DYER].

69. *Id.* at 26.

70. Press Release No. 18-023, U.S. Dep’t of Justice, *5 Former KPMG Executives and PCAOB Employees Charged in Manhattan Federal Court for Fraudulent Scheme to Sell Valuable and Confidential PCAOB Information and Use that Information to Fraudulently Improve KPMG Inspection Results* (Jan. 23, 2018), <https://www.justice.gov/usao-sdny/pr/5-former-kpmg-executives-and-pcaob-employees-charged-manhattan-federal-court-fraudulent> [https://perma.cc/X6MQ-79ZQ]; Press Release No. 19-075, U.S. Dep’t of Justice, *Former KPMG Executive and Former PCAOB Employee Convicted of Wire Fraud for Scheme to Steal and Use Confidential PCAOB Information* (Mar. 11, 2019), <https://www.justice.gov/usao-sdny/pr/former-kpmg-executive-and-former-pcaob-employee-convicted-wire-fraud-scheme-steal-and> [https://perma.cc/R5A-R6ZJ].

71. See Press Release No. 18-023, U.S. Dep’t of Justice, *supra* note 70 (stating that five defendants were charged and a sixth pled guilty); Press Release No. 19-075, U.S. Dep’t of Justice, *supra* note 70 (noting that two of the original five charged were convicted). The cases against the remaining defendants are ongoing.

72. Ingram & Aubin, *supra* note 38. See also Richard L. Cassin, *Ex-KPMG Partner Pleads Guilty in PCAOB Cheating Scandal*, THE FCPA BLOG (Oct. 7, 2019, 1:38 PM),

increased over time.<sup>73</sup> Another report stated that accountants are “in the same category of more established big donors like telephone companies, higher education and the building trade unions.”<sup>74</sup>

This money comes with strings. Accounting firms have successfully deterred and/or eliminated regulation that, in theory, would incentivize high-quality audits. For example, despite multiple bills by members of Congress<sup>75</sup> and pushes by PCAOB members,<sup>76</sup> PCAOB disciplinary proceedings are currently nonpublic. The proceedings only become public after a settlement or when litigation is complete (including the completion of any appeals).<sup>77</sup> These restrictions prevent investors from learning of infractions in a timely manner.<sup>78</sup>

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<https://fcpablog.com/2019/10/07/ex-kpmg-partner-pleads-guilty-in-pcaob-cheating-scandal/> [<https://perma.cc/8QFF-VWGK>].

73. See Ingram & Aubin, *supra* note 38. (“Even going back to 1999, the earliest year for which online reports are available, annual spending by the industry, including the now-defunct Arthur Andersen, was lower than last year’s.”).

74. Stephen Labaton, *Enron’s Collapse: The Lobbying; Auditing Firms Exercise Power in Washington*, N.Y. TIMES (Jan. 19, 2002), <https://www.nytimes.com/2002/01/19/business/enron-s-collapse-the-lobbying-auditing-firms-exercise-power-in-washington.html> [<https://perma.cc/V47E-L6SF>].

75. See Laura Tieger Salisbury, *Senators Revive Bill to Make PCAOB Disciplinary Actions Public*, BLOOMBERG L. (Mar. 21, 2017, 6:34 PM), <https://news.bloomberglaw.com/corporate-law/senators-revive-bill-to-make-pcaob-disciplinary-actions-public> [<https://perma.cc/AT6F-WVVW>]; Robert Schmidt & Anthony Capaccio, *Is Your Auditor Being Investigated? New Law May Expose Misdeeds*, BLOOMBERG NEWS (Feb. 4, 2019, 3:00 AM), <https://www.bloomberg.com/news/articles/2019-02-04/is-your-auditor-being-investigated-new-law-may-expose-misdeeds> [<https://perma.cc/3VR5-HGSB>].

76. See, e.g., Claudius B. Modesti, Dir. of Enf’t, Pub. Co. Accounting Oversight Bd., Speech at the New York State Society of CPAs’ SEC Conference: The Need for Transparency in PCAOB Disciplinary Proceedings (Sept. 28, 2010), [https://pcaobus.org/News/Speech/Pages/09282010\\_ModestiTransparency.aspx](https://pcaobus.org/News/Speech/Pages/09282010_ModestiTransparency.aspx) [<https://perma.cc/35QL-LFFM>] (discussing a proposed amendment to the Sarbanes-Oxley Act of 2002 to make PCOAB disciplinary proceedings public).

77. 15 U.S.C. § 7215(d) (2012). The proceedings are only made public prior to completion if the PCAOB finds good cause to make them public and all parties consent to making them public. 15 U.S.C. § 7215(c)(2); see also Modesti, *supra* note 76 (“Right now, the PCAOB is virtually unique among similar regulators in that our disciplinary proceedings are required by law to be kept confidential through charging, hearings, initial decision, and even appeal.”).

78. Press Release, Chuck Grassley, U.S. Senator for Iowa, Reed and Grassley Seek to Increase Transparency at Accounting Watchdog (Nov. 18, 2011), <https://www.grassley.senate.gov/news/news-releases/reed-and-grassley-seek-increase-transparency-accounting-watchdog> [<https://perma.cc/T4D3-UHPD>]. As another example of the Big Four’s lobbying influence, the PCAOB previously pushed for mandatory rotations of the audit firm, as opposed to only a mandatory rotation of the audit partner—a change that the Big Four opposed. The change never materialized. Vincent Ryan, *PCAOB Abandons Auditor Rotation*, CFO (Feb. 6, 2014), <http://www.cfo.com/auditing/2014/02/pcaob-abandons-auditor-rotation/> [<https://perma.cc/8V8J-PT55>].

*c. Reluctance to Reduce the Size of the Accounting Market*

After Arthur Andersen's collapse reduced the Big Five to the Big Four, regulators have been handicapped in imposing severe penalties because they are hesitant to cause the collapse of another large accounting firm—and therefore further reduce competition. For example, in 2005, the DOJ filed tax fraud charges against eight partners at KPMG.<sup>79</sup> The misconduct was egregious. In addition to tax fraud, there was strong evidence that KPMG itself was guilty of obstruction.<sup>80</sup>

Documents released from the negotiations between the DOJ and KPMG indicate that there were discussions about whether any agreement would “put KPMG under” or “kill” the firm.<sup>81</sup> In sum, KPMG feared that if it were put under federal indictment like Arthur Andersen, it would be unable to survive. In the end, the DOJ charged eight partners with tax fraud and required the firm to pay \$456 million in penalties, but KPMG itself was spared from a potentially lethal criminal indictment.<sup>82</sup>

In KPMG's most recent example of bad behavior—when it cheated on its PCAOB inspections—the firm was spared again. Although the DOJ brought criminal charges against individual employees for their role in helping KPMG cheat on its PCAOB audit inspections, KPMG itself was not indicted.<sup>83</sup> As in the 2005 scandal, regulators were hesitant to bring charges against the firm for fear of reducing the Big Four to the Big Three.<sup>84</sup> This concern reduces

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79. Jonathan D. Glater, *8 Former Partners of KPMG Are Indicted*, N.Y. TIMES (Aug. 30, 2005), <https://www.nytimes.com/2005/08/30/business/8-former-partners-of-kpmg-are-indicted.html> [<https://perma.cc/CBZ8-ERMD>].

80. See John R. Wilke, *KPMG Faces Indictment Risk on Tax Shelters*, WALL ST. J. (June 16, 2005, 12:01 AM), [https://www.wsj.com/articles/SB111888827431261200\\_1](https://www.wsj.com/articles/SB111888827431261200_1) [<https://perma.cc/Q5M2-ZEYL>] (“KPMG tried for years to delay or conceal evidence behind misleading and sometimes false claims of legal privilege.”).

81. Francine McKenna, *US Department of Justice v KPMG: Document Shows “Too Few To Fail” Was Opening Premise*, RE: THE AUDITORS (Apr. 19, 2014), <http://retheauditors.com/2014/04/19/us-department-of-justice-v-kpmg-document-shows-too-few-to-fail-was-opening-premise/> [<https://perma.cc/BER8-3E6N>].

82. Press Release No. 05-433, U.S. Dep't of Justice, *KPMG to Pay \$456 Million for Criminal Violations in Relation to Largest-Ever Tax Shelter Fraud Case* (Aug. 29, 2005) [https://www.justice.gov/archive/opa/pr/2005/August/05\\_ag\\_433.html](https://www.justice.gov/archive/opa/pr/2005/August/05_ag_433.html) [<https://perma.cc/H85P-2NM9>].

83. See Press Release No. 18-023, U.S. Dep't of Justice, *supra* note 70 (discussing charges against former KPMG executives and PCAOB employees); Press Release No. 19-075, U.S. Dep't of Justice, *supra* note 70 (discussing convictions of a former KPMG executive and PCAOB employee).

84. See Jonathan Weil, *Nine are Charged in KPMG Case on Tax Shelters*, WALL ST. J. (Aug. 30, 2005), <https://www.wsj.com/articles/SB112533172910025699> [<https://perma.cc/7Z54-6BJ7>] (“Attorney General Alberto Gonzales said the Justice Department weighed ‘collateral consequences’ in deciding not to indict KPMG . . .”).

regulators' negotiating leverage. Further, by taking the death penalty off the table, regulators cannot bring charges that may be deserved.

In sum, there are reasons to expect suboptimal government regulation of accounting firms. First, regulatory capture can impede regulatory effectiveness. Second, through lobbying, accounting firms have thwarted policies that would have theoretically induced higher-quality audits. Third, regulators are handicapped in imposing penalties, as they do not want to reduce the Big Four to the Big Three.

## 2. Private Enforcement

Private enforcement, which could come in the form of litigation, shareholder voting, and/or termination, is also unlikely to be an effective deterrent. First, it is unclear whether litigation risk improves audit quality. Further, even if it does improve audit quality, auditors' litigation risk has declined significantly over the past two decades. Second, shareholders are unlikely to provide meaningful input on the company's auditor unless they have additional information that, under the current regime, is not provided. Third, issuers face such significant costs for terminating an auditor that termination is an infrequent event—thus limiting the incentive created by this threat.

### *a. Litigation Against Audit Firms*

Empirical literature is mixed on whether litigation risk serves to improve audit quality. There is a consensus that auditors mitigate litigation risk by, for example, charging higher fees and issuing more going-concern opinions,<sup>85</sup> but it is unclear that these strategies improve audit quality. Increased audit fees could be consistent with greater effort or with auditor rents. Similarly, an increase in going-concern opinions could be consistent with increased audit quality and greater conservatism, or with increased risk aversion to the detriment of accuracy.

Further, even if we believe that litigation risk improves audit quality, litigation is no longer the threat it once was. Shareholder litigation has traditionally represented the biggest litigation risk for

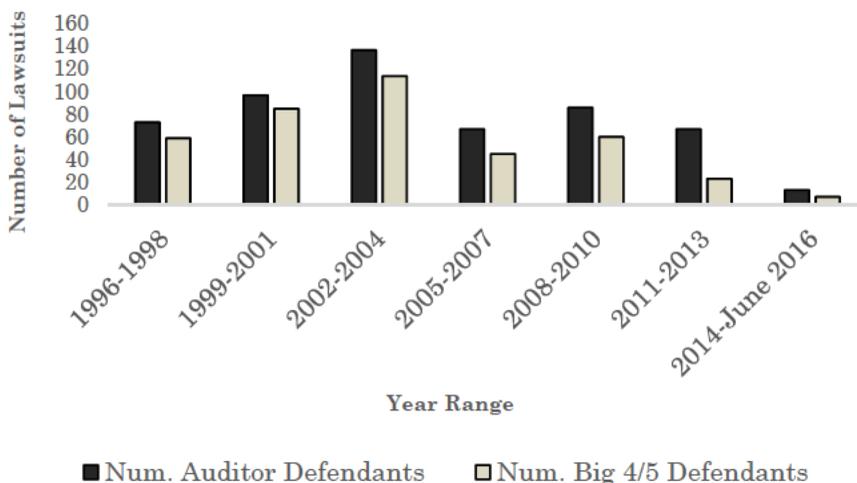
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85. If the auditor has substantial doubt that the issuer will continue to survive in the future (defined as the following year), the auditor must issue a "going-concern qualification" indicating that the auditor questions the company's ability to continue as an operating company. For an overview of research on the relationship between litigation risk and audit quality, see DeFond & Zhang, *supra* note 39.

auditors. However, shareholder litigation against auditors has declined significantly over the past decades.<sup>86</sup>

Figure 2, below, shows the number of shareholder class action lawsuits against auditor defendants over each three-year period from 1996 through 2016 (the data end in June 2016), along with the proportion of those defendants from the “Big Four/Five” accounting firms.<sup>87</sup> Only litigation brought by shareholders in federal court alleging violations of federal law is included.<sup>88</sup>

FIGURE 2: NUMBER OF SHAREHOLDER CLASS ACTION LAWSUITS AGAINST AUDITOR DEFENDANTS, 1996 TO 2016



As shown, the frequency of litigation filings has declined since its peak at the turn of the century, especially against the biggest accounting firms. Shareholders brought only twenty-eight class actions

86. See Honigsberg et al., *supra* note 26, at 30 (finding a decline in Rule 10b-5 liability exposure for auditors since the PLSRA and particularly following *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), even after controlling for changes in audit quality).

87. The Big Four audit firms include PricewaterhouseCoopers, Deloitte & Touche, KPMG, and Ernst & Young. Prior to its demise, Arthur Andersen was part of this select clique (known as the “Big Five”). The figure includes Arthur Andersen in the years prior to its demise.

88. Shareholder litigation against auditors occurs almost exclusively in federal courts under federal securities laws. See Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.); *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061, 1067–68 (2018). As noted above, common law notions of privity prevent shareholder litigation against auditors in most states, and federal law requires that most class action lawsuits brought under federal securities laws must be in federal court. Honigsberg et al., *supra* note 26.

against auditors from 2012 to June 2016, and most of these auditor defendants were non-Big Four.

Figures 3 and 4 examine other important trends in litigation against auditors: dismissal rates and settlement values. Figure 3 shows that, as a percentage of the number of lawsuits alleging a violation of Rule 10b-5, dismissals of those claims have increased (where dismissals are defined as a dismissal of a Rule 10b-5 claim with prejudice or a dismissal without prejudice but the plaintiff declines to amend). For summary purposes, Figure 3 presents average dismissal rates over each three-year period.

FIGURE 3: DISMISSAL RATES FOR RULE 10b-5 CLAIMS BROUGHT BY SHAREHOLDERS AGAINST AUDITORS, 1996 TO 2016

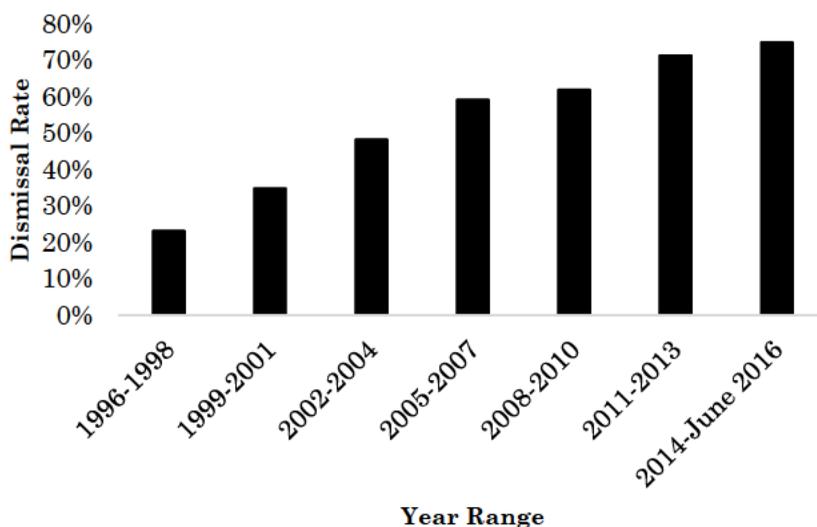
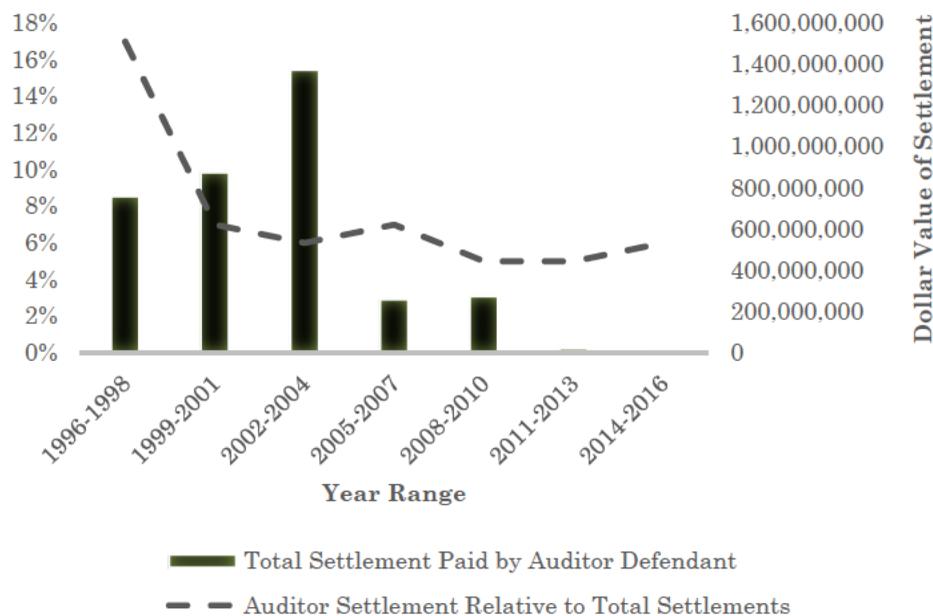


Figure 4 presents settlement values over each three-year period. Total payouts are presented as black bars, and the auditor payout as a percentage of the total payout by all defendants is presented as a dotted line (note that some cases in the final time periods remain ongoing). In terms of total payouts, settlements peaked at the turn of the century and have significantly declined thereafter. Relative to total payouts by defendants in the same cases, auditor settlements were highest in 1996–1998 (17%) and have remained relatively constant since (5%–7%).

FIGURE 4: SETTLEMENT VALUES IN CLASS ACTION LAWSUITS AGAINST AUDITORS, 1996 TO 2016



One explanation for the decline in auditor litigation is that audit quality has improved—that is, perhaps auditors perform better and there are fewer reasons to sue them. However, further analysis shows that the decline is robust to controls for improvements in audit quality. For example, the most consistently significant determinant for successful litigation against auditors is whether there is a restatement.<sup>89</sup> However, over the period from 2002 to 2016, auditors became less likely to be sued following a severe restatement (defined as a restatement of 10% or more of net income).<sup>90</sup> As such, although audit quality may be a factor, it cannot explain the decline in full.

There are other possible explanations for the decline.<sup>91</sup> One explanation that I offered in prior work is the Supreme Court's

89. Dain C. Donelson & Robert A. Prentice, *Scienter Pleading and Rule 10b-5: Empirical Analysis and Behavioral Implications*, 63 CASE W. RES. L. REV. 441, 484–86 (2012).

90. See Honigsberg et al., *supra* note 26, at 29 (finding a decline in the likelihood that auditors will face lawsuits following severe restatements between 2002 and 2016).

91. One possible explanation is that plaintiffs were less likely to have the benefit of an SEC enforcement action to help with pleading because the SEC brought fewer auditing-related enforcement actions after the creation of the PCAOB. Another possible explanation is that a reduction in auditor-provided nonaudit services hampered plaintiffs' ability to plead scienter. See Jamie J. Schmidt, *Perceived Auditor Independence and Audit Litigation: The Role of Nonaudit Services Fees*, 87 ACCT. REV. 1033, 1060 (2012).

narrowing of secondary actor liability. Indeed, the decline in litigation following a restatement is largely driven by the years following *Janus*,<sup>92</sup> an empirical trend consistent with the legal effects of *Janus*.

Prior to *Janus*, the law stated that auditors needed to “make” a statement to be liable as a primary actor under Rule 10b-5, but circuits disagreed on what it meant to make a statement.<sup>93</sup> Some circuits imposed a strict requirement that the auditor make the false or misleading statement, but other circuits allowed the auditor to be liable for the issuer’s misconduct if the auditor had “substantially assisted” the issuer’s misconduct by, for example, proposing accounting treatments.<sup>94</sup> In essence, the circuits differed on whether plaintiffs had to meet each element of Rule 10b-5 based entirely on the audit report (relatively boilerplate language stating that the auditor reviewed the company’s financials and found them to be in compliance), or whether plaintiffs could rely on other aspects of the auditor’s behavior in stating a claim.<sup>95</sup>

In *Janus*, the Court endorsed an auditor-friendly requirement that an actor must have “ultimate authority” over a statement to “make” the statement and therefore be subject to primary liability.<sup>96</sup> As a practical matter, this means shareholders suing auditors under Rule 10b-5 will have to state a claim based on the audit report alone<sup>97</sup>—a significant uphill battle for plaintiffs, who tend to have difficulty alleging elements such as scienter based solely on the audit report.<sup>98</sup>

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92. See Honigsberg et al., *supra* note 26, at 29 (“[T]he likelihood the auditor will be sued is roughly two percentage points lower following *Janus*.”).

93. Browning Jeffries, *The Implications of Janus on Issuer Liability in Jurisdictions Rejecting Collective Scienter*, 43 SETON HALL L. REV. 491, 499–509 (2013).

94. See Honigsberg et al., *supra* note 26, at 15–16. The Second, Fifth, Eighth, Tenth, and Eleventh Circuits generally followed the “bright-line” standard (the more stringent standard), but the Fourth and Ninth Circuits followed the “substantial participation” test (the looser standard). *Id.*

95. See *id.* (noting differences between tests applied among circuits, namely whether plaintiffs were required to demonstrate 10b-5 liability solely from the audit report or whether plaintiffs could point to an auditor’s “substantial participation” in the fraud).

96. *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011).

97. In a review of cases in the Fourth and Ninth Circuits filed post-*Dura* and pre-*Janus* and alleging the auditor violated Rule 10b-5, more than half alleged that the auditor was liable based on its substantial participation in the issuer’s misstatement (these are the two circuits that allowed evidence of the auditor’s substantial participation to be considered). By contrast, in the five years after *Janus*, all complaints argued the auditor was liable based solely on the audit report.

98. See *Scott v. ZST Dig. Networks, Inc.*, No. CV 11-03531 GAF, 2012 WL 538279 (C.D. Cal. Feb. 14, 2012). ZST Digital Networks was required to file financial statements with U.S. and Chinese securities regulators. The filings were vastly different; ZST showed a profit in the U.S. filings and a loss in the Chinese filings. The differences extended beyond different accounting rules in place in the different countries to reflect differences in the business fundamentals. Despite the plaintiff’s arguments that the auditor was reckless in providing a clean audit opinion in the U.S.

In sum, it appears unlikely that litigation risk will provide the incentive necessary to induce optimal audit quality. Even if litigation risk improves audit quality, the Court's narrowing of secondary actor liability under Rule 10b-5 has greatly reduced litigation risk for auditors.

### *b. Shareholder Voting*

Another source of private enforcement, shareholder voting, is also unlikely to serve as a significant deterrent. As described earlier, shareholders rarely decline to ratify the auditor. This reflects the classic problem of rational apathy. The cost to shareholders of engaging in the fact-finding necessary to oppose an auditor far exceeds the benefit. After all, the benefit is opaque; there is no guarantee that management will switch auditors even if a nontrivial number of shareholders do not vote to ratify the auditor.<sup>99</sup> And the costs are high, as critical information necessary for shareholders to make an informed decision is unavailable and/or not easily accessible.

At present, the audit report—which contains the most widely accessible information on the audit—contains limited detail on how that audit was conducted.<sup>100</sup> Without crucial information pertaining to the design of the audit, the treatment of critical accounting judgments, the auditor's disciplinary history, and the communications between the auditor and the audit committee, shareholders cannot provide an informed check on the auditor's conduct. Thus, it is not surprising that these votes are considered uninformed and lack influence.

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filings when the Chinese filings were vastly different, the court declined to find that the plaintiff had properly pled scienter.

99. For example, shareholders at Imperial Holdings did not vote to ratify the auditor (52.71% of votes were cast against ratification). Yet, Imperial retained the auditor. John Pakaluk, *Auditor Ratification: An Overview of Russell 3000 Companies*, AUDIT ANALYTICS (Apr. 30, 2014), <https://blog.auditanalytics.com/auditor-ratification-an-overview-of-russell-3000-companies/> [<https://perma.cc/6XNQ-WKY7>]. Similarly, Big Lots, Inc., Healthwarehouse.com, and Immersion Corp. all retained their auditors after more than 40% of shareholders voted against auditor ratification. McKeon, *supra* note 34.

100. The audit report is essentially a pass/fail system. Although it can be unqualified, qualified, or unqualified with explanatory language, it is typically unqualified with no additional language (i.e., the company receives a "pass"). From January 1, 2002, through February 20, 2019, Audit Analytics indicated that roughly 85% of all audit opinions issued to U.S.-based companies were unqualified without additional explanatory paragraphs (this percentage rises to over 99% for S&P 500 companies). In an attempt to provide more feedback to investors, the PCAOB recently adopted a new rule to mandate disclosures of critical accounting matters. PUB. CO. ACCOUNTING OVERSIGHT BD., RELEASE NO. 2017-001, THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS (2017), <https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf> [<https://perma.cc/49B2-7WXX>].

*c. Termination*

Finally, the last source of private enforcement, termination, is unlikely to induce auditors to act with optimal levels of care. Auditor termination is infrequent,<sup>101</sup> and it is a very costly event for the issuer. To see why, consider the reasons below.

First, auditor turnover is a negative market signal. Issuers are notorious for firing their auditor to prevent the release of an undesirable audit opinion. Thus, investors often respond negatively to auditor turnover because they are concerned that the company changed its auditor to block the release of a damaging audit opinion.<sup>102</sup> Reactions are particularly negative when a firm switches its auditor from a Big Four firm to a non-Big Four firm.<sup>103</sup> Regulators, too, are aware that issuers fire auditors to prevent the release of damaging information, so they are more likely to investigate a company after auditor turnover. Thus, a company that wants to change its auditor must weigh the benefits of the change against the likely negative market reaction upon announcing the change and the increased possibility of regulatory scrutiny.<sup>104</sup> This is not an attractive choice.

Second, firm managers are often reluctant to switch auditors because the new auditor will be less familiar with their business and/or industry, which results in unnecessary cost, time, and effort to get the new auditor up to speed.<sup>105</sup> Even if the new auditor is willing to provide

101. Floyd Norris, *Deep Secret: Why Auditors are Replaced*, N.Y. TIMES (July 28, 2006), <https://www.nytimes.com/2006/07/28/business/28norris.html> [<https://perma.cc/JR35-HYBT>].

102. John W. Eichenseher et al., *Market Reaction to Auditor Changes by OTC Companies*, 9 AUDITING, 1989, at 29, 38–40; *see also* Dov Fried & Allen Schiff, *CPA Switches and Associated Market Reactions*, 56 ACCT. REV. 326, 338–39 (1981) (finding a correlation between auditor changes and negative market reactions).

103. Eichenseher et al., *supra* note 102, at 39 (finding a negative market response when a company moved away from a Big Eight firm).

104. *See* Eric R. Holzman et al., *Who's on the Hot Seat for an SEC Investigation and How Do They Respond?* 18 (Feb. 21, 2019) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3223815](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3223815) [<https://perma.cc/Z6HC-M3ZF>].

105. Kember J. Dunham, *Firms that Want to Switch Auditors Find It Takes Time, Money and Faith*, WALL ST. J. (Mar. 15, 2002), <https://www.wsj.com/articles/SB1016150533124417920?> [<https://perma.cc/7BZQ-XTQ8>]. As an example, consider General Electric (GE). Following significant cash flow issues, accounting probes, and massive layoffs, GE announced in 2018 that it would fire its CEO and that eight of its seventeen directors would retire. Nonetheless, even though only 65% of shareholders voted to ratify the auditor (one of the lowest levels of support in recent years), GE has, at present, retained KPMG (although it has opened the door to dismissing KPMG in the future). GE's explanation for retaining KPMG was notable, as GE stated that it was important to maintain continuity with its auditor—despite that GE was apparently comfortable breaking continuity with its directors and CEO. Brendan Case, *GE Opens Door to Replace KPMG as Auditor After Financial Miscues*, BLOOMBERG (Dec. 14, 2018), <https://www.bloomberg.com/news/articles/2018-12-14/ge-opens-door-to-replace-kpmg-as-auditor-after-financial-miscues> [<https://perma.cc/Y32W-H94U>]; Cydney Posner, *Shareholder Vote on Auditors Puts the Heat on the Board*, COOLEY PUBCO (Apr. 26, 2018),

the issuer with a significant discount as an incentive to switch, that switch is still going to be costly for the issuer because the new auditing team will require assistance and employee time to learn the company's reporting systems and business.

Finally, even assuming that a firm wants to switch its auditor, there are few options. A frequently cited benefit of the Big Four is that they have the expertise and structure to conduct audits of complex businesses.<sup>106</sup> For an issuer who needs this expertise, there are likely to be fewer than four realistic options. First, due to SOX's restrictions on the ability of audit firms to provide nonaudit services to their audit clients,<sup>107</sup> managers will be unable to hire another Big Four firm if that firm provides it with certain nonaudit services.<sup>108</sup> In recent years, the Big Four have significantly increased sales of nonaudit services to nonaudit clients—thus potentially preventing an issuer from hiring the firm as an auditor.<sup>109</sup> Second, there is significant auditor concentration in certain industries. For example, Deloitte and Ernst & Young have historically audited 88% of the casino industry.<sup>110</sup>

In sum, the risk of termination is unlikely to induce auditors to conduct high-quality audits. Firing an auditor leads to substantial costs for the issuer, so audit committees are hesitant to do so. Auditors, of course, know the audit committee will be reluctant to fire them, thus mitigating the incentive that would otherwise arise from the risk of termination.

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<https://cooleypubco.com/2018/04/26/shareholder-vote-on-auditors-puts-heat-on-board/> [<https://perma.cc/R59G-G39A>]; Michael Rapoport, *KPMG Gets Cold Shoulder From GE Shareholders*, WALL ST. J. (Apr. 25, 2018), [https://www.wsj.com/articles/kpmg-follows-pwc-in-adding-independent-directors-to-its-board-1524680342?](https://www.wsj.com/articles/kpmg-follows-pwc-in-adding-independent-directors-to-its-board-1524680342?https://perma.cc/5NQV-AQLT) [<https://perma.cc/5NQV-AQLT>].

106. Chih-Liang Liu & Shu-Miao Lai, *Organizational Complexity and Auditor Quality*, 20 CORP. GOVERNANCE 352, 353, 365–66 (2012); see also Dunham, *supra* note 105 (arguing that firms are reluctant to switch auditors as the new auditors will be less accustomed to their business and have less industry expertise).

107. Thomas L. Riesenber, *The Non-Audit Restrictions of the Sarbanes-Oxley Act*, D.G. MCDERMOTT ASSOCS. (Sept. 24, 2002), <https://www.dgm.com/information-center/sarbanes-oxley-information/non-audit-service-restrictions-of-the-sarbanes-oxley-act-article> [<https://perma.cc/7FED-CLZA>].

108. See Liz Loxton, *How the Big Four Have Returned to Consulting with a Bang*, ACCOUNTANCY AGE (Sept. 27, 2015), <https://www.accountancyage.com/aa/feature/2427739/feature-how-the-big-four-have-returned-to-consulting-with-a-bang> [<https://perma.cc/XS8E-F7K4>].

109. See Editorial, *Maybe the Big Four Auditing Firms Do Need to Be Broken Up*, BLOOMBERG (June 18, 2018), <https://www.bloomberg.com/opinion/articles/2018-06-18/maybe-the-big-four-auditing-firms-do-need-breaking-up> [<https://perma.cc/V9CM-84E8>].

110. See, e.g., *Special Report: Called to Account – The Future of Auditing*, ECONOMIST (Nov. 20, 2004), <https://www.economist.com/special-report/2004/11/18/called-to-account> [<https://perma.cc/B8ND-RANW>].

### 3. Reputational Risk

Firm reputation risk likely provides the greatest incentive for auditors to provide high-quality audits. However, due to the aforementioned stickiness of the relationship between auditors and issuers—and the significant costs to terminate an auditor—there is significant reason to doubt that reputation risk provides market incentives to improve audit quality.

Indeed, consistent with the high costs of terminating an auditor, U.S. issuers today do not fire Big Four auditors for standard audit failures, such as restatements.<sup>111</sup> This means that reputational sanctions will not provide marginal incentives to improve audit quality, leading to suboptimal incentives for audit firms (and the partners who own those firms). Although partners at these firms are incentivized to avoid extreme bad behavior that could “kill” the firm, they are not incentivized to provide marginally better audit quality for purely business reasons. Instead, as described below in Part II.B, they are incentivized to focus on growth.

#### *B. Benefits of Individual Auditor Brands*

Individual accountability could provide a counterweight to the current incentive structure.<sup>112</sup> First, as described earlier, audit partners do not internalize the full consequences of an audit failure. Promoting individual brands will better address this inefficiency and reduce externalities by causing audit partners to internalize these failures. Second, greater reliance on overseas participants has significantly changed audit design in a manner likely to increase risk and introduce coordination challenges. Prior research has indicated that holding a single person accountable could reduce this heightened risk.<sup>113</sup> Third, there are significant differences in quality across audit partners, even among partners in the same firm. Providing this information to market participants would allow them to select better auditors. Finally, there is reason to believe that individual reputation markets could increase competition within the accounting industry.

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111. See Kedia, Khan & Rajgopal, *supra* note 21, at 29 (describing how market share for U.S. auditors remains constant following routine audit failures).

112. Although 2018 saw renewed calls to break up the Big Four to increase competition, such dramatic action seems politically infeasible in the United States. For purposes of this Part, I assume the industry structure is fixed (except for any changes caused by increased accountability).

113. See *infra* Section II.B.2.

## 1. Reducing Externalities by Internalizing Failure

In theory, market forces will penalize an underperforming firm, and the firm will then penalize the underperforming partner. Each partner will be properly incentivized to conduct high-quality audits for clients with acceptable levels of risk. However, as described earlier, clients do not leave Big Four auditors following standard audit failures, meaning that the market does not provide marginal deterrence incentives for an underperforming firm.

Without market incentives to promote audit quality, the Big Four have rationally structured their compensation to promote retaining (and increasing) their client base.<sup>114</sup> Although the exact compensation structure is not publicly available and varies by firm, research has concluded that compensation is driven primarily by the size of a partner's clientele and/or the number of publicly traded clients.<sup>115</sup> Attracting new clients is strongly related to an increase in compensation.<sup>116</sup> In at least one of the Big Four, losing a client reduces compensation.<sup>117</sup>

Given the financial incentives, a rational auditor will hesitate to push back strongly against her clients—and her firm will support her decision. Such incentives are consistent with observed behavior. Consider, for example, internal feedback reviews provided to a former Senior Manager at PricewaterhouseCoopers who became an SEC whistleblower.<sup>118</sup> “I don't think the way he develops his client relationships is very effective. He doesn't trust any of his clients,” said one comment. This performance evaluation contrasts sharply with the Supreme Court's view of an auditor's role as a “public watchdog” that requires “total independence from the client at all times and requires complete fidelity to the public trust.”<sup>119</sup>

Also consistent with these incentives are the repeated instances in which auditors have assisted clients with the creation of the financial statements—and then audited those same financials. Independence rules prohibit this practice,<sup>120</sup> as it amounts to the auditor auditing himself. Although difficult to identify, such violations of independence

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114. Knechel et al., *supra* note 52.

115. *Id.* at 383.

116. *Id.*

117. *Id.* at 384.

118. David S. Hilzenrath, *PwC Whistleblower Alleges Fraud in Audits of Silicon Valley Companies*, PROJECT ON GOV'T OVERSIGHT (May 10, 2018), <https://www.pogo.org/investigation/2018/05/pwc-whistleblower-alleges-fraud-in-audits-of-silicon-valley-companies/> [<https://perma.cc/NT3A-NMTT>].

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

120. Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(g) (2012).

have been revealed through litigation,<sup>121</sup> PCAOB inspections,<sup>122</sup> SEC enforcement actions,<sup>123</sup> and whistleblowers.<sup>124</sup> These anecdotes contradict the image of a skeptical professional seeking to serve the investors' interests but are entirely consistent with the incentive structure. Audit partners receive a disproportionate share of the financial benefits paid by a client but share the costs of an audit failure with their firm (or, at least, the office of their firm).

Promoting individual auditor brands will cause partners to internalize these failures. As described previously, there are robust reputation markets in many areas of capital markets, and these markets provide strong incentives to avoid accounting failures. As applied to audit partners, who frequently enjoy careers as high-level corporate managers or directors after making partner,<sup>125</sup> we would expect a similar effect: these auditors will work harder to avoid reputational harm because their reputation is a valuable asset. Not only is the auditor's reputation valuable while he remains at the accounting firm, where clients must agree to hire him, but it is valuable following

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121. See *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 152, 158–59 (D. Mass. 2002) (finding “clean” audits issued by defendant for financial statements it also helped prepare contained material misrepresentations); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 433 (N.D. Ill. 1995) (determining facts were sufficient to support an inference that defendant misstated financial information in a Prospectus it had a central role in developing and further concealed the information in a later audit). Even auditors who do not prepare statements may overstep their role as auditors by suggesting accounting treatments. See, e.g., *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336 (S.D.N.Y. 2004); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (discussing plaintiffs' claims that the auditor materially assisted in the preparation of misstated financial statements).

122. See, e.g., News Release, Pub. Co. Accounting Oversight Bd., PCAOB Fines Deloitte Canada \$350,000 for Failing to Maintain Independence Over Three Consecutive Audits (Oct. 16, 2008), [https://pcaobus.org/News/Releases/Pages/PCAOB-Fines-Deloitte-Canada-\\$350,000.aspx](https://pcaobus.org/News/Releases/Pages/PCAOB-Fines-Deloitte-Canada-$350,000.aspx) [<https://perma.cc/74DY-KRGZ>] (discussing a PCAOB investigation which uncovered that one Deloitte branch had audited financial statements that another related branch created).

123. See, e.g., Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges PwC LLP With Violating Auditor Independence Rules and Engaging in Improper Professional Conduct (Sept. 23, 2019), <https://www.sec.gov/news/press-release/2019-184> [<https://perma.cc/6DJB-FPLN>] (discussing an SEC enforcement action against an auditor at PwC who violated independence rules by providing certain nonaudit services that assisted in the audit process).

124. See, e.g., Hilzenrath, *supra* note 118 (detailing an account submitted to the SEC by a former auditor that alleged his former accounting firm compromised ethical standards by overstepping independence rules).

125. For example, one study found that 6% of audit committee members are public accounting experts, and 14% of audit committee chairs have public accounting experience. John L. Abernathy et al., *The Association Between Characteristics of Audit Committee Accounting Experts, Audit Committee Chairs, and Financial Reporting Timeliness*, 30 *ADVANCES ACCT.* 283, 289 (2014). Although SOX requires a one-year cooling off period before an auditor can work for a client in a financial reporting oversight role, auditors can work for a different industry client with no cooling-off period. Further, even with the one-year cooling-off period, auditors may return to those clients later in their careers. 17 C.F.R. § 210.2-01(c)(2) (2019).

his tenure as an auditor for other prestigious employment opportunities.<sup>126</sup>

Forcing the auditor to build a brand that is separate from that of her firm will force individual audit partners to publicly internalize the costs of audit failure. This will provide strong incentives to avoid such failure, as auditors will be incentivized to maintain a high-quality reputation both during their tenure at the accounting firm and beyond.

## 2. Improved Audit Quality

A second benefit to individual reputation markets for auditors is that accountability frequently improves outcomes, particularly in circumstances requiring coordination challenges.<sup>127</sup> Such intuition is why, for example, SOX requires the CEO and CFO to sign that they are directly responsible for the accuracy of the financial reporting and the quality of the internal controls. To date, there is evidence that this signature requirement has been effective; 68% of practicing auditors stated that they believe it has improved reporting integrity.<sup>128</sup>

Regarding auditing specifically, prior work shows that accountability reduces auditors' information biases and enhances effort

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126. Although it is possible that a focus on individual brands will change demand, leading firms to change their compensation structure, such a change is tenuous. More importantly, it is unnecessary to improve incentive-alignment. Lucrative opportunities outside traditional accounting provide Big Four partners with financial incentives to avoid public association with audit failure, regardless of internal compensation policies.

127. See Barry R. Schlenker et al., *The Triangle Model of Responsibility*, 101 PSYCHOL. REV. 632, 634 (1994) (hypothesizing that accountability is a social mechanism of control where collectively set prescriptions of conduct can be judged and then rewarded or punished accordingly); see also Marceline B. R. Kroon, Paul't Hart & Dik van Kreveld, *Managing Group Decision Making Processes: Individual Versus Collective Accountability and Groupthink*, 2 INT'L J. CONFLICT MGMT. 91, 108 (1991) (finding that participants held individually accountable were more likely to make better decisions than those held collectively accountable).

128. Jeffrey Cohen, Ganesh Krishnamoorthy & Arnie Wright, *Corporate Governance in the Post-Sarbanes-Oxley Era: Auditors' Experiences*, 27 CONTEMP. ACCT. RES., 751, 771 (2010). Additional work finds that earnings management decreased following the Sarbanes-Oxley Act, but these studies cannot identify the specific effect of the signature requirement, as they cannot empirically distinguish the effects of the different provisions that went into effect simultaneously. See, e.g., Gerald Lobo & Jian Zhou, *Did Conservatism in Financial Reporting Increase After the Sarbanes-Oxley Act? Initial Evidence*, 20 ACCT. HORIZONS 57, 67–68 (2006) (finding a decrease in earnings management following the implementation of the Sarbanes-Oxley Act).

and consensus.<sup>129</sup> There is also some evidence that it improves audit documentation.<sup>130</sup>

The incentive effects of individual accountability are particularly important given the changes in audit design over the past decade. Auditors today frequently rely on overseas auditors, where the overseas auditors are termed either “component” auditors or “offshore” auditors. For multinational firms, presumably over half of audit hours are frequently performed overseas. As described below, this increase in overseas auditors imposes coordination challenges that increase the risk of audit failure.

#### *a. Component Auditors*

Component auditors are foreign affiliates of the lead accounting firm that audit the issuer’s international operations. The affiliates may share the same name as the U.S. auditor (for example, PricewaterhouseCoopers France) but need not. The lead auditor generally relies on the same underlying component auditor(s) from year to year, but there can be variation.

Typically, multinational firms have more than one component auditor, and the number of hours performed by each component varies significantly. As shown in Table 1, the firms that disclose the use of component auditors in Form AP have, on average, 4.69 audit participants. Of those, 2.95 participants perform less than 5% of audit hours and 1.75 perform more than 5% of audit hours. At the extreme, one firm used sixty-five audit participants. On average, these component auditors perform 29% of total audit hours. At the extreme,

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129. See Joseph F. Brazel, Christopher P. Agoglia & Richard C. Hatfield, *Electronic Versus Face-to-Face Review: The Effects of Alternative Forms of Review on Auditors’ Performance*, 79 ACCT. REV. 949, 953–54 (2004) (finding that test subjects held accountable for their work during face-to-face review, as opposed to e-review, prepared work papers which exhibited higher judgment quality and reflected increased effort in comprehensive evaluation of the evidence); Todd DeZoort, Paul Harrison & Mark Taylor, *Accountability and Auditors’ Materiality Judgements: The Effects of Differential Pressure Strength on Conservatism, Variability, and Effort*, 31 ACCT. ORGS. & SOC’Y 373, 383 (2006) (finding that auditors in an experiment exerted more effort, as measured by time spent and explanation length, in their auditing task when they were under higher accountability pressure); Jane Kennedy, *Debiasing Audit Judgment with Accountability: A Framework and Experimental Results*, 31 J. ACCT. RES. 231, 240 (1993) (finding that test subjects who were informed they would be held accountable for their decisionmaking prior to receiving positive/negative sequential information exhibited no recency bias, in contrast to subjects who were held not accountable or post-accountable).

130. See H. THOMAS JOHNSON & ROBERT S. KAPLAN, *RELEVANCE LOST: THE RISE AND FALL OF MANAGEMENT ACCOUNTING* 12–13 (1987).

one firm used component auditors for 100% of audit hours (this issuer is not based in the United States).<sup>131</sup>

TABLE 1: DESCRIPTIVE STATISTICS ON THE USE OF COMPONENT AUDITORS, AS DISCLOSED IN FORM AP

	<b>Number of Component Auditors Performing Less than 5% of Total Audit Hours (Total)</b>	<b>Number of Component Auditors Performing Greater than 5% of Total Audit Hours (Total)</b>	<b>Number of Component Auditors (Total)</b>	<b>Estimated Component Auditor Hours (% of Total Audit Hours)</b>
<b>Mean</b>	2.95	1.75	4.69	29%
<b>Median</b>	1	1	3	25%
<b>Minimum</b>	0	1	1	1%
<b>Maximum</b>	63	7	65	100%

Research on component auditors is limited, presumably because information on their use was largely unavailable until recently.<sup>132</sup> However, the initial studies provide reason to believe that greater use of component auditors is positively associated with audit failures. For example, using private data from the PCAOB, Professors Denise Downey and Jean Bedard show that misstatements are generally higher for engagements with greater foreign auditor participation.<sup>133</sup> Similarly, another team of researchers found that issuers with significant reliance on component auditors have lower audit quality than a matched sample of issuers—and that the market responds negatively to the disclosure of these component auditors.<sup>134</sup>

131. Table 1 includes the 1,347 issuers noting the use of component auditors in Form AP (current as of June, 2018). *See generally* PUB. COMPANY ACCT. OVERSIGHT BD., AUDITOR SEARCH, <https://pcaobus.org/Pages/AuditorSearch.aspx> (last visited Aug. 20, 2019) [<https://perma.cc/F9PD-SDNQ>] (providing a downloadable version of the data set, updated daily).

132. Historically, only minimal information on the use of other audit participants was disclosed on PCAOB Form 2. *See* PUB. COMPANY ACCT. OVERSIGHT BD., FORM 2 – ANNUAL REPORT FORM, [https://pcaobus.org/Rules/Pages/Form\\_2.aspx](https://pcaobus.org/Rules/Pages/Form_2.aspx) (last visited Aug. 14, 2019) [<https://perma.cc/WN3E-Y9LL>].

133. *See* Denise H. Downey & Jean C. Bedard, Do Use of Foreign Auditor Personnel and Lead Engagement Partner Incentives Affect Audit Quality for U.S. Multinational Companies? (2019) (unpublished manuscript) (on file with author).

134. *See* Carol Callaway Dee, Ayalew Lulseged & Tianming Zhang, *Who Did the Audit? Audit Quality and Disclosures of Other Audit Participants in PCAOB Filings*, 90 ACCT. REV. 1939, 1962 (2015) (finding that issuers for which auditors disclosed the use of other participants in Form 2 had lower audit quality than a matched group of issuers); *see also* Juan Mao, Michael Ettredge &

It is not difficult to imagine that the use of component auditors could cause audit quality to decrease.<sup>135</sup> The lead engagement partner is responsible for supervising all component auditors and integrating their work product, and the scrutiny applied to the component auditors varies wildly.<sup>136</sup> For example, some countries will not allow work papers created by the component auditor to be removed from the country.<sup>137</sup> In such instances, some U.S. engagement partners will insist on

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Mary S. Stone, *Group Audits: Are Audit Quality and Price Associated with the Lead Auditor's Decision to Accept Responsibility?* 29 (July 2019) (unpublished manuscript) (on file with author) (finding that lead auditors accepting responsibility for work done by other auditors charge higher audit fees but provide the same or lower quality audits).

135. For two reasons, reliance on Chinese component auditors has received the most attention. First, Chinese auditors are considered notoriously problematic. This is true even for affiliates of respected U.S. accounting firms. For example, consider China-Biotics Inc., an audit client of BDO Limited (a Hong-Kong based affiliate of US-based BDO Seidman). When comparing the financials filed with the U.S. SEC with those filed with the SEC's Chinese counterpart, the State Administration for Industry and Commerce ("SAIC"), the numbers are not even in the same ballpark. China-Biotics Inc. reported revenue of \$42.3 million in its 2008 financials filed with the SEC but only \$0.5 million in its SAIC financials for the same year. Chinese Company Analyst, *Orient Paper: Not All BDOs Are the Same*, SEEKING ALPHA (July 6, 2010), <https://seekingalpha.com/article/213213-orient-paper-not-all-bdos-are-the-same?page=4> [https://perma.cc/T9KA-6LSK]. Net income was negative in the filings provided to the SAIC, but positive \$17.5 million in the filings provided to the SEC. *Id.* Without the company name, no reader would think these filings represented the same company. China's refusal to allow PCAOB inspections has only fueled the concerns regarding audit quality in China. Second, many U.S. firms have substantial audit operations in China, meaning that a misstatement of the Chinese portion of the audit would likely be material. As an example, consider Walmart's 2018 audit. Anywhere from 35 to 70% of the audit hours were performed by component auditors, with Ernst & Young Hua Ming LLP in Beijing performing 10 to 20% of the work. A significant misstatement of the Chinese portion of the audit would be material to the whole audit. For media coverage, see, for example, Michael Rapoport, *The Chinese Blind Spot in U.S. Companies' Financials*, WALL ST. J. (July 21, 2018), <https://www.wsj.com/articles/the-chinese-blind-spot-in-u-s-companies-financials-1532170801> [https://perma.cc/6CDK-XYFV]. For discussions of Chinese auditors, see, for example, Ferdinand A. Gul, Andy Y. Ng & Marian Yew Jen Wu Tong, *Chinese Auditors' Ethical Behavior in an Audit Conflict Situation*, 42 J. BUS. ETHICS 379, 379–80 (2003); *Issuers that Are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions Where the PCAOB Is Denied Access to Conduct Inspections*, PUB. COMPANY ACCT. OVERSIGHT BD. (Sept. 10, 2018), <https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx> [https://perma.cc/N8GV-JBPD].

136. See Denise Hanes Downey & Jean C. Bedard, *Coordination and Communication Challenges in Global Group Audits*, 38 AUDITING, Feb. 2019, at 123, 127–30 (providing an overview of the communication techniques used for group audits); see also Dan Sunderland & Gregory M. Trompeter, *Multinational Group Audits: Problems Faced in Practice and Opportunities for Research*, 36 AUDITING, Aug. 2017, at 159, 164 (commenting on barriers between the group and component auditors, such as distance, language, and customs, along with limitations which prevent the group auditor from controlling assignments and level of supervision for component auditors).

137. For example, the Chinese government restricts audit documentation from leaving the country. See Jay Clayton, Wes Bricker & William D. Duhnke III, *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China*, SEC (Dec. 7, 2018), <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other> [https://perma.cc/S8M3-L4YW].

embedding one or more members of the U.S. team with the component auditor to allow the U.S. team to monitor the component. However, other U.S. engagement partners may simply take the component auditor at its word that the numbers supplied by management are materially free from inaccuracies.<sup>138</sup>

### *b. Offshore Auditors*

Audit work is also performed overseas by “offshore” auditors. In response to financial pressure to cut costs following the recent financial crisis, accounting firms started sending more and more work to “offshore auditors,” meaning that the lead auditor delegates work to the firm’s offices located outside the lead auditor’s country of headquarters. Estimates suggest that offshore auditors perform 10 to 20% of audit hours.<sup>139</sup> Offshoring differs from the use of component auditors because the offshore auditors assist in the work of the lead auditor rather than audit the issuer’s international operations. Further, unlike the work of component auditors, work sent to offshore centers is typically not disclosed. These centers are frequently part of the U.S. firm, so sending work to these centers does not count as sending work to a foreign affiliate.<sup>140</sup>

Commentators have expressed concern that offshoring audit work may lead to any number of negative outcomes, ranging from a deterioration in audit quality to data and privacy issues.<sup>141</sup> However, proponents of audit offshoring have touted its efficiency and pointed to its potential benefits; for example, by offshoring dredge work, U.S. team members can focus on more nuanced accounting issues.

There is limited empirical evidence on the effects of audit offshoring, likely due to the lack of data availability. The only

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138. See Sunderland & Trompeter, *supra* note 136, at 164.

139. See Mignon Farnet, *Globalization and Offshoring: The Effects of a Globalized Workplace on Auditing Procedures* 48 (May 2016) (unpublished B.S. capstone project, Syracuse University Honors Program), [https://surface.syr.edu/honors\\_capstone/974/?utm\\_source=surface.syr.edu%2FHonors\\_capstone%2F974&utm\\_medium=PDF&utm\\_campaign=PDFCoverPages](https://surface.syr.edu/honors_capstone/974/?utm_source=surface.syr.edu%2FHonors_capstone%2F974&utm_medium=PDF&utm_campaign=PDFCoverPages) [<https://perma.cc/YTR4-M2SV>] (estimating that approximately 10% of work is offshored); Dena Aubin & Sumeet Chatterjee, *Analysis: As More U.S. Audit Work Moves to India, Concerns Arise*, REUTERS (Oct. 16, 2012), <https://www.reuters.com/article/us-usa-audit-india/analysis-as-more-u-s-audit-work-moves-to-india-concerns-arise-idUSBRE89F1GC20121016> [<https://perma.cc/USH5-VX62>] (“PwC’s goal is to send about 20 percent of audit work to the delivery centers, said the firm’s global chairman, Dennis Nally.”).

140. For example, Deloitte India is a region within the Deloitte U.S. organization. See *Our Offices*, DELOITTE., <https://www2.deloitte.com/ui/en/footerlinks/office-locator.html#> (last visited Aug. 14, 2019) [<https://perma.cc/KX2E-DL9R>].

141. See Tammy Whitehouse, *Offshored External Audits Expose Regulatory Issues*, COMPLIANCE WK. (Apr. 1, 2009), <https://www.complianceweek.com/offshored-external-audits-expose-regulatory-issues/5228.article> [<https://perma.cc/7RCA-Q6NM>].

significant work studying audit offshoring has bypassed the lack of data availability by conducting interviews and/or experimental research.<sup>142</sup> These studies typically suggest that offshoring lowers audit quality—or, more precisely, that market participants believe it does. For example, two experimental studies have provided evidence that “jurors” (that is, experimental participants who were asked to play the role of jurors for the experiment) perceive outsourced audit work to be of lower quality and were more likely to award greater damages when work was performed offshore.<sup>143</sup>

In sum, auditing has changed significantly in ways that seem likely to increase the risk of audit failure. Solutions designed to induce high-quality audits need to consider these changes in audit design. One such solution is increased individual accountability, which prior research suggests can reduce coordination challenges and mitigate the risk of audit failure by reducing auditors’ information biases and enhancing auditors’ effort and consensus.

### 3. Market Participant Incentives

Finally, a third benefit to individual auditor accountability is that market participants will have better information when selecting an auditor. There are significant differences in quality among audit partners, even partners within the same firm. Providing this information to the market will allow for more informed auditor selection.

#### *a. Heterogeneity in Audit Partner Quality*

Significant research shows that audit partners differ in quality. Most of these studies are international, as partner identities were not disclosed in the United States until recently. However, some U.S.-based research finds consistent results, suggesting that the international studies translate to the U.S. setting.

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142. See Denise Hanes Downey, *An Exploration of Offshoring in Audit Practice and the Potential Consequences of Associated Work “Redesign” on Auditor Performance*, 37 *AUDITING*, May 2018, at 197, 202, 209 (examining offshore auditing by interviewing six different auditors with varying experience and completing an experiment to measure work design issues present in offshore auditing); Alex Lyubimov, Vicky Arnold & Steve G. Sutton, *An Examination of the Legal Liability Associated with Outsourcing and Offshoring Audit Procedures*, 32 *AUDITING*, May 2013, at 97 (conducting an experiment which measured jurors’ perceptions of auditor liability after an audit failure for insource, outsource, onshore, and offshore work).

143. Brian Daughtery, Denise Dickins & M. G. Fennema, *The Effects of Offshoring Audit Tasks on Jurors’ Evaluations of Damage Awards Against Auditors*, in 16 *ADVANCES IN ACCT. BEHAV. RES.* 55, 73 (Donna Bobek Schmitt ed., 2013); Lyubimov, Arnold & Sutton, *supra* note 142, at 115.

In particular, research has found that certain partners are significantly more likely to be associated with negative accounting events, such as restatements. For example, using Taiwanese data, one study found that the likelihood of poor audit quality is higher when the engagement partner has a recent history of poor audit quality, holding observable client risk characteristics constant. Similar results have been found using data from other countries.<sup>144</sup> For example, researchers using Swedish data found that audit characteristics, such as aggressiveness and conservatism, persist over time and are highly correlated across audits led by the same partner. The authors conclude that “[a]uditor aggressive or conservative reporting is a systematic audit partner attribute and not randomly distributed across engagements.”<sup>145</sup>

Within the United States, data limitations have led studies to focus on forced turnovers<sup>146</sup> rather than time-series analyses.<sup>147</sup> Securities law requires that lead audit partners rotate off an audit engagement for an SEC registrant after five years,<sup>148</sup> so several studies examine accounting quality when the new auditor comes on board. For example, Professors Laurion, Lawrence, and Ryan identified mandatory partner rotations using SEC comment letters, and they found evidence of increases in restatements and deferred tax valuation allowances following partner rotations.<sup>149</sup> Professors Gipper, Hail, and Leuz similarly examine changes in audit quality following a rotation, but they obtain private PCAOB data, allowing for a much larger sample.<sup>150</sup> They find a higher likelihood that the auditor issues an

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144. Knechel, Vanstraelen & Zerni, *supra* note 52 (finding variation using Swedish data). For studies using Chinese data, see Ferdinand A. Gul, Donghui Wu & Zhifeng Yang, *Do Individual Auditors Affect Audit Quality? Evidence from Archival Data*, 88 ACCT. REV. 1993 (2013) and Xiaoke Wang et al., *Engagement Audit Partner Experience and Audit Quality*, 3 CHINA J. OF ACCT. STUD., no. 3, 2015, at 230.

145. W. Robert Knechel, Ann Vanstraelen & Mikko Zerni, *Does the Identity of Engagement Partners Matter? An Analysis of Audit Partner Reporting Decisions*, 32 CONTEMP. ACCT. RES. 1443, 1473 (2015).

146. In addition to studies on mandatory auditor rotations under securities laws, one study examines clients required to switch to new accounting firms after the demise of Arthur Andersen and finds these firms were much more likely to restate earnings, further suggesting variation in auditors. Alexander Dyck, Adair Morse & Luigi Zingales, *How Pervasive is Corporate Fraud?* 4 (Rotman Sch. of Mgmt., Working Paper No. 2222608, 2013), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2222608](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222608) [<https://perma.cc/B2JV-C53K>].

147. Time-series analysis examines the same observations at successive times (e.g., the same firms in different years).

148. 15 U.S.C. § 78j-1(j) (2012).

149. Henry Laurion, Alastair Lawrence & James P. Ryans, *U.S. Audit Partner Rotations*, 92 ACCT. REV., May 2019, at 209, 232.

150. Brandon Gipper, Luzi Hail & Christian Leuz, *On the Economics of Audit Partner Tenure and Rotation: Evidence from PCAOB Data* (Nat'l Bureau of Econ. Research, Working Paper No. w24018, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3023725](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023725)

internal control weakness.<sup>151</sup> There are two explanations for the increase in accounting-related issues when a new partner arrives. First, the incoming partner may identify additional issues undetected by the prior partner. Second, the incoming partner may not be comfortable with the accounting interpretations accepted by the prior partner.<sup>152</sup>

### *b. Market Participants*

If market participants such as audit committees and shareholders are provided with sufficient detail to identify the heterogeneity across individual auditors, they have strong incentives to use the information to select higher-quality auditors.

*Audit Committees.* The audit committee is a subcommittee of the Board of Directors and is primarily responsible for providing oversight of the reporting process. Audit committee members have strong incentives to select high-quality auditors. First, they have a fiduciary duty to shareholders. Second, directors incur career-limiting reputational sanctions if they are associated with an audit failure.<sup>153</sup> As noted previously, directors are more likely to depart a firm following earnings restatements or financial fraud. Finally, should the audit committee members make a poor selection, shareholders can, in theory, vote them out.<sup>154</sup> In sum, out of self-preservation, audit committees

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[<https://perma.cc/33WE-QJG8>]. Note that this study failed to find other “fresh look” benefits of mandatory rotations.

151. *Id.* Internal controls are processes and procedures that induce high-quality financial reporting. Internal controls are abstract in theory, but they are intuitive in practice. Consider this common scenario: A controller receives an email that appears to be from a supplier, and the email requests that the controller send payment to a new routing number. The controller remits payment according to the instructions in the email, only to later learn that he has been defrauded. The email was not from the supplier, but from a bad actor who is now millions of dollars richer. Rather than simply wire millions of public-company dollars to a new account, the controller should have called the supplier to confirm the email’s legitimacy. And the failure to do so reflects an internal control weakness: either the company lacks procedures requiring verification of new accounts before making payments, or the company’s controller failed to follow those procedures. Either way, the company’s controls are problematic. *See, e.g.,* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, THE IMPORTANCE OF INTERNAL CONTROL IN FINANCIAL REPORTING AND SAFEGUARDING PLAN ASSETS 4 (2014), <https://www.aicpa.org/content/dam/aicpa/interestareas/employeebenefitplanauditquality/resources/planadvisories/downloadabledocuments/plan-advisoryinternalcontrol-hires.pdf> [<https://perma.cc/62CB-V6GS>].

152. Of course, it is entirely possible that two partners are of identical quality but identify different accounting issues, leading to disclosure of accounting-related issues upon rotation.

153. *See supra* notes 43–44 and accompanying text (describing the negative consequences of being associated with an audit failure).

154. For example, Institutional Shareholder Services (ISS) recommended against audit committee members at Ryman Hospital Partners after these directors approved spending on nonaudit services that ISS deemed excessive. Geert De Lombaerde, *Proxy Advisor Calls for ‘No’ Vote on Ryman Directors*, *E&Y*, NASHVILLE POST (May 1, 2013),

have strong incentives to use all available information to select a high-quality auditor.

*Shareholders.* Shareholders, too, are likely to use the information. When picking stocks, they have strong incentives to avoid companies with low-quality accounting.<sup>155</sup> Shareholders suffer significant losses upon disclosure of a restatement—far more than the value of the restatement itself.<sup>156</sup> By obtaining information on the partner leading the audit, investors can better assess the financial risk of a company and price the stock accordingly. Indeed, an experimental study supports this view; the authors found that shareholders were less likely to select a peer firm audited by a partner who had overseen an audit failure.<sup>157</sup> Knowing that investors rely on the information when purchasing a stock will provide even greater pressure on audit committees to select high-quality auditors.<sup>158</sup>

In sum, there is ample reason to expect broader dissemination of information on the quality of individual auditors to reduce audit failures. It is clear that information on individual auditors is value-relevant, and that auditors are not interchangeable. Shareholders and, especially, audit committee members have strong incentives to use this type of information.<sup>159</sup>

#### 4. Increased Competition

Finally, auditor reputation markets could increase competition. The lack of competition in the upper echelon of accounting, where four

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<https://www.nashvillepost.com/business/area-stocks/article/20469678/proxy-advisor-calls-for-no-vote-on-ryman-directors-ey> (last visited Sept. 27, 2019) [<https://perma.cc/U47R-4QDC>].

155. Even if the collection action problem leads investors to be rationally apathetic with regard to shareholder voting, it does not follow that an investor will neglect to conduct research before purchasing a stock.

156. See Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581 (2008) (examining the financial impact on firms caught engaging in financial misrepresentation). The extreme negative market reaction to accounting failures contrasts with other negative events. For example, the loss in market value caused by other events (*e.g.*, environmental fine) is similar to the cost of the fine. However, the loss in value caused by accounting failures is greater than the loss of the restatement itself.

157. Tamara A. Lambert, Benjamin L. Luippold & Chad M. Stefaniak, *Audit Partner Disclosure: An Experimental Exploration of Accounting Information Contagion*, 30 BEHAV. RES. IN ACCT. 27, 37 (2018).

158. It is also possible that shareholders would use the information when voting, making private enforcement more effective. With more information, shareholders could provide more informed votes on auditor ratification, and they could target individual directors on the audit committee if they were not pleased with the auditor selection. However, due to rational apathy in voting, this avenue is less likely.

159. Other recent work has called for increases in shareholders' power over the auditor's appointment. See Coffee, *supra* note 64, at 2 (“[A] more feasible approach would be to give investors greater ability to select and remove the auditor.”).

firms dominate the market, is a constant regulatory concern. Various proposals ranging from mandatory multi-firm audits to a forced breakup of the Big Four have gotten some traction, particularly in the United Kingdom.<sup>160</sup>

By contrast, my proposal could increase competition naturally. As noted previously, some of the reasons why issuers are hesitant to terminate their auditors include that (1) they are concerned the market will “punish” them if they switch to a non–Big Four auditor; (2) there can be significant costs associated with switching (e.g., employees at the issuer will incur significant time getting the new auditor up to speed); and (3) there are often few options, as some firms have more industry expertise and other firms are excluded because they provide certain nonaudit services.

Public knowledge of the auditor’s reputation could mitigate these concerns. If the market trusts the reputation of an individual partner, clients may be able to switch to non–Big Four accounting firms without penalty if they switch to (or with) a highly regarded audit partner.<sup>161</sup> Further, if they switch with a partner who brings her team to the new firm, the costs for the “new” team to get set up will be trivial. Finally, even if the new accounting firm has limited experience with an industry, there may be a partner with substantial expertise—or the accounting firm may hire a partner specifically to obtain such expertise.

Ultimately, accounting firms could look more like law firms, which have thriving lateral markets.<sup>162</sup> Accounting firms, at present, do not. After all, if an individual auditor has no public reputation and her clients are unlikely to follow her switch, recruiting a lateral is far less attractive. However, based on similar industries, such as credit and firm analysts, there is reason to believe that building a partner’s brand

160. See Louis Ashworth, *Pressure Mounts on the CMA to Break Up Accountancy’s Big Four*, CITY A.M. (Oct. 1, 2018, 12:34 AM), <http://www.cityam.com/264093/pressure-mounts-cma-break-up-accountancys-big-four> [https://perma.cc/4TQE-F6HX]; Paulina Duran, *Australia Calls on Bank Outsiders to Break Up Big Four Dominance*, REUTERS (Aug. 3, 2018, 11:40 PM), <https://www.reuters.com/article/us-australia-banks/australia-calls-on-bank-outsiders-to-break-up-big-four-dominance-idUSKBN1K00EV> [https://perma.cc/HQF2-9TCZ]; Madison Marriage, *EY Hits Back at Calls to Break Up Big Four Accounting Firms*, FIN. TIMES (Sept. 13, 2018), <https://www.ft.com/content/36188f82-b6a9-11e8-bbc3-ccd7de085ffe> [https://perma.cc/T2XE-R34E]; Joseph Smith, *Multi-firm Audits can Break the Big Four’s Oligopoly*, FIN. TIMES (July 23, 2019), <https://www.ft.com/content/bc5afbc4-a3fd-11e9-a282-2df48f366f7d> [https://perma.cc/G8Y9-HTV4].

161. For example, perhaps a high-quality partner who leaves KPMG for a smaller accounting firm, such as Grant Thornton, would be able to retain his clients because market participants would trust the partner, even though Grant Thornton is outside the Big Four.

162. Dylan Jackson, *Law Firm Lifers and the Hot Lateral Market*, LAW.COM: DAILY BUS. REV. (Apr. 2, 2019), <https://www.law.com/dailybusinessreview/2019/04/02/law-firm-lifers-and-the-hot-lateral-market/> [https://perma.cc/DYM4-3CPK].

separately from that of her firm could have this type of effect on mobility and competition.<sup>163</sup>

In sum, there is reason to believe that individual auditor reputation markets could increase competition in the industry. Of course, this is not a perfect fix, and there remains reason to doubt that individual accountability alone would break up the Big Four. Nonetheless, it is a possibility worth pursuing—and would certainly be more politically palatable than drastic regulatory action to break up the Big Four.

### C. Objections

There are many reasons to be skeptical of reputation markets for individual auditors. In this section, I discuss some common objections.

#### 1. Audit Fees

First, a greater focus on the reputation of the audit partner will likely raise the costs of an audit. The auditor will bear increased risk, which will incentivize her to (1) incur more audit hours to validate the underlying opinion and (2) increase her personal compensation to account for the increased risk. As described below, empirical work indicates that this conjecture has already occurred, as there is evidence that audit fees increased after firms were required to disclose the name of the lead audit partner (the biggest step in developing reputation markets).

Although not ideal, the benefits of individual accountability outweigh the increase in fees, particularly because the increase in fees associated with disclosure of the partner's identity appears to be relatively modest. For example, when examining the change in audit fees after mandatory audit partner disclosure in the United Kingdom, Professors Carcello and Li found average audit fees of \$475,900 in the pre-period and \$477,000 in the post-period.<sup>164</sup> Similar studies have

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163. See Section I.C.2 (explaining the improved audit quality that results from individual auditor brands). Further consider, for example, Mike Mayo. After Credit Suisse First Boston fired Mayo, he worked at CLSA (a Chinese brokerage) but remained a highly visible presence in the media. After CLSA, he went to work for Wells Fargo, bringing members of his team with him. Laura Noonan & Ben McLannahan, *Big Banks' Critic Mike Mayo to Join Wells Fargo*, FIN. TIMES (June 12, 2017), [https://www.ft.com/content/\\_\\_\\_\\_ccce5678-4f35-11e7-bfb8-997009366969](https://www.ft.com/content/____ccce5678-4f35-11e7-bfb8-997009366969) [https://perma.cc/EBH8-ME2J].

164. Joseph V. Carcello & Chan Li, *Costs and Benefits of Requiring an Engagement Partner Signature: Recent Experience in the United Kingdom*, 88 ACCT. REV. 1511, 1524 (2013). The difference was not significant with univariate results, but it becomes significant in regression

examined whether U.S. audit fees also increased following the introduction of Form AP, but the results have been inconsistent.<sup>165</sup>

Regardless, even if the findings that the disclosure led to a modest increase in audit fees are correct, the cost of poor accounting quality is far more significant. On average, prior work has found that restatements result in losses of market value of 9.2%,<sup>166</sup> far exceeding the financial cost of the misstatement.<sup>167</sup> For even the smallest company in the S&P 500, an estimate of -9.2% suggests a loss of over \$260 million.<sup>168</sup> If the development of individual brands provides even a 1% decrease in the frequency of significant audit failures, that savings will, on average, far, far exceed the increase in audit fees.

## 2. Increased Conservatism

Second, this proposal may lead to more conservative financial reporting. If auditors are concerned with their individual reputations, or if they believe the disclosure will increase their risk of legal liability, they may be overly conservative. Preliminary evidence suggests that such an effect is likely. In the United Kingdom, the frequency of going-concern opinions was 3.3% in the year prior to audit partner disclosure and 6.5% in the year following audit partner disclosure.<sup>169</sup>

On the one hand, excessive conservatism does not improve audit quality, as it sends a false signal to the market. On the other hand, accounting is, by definition, conservative. As a whole, the profession has chosen to err on the side of conservatism. For example, this is the intuition for why assets are recorded at historical cost and written down if their value decreases—but are not “written up” if they appreciate.

Moreover, companies may provide additional disclosures that counteract the conservatism of auditors. For example, over 90% of companies now provide both Generally Accepted Accounting Principles

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analysis with control variables. *Id.* at 1532. Of course, this only reflects any increase associated with the disclosure of the engagement partner, which is only one aspect of increasing individual accountability. And this reflects an increase in the United Kingdom, which is less litigious than the United States.

165. See *supra* note 61.

166. Zoe-Vonna Palmrose, Vernon J. Richardson & Susan Scholz, *Determinants of Market Reactions to Restatement Announcements*, 37 J. ACCT. ECON. 59, 60 (2004) (finding mean returns of -9.2% over a two-day event window).

167. Karpoff, Lee & Martin, *supra* note 156, at 594–96.

168. *October 2019 List of All S&P 500 Stocks & Companies*, SURE DIVIDEND (Oct. 2, 2019), <https://www.suredividend.com/sp-500-stocks/>.

169. Carcello & Li, *supra* note 164, at 1524.

“GAAP”) and non-GAAP financials in their annual reports.<sup>170</sup> The non-GAAP numbers are rarely audited.<sup>171</sup> Therefore, the increased conservatism only affects a subset of the information that companies report to their investors, allowing companies to fight back if they believe the auditor is overly conservative.

### 3. Personal Concerns

Third, there are personal concerns for the auditor herself. Introducing reputation markets raises serious concerns regarding fairness, safety, and privacy. It is entirely possible that some auditors will unfairly receive an undeserved reputational stigma. For example, perhaps a certain auditor is put on risky audits precisely because he is of high quality and best positioned to prevent misstatements. This auditor is likely to be associated with a higher than baseline probability of audit failure, an outcome entirely inconsistent with his actual quality. To prevent such outcomes, high-quality partners may refuse to work with high-risk clients, even though these are the clients that would benefit most from their expertise.

Of course, this issue is not unique to auditors. Perhaps most similarly, FINRA has comparable concerns with BrokerCheck, its online database containing past broker misconduct. This database includes unverified customer complaints, prompting concerns that certain brokers are unfairly targeted. In response, FINRA allows brokers two options. First, brokers can respond to each complaint, and their response will be publicly visible just below the initial complaint.<sup>172</sup> Second, brokers may expunge infractions from the database.<sup>173</sup>

Greater individual reputational risk also raises concerns regarding safety and privacy. Individuals (and their families) involved in high-profile financial failures have been threatened. For example, when it was publicly disclosed in March 2009 that American International Group (“AIG”) intended to pay over \$150 million in

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170. Matthew Stock, *Deceptive Non-GAAP Financials Will Lead to Future SEC Whistleblower Awards*, ACCT. TODAY (May 18, 2018), <https://www.accountingtoday.com/opinion/deceptive-non-gaap-financials-will-lead-to-future-sec-whistleblower-awards> [<https://perma.cc/DE2F-7QVW>].

171. See PUB. COMPANY ACCT. OVERSIGHT BOARD, AS 2710: OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS, <https://pcaobus.org/Standards/Auditing/Pages/AS2710.aspx> (last visited Aug. 23, 2019) [<https://perma.cc/4XCF-X8R9>] (“[T]he auditor has no obligation to perform any procedures to corroborate other information contained in a document.”).

172. *Guidelines for Broker Comments on BrokerCheck*, FIN. INDUSTRY REG. AUTHORITY, <https://www.finra.org/registration-exams-ce/individuals/guidelines-broker-comments-brokercheck> (last accessed Oct. 27, 2019) [<https://perma.cc/D5DN-22TV>].

173. See Honigsberg & Jacob, *supra* note 45, at 5–6 (describing the process and frequency of expungement).

employee bonuses after receiving a taxpayer-funded bailout at the height of the financial crisis, AIG employees received death threats.<sup>174</sup> Consequently, AIG had to hire guards and required an increased police presence.<sup>175</sup> In sum, although society has chosen to require individual disclosure for other actors,<sup>176</sup> the potential safety issues are serious concerns.

#### 4. Litigation Risk

Fourth, there are concerns that the disclosures will give rise to private liability beyond reputational costs.<sup>177</sup> Exposing individuals to such litigation risk could raise audit costs considerably and, as mentioned earlier, would not necessarily increase audit quality. Although an increase in litigation risk may ultimately be necessary to induce the proper incentives,<sup>178</sup> a market-oriented solution is preferable to increasing litigation risk at this time.<sup>179</sup>

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174. Brady Dennis & David Cho, *Rage at AIG Swells As Bonuses Go Out*, WASH. POST (Mar. 17, 2009), <http://www.washingtonpost.com/wp-dyn/content/article/2009/03/16/AR2009031602961.html> [<https://perma.cc/78VL-AKU4>].

175. *Id.*; see also *AIG Bonus Outrage has Employees Living in Fear*, ASSOCIATED PRESS (Mar. 20, 2009, 6:47 PM), [http://www.nbcnews.com/id/29802167/ns/business-stocks\\_and\\_economy/t/aig-bonus-outrage-has-employees-living-fear/](http://www.nbcnews.com/id/29802167/ns/business-stocks_and_economy/t/aig-bonus-outrage-has-employees-living-fear/) [<https://perma.cc/Y2MJ-22BA>] (“Security companies in New York say the financial crisis has created brisk business in everything from bomb-sniffing dogs to bodyguards for executives.”).

176. For example, we require such disclosure for broker-dealers, investment advisers, and sexual offenders, among others. See Megan’s Law, 42 U.S.C. § 14071(d), (repealed 2006) (requiring the release of relevant information to protect the public from sexually violent offenders); BROKERCHECK, <https://brokercheck.finra.org/> (last visited Sept. 27, 2019) [<https://perma.cc/4BWU-TGGP>] (providing a free tool to research financial brokers’ background and experience); INVESTMENT ADVISER PUB. DISCLOSURE, <https://www.adviserinfo.sec.gov/> (last visited Mar. 19, 2019) [<https://perma.cc/55DU-PGHS>] (offering Form ADV and investment adviser history).

177. See Cathy J. Cole, *Audit Partner Accountability and Audit Transparency: Partner Signature or Disclosure Requirement*, 14 J. ACCT. & FIN. 84, 94 (2014) (describing comment letters noting potential increases in litigation risk).

178. Past reforms have focused on reducing conflicts of interest rather than increasing private enforcement. See Coffee, *supra* note 64, at 2 (noting that prior reforms imposed consulting restrictions, a cooling-off period, and independence rules). However, policymakers have now reduced conflicts of interest to the extent reasonably feasible. Should there be another significant accounting failure along the lines of Enron, it is plausible that Congress will increase litigation risk despite that its effect on audit quality is unclear. This pending threat provides greater incentive to find a market-based solution.

179. Two more objections bear mention. First, it is possible that a greater focus on individual brands will have no effect, as auditors already have significant incentives to perform high-quality work. If so, there would be a cost with no benefit. However, given that some preliminary research on disclosure of the name of the audit partner suggests this disclosure alone had an effect, this objection seems inconsistent with the data. Second, another objection is that separating the brand of an auditor from that of her firm may reduce firm accountability. If so, the firm may reduce the support that it provides to auditors. However, given that audit partners own the firm and determine its spending priorities, the partners are incentivized to continue funding the firm’s infrastructure and internal support to the degree they are beneficial.

### III. TOWARD OPTIMAL AUDITOR BRAND DEVELOPMENT

Regulators in the United States recently mandated disclosure of the engagement partner—the preliminary step in developing individual auditor brands. However, this disclosure is only a first step. For private markets to develop useful Auditor Scorecards and build efficient reputation markets, regulators should mandate disclosure of additional relevant information and ensure that usable information is revealed through their enforcement actions.<sup>180</sup>

#### *A. Additional Disclosures*

To be most effective, the Scorecard needs to contain information that will allow market participants to identify high- and low-quality auditors. With sufficient time-series data, the partner name alone will provide a noisy signal. However, regulators should mandate disclosure of information that will provide the market with a more precise signal—and sooner.

#### 1. PCAOB Disciplinary Proceedings

For starters, the PCAOB should be permitted to publicly disclose PCAOB disciplinary proceedings. As noted earlier, these proceedings are confidential and nonpublic unless all parties consent to make the information public,<sup>181</sup> and the confidentiality extends until the case is either settled or all appeals have been exhausted.<sup>182</sup> This provides parties with significant incentives to fully draw out the appeals process, including appealing any discipline up to the SEC. This can take years.

Officially, the explanation for the confidentiality is that PCAOB disciplinary proceedings contain market-moving information, and disclosing such unproven allegations prematurely would disadvantage issuers. That is, disclosure of a PCAOB disciplinary proceeding not only punishes the accounting firm, but also the client. Unofficially, congressional staffers say that the explanation for the confidentiality is that the accounting firms have lobbied heavily for its protection.

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180. Professor Coffee has similarly called for a scorecard-related disclosure. In particular, he called for disclosure of the grades that audit firms receive from regulators. Coffee, *supra* note 64, at 10. But, due to individual variation, it is an empirical question as to whether the general grade is reflective of the individual audits.

181. Modesti, *supra* note 76.

182. 15 U.S.C. § 7215(d)(1) (2012).

Bipartisan congressional representatives have proposed to make the proceedings public, all to no avail.<sup>183</sup>

Of course, there needs to be some level of certainty before disclosing the disciplinary proceedings. However, the requirement that all appeals must be complete is excessive and deprives the public of timely and value-relevant information. It is also unnecessary to protect the issuer, as regulators can release disciplinary actions against an auditor while withholding the name of the issuer.<sup>184</sup> Going forward, similar to the SEC's process, the disciplinary proceedings should be disclosed when the regulator decides to file an enforcement action.<sup>185</sup>

## 2. Overseas Auditors

Regulators should require disclosure not only on the existence of other audit participants, but on the lead auditor's supervision of those other auditors. As mentioned previously, supervision can vary wildly. Providing this additional context would make the information in Form AP far more meaningful.

Further, Form AP requires disclosure of the use of component auditors, but it does not require any information on offshore auditors. Regulators should require that accounting firms disclose the use of offshore auditors and the type of work that is sent to these offshore auditors. If the information is nonjudgmental audit work, such as counting widgets, it seems unlikely that investors will be terribly concerned. However, if the offshore auditor is performing judgmental work that requires, for example, the subjective determination of whether an accounting treatment is acceptable, investors are likely to be more concerned.

### *B. Enforcement Priorities*

Finally, to the extent possible and equitable, regulators should highlight the fault of the individual(s) involved when bringing disciplinary actions against auditors. Individual accountability in corporate enforcement was a focus of the Obama Administration—Sally Yates authored a memo stating that the DOJ should focus on the

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183. See sources cited *supra* note 75.

184. See, e.g., sources cited *supra* note 123.

185. U.S. SEC. & EXCHANGE COMMISSION, DIVISION OF ENFORCEMENT, ENFORCEMENT MANUAL 18 (2017), <https://www.sec.gov/divisions/enforce/enforcementmanual.pdf> [https://perma.cc/UYK8-Y2NZ].

individuals involved in corporate malfeasance<sup>186</sup>—and some regulatory actions already take this approach.<sup>187</sup> However, the Trump Administration has appeared to back off individual accountability in corporate enforcement, arguing that it is prohibitively costly to make a case against all individuals involved.<sup>188</sup> It is unclear to what extent the Trump administration's decision to focus less on individual accountability for corporate actors is political, as the administration continues to focus on individuals in other settings such as immigration. However, if the administration is correct that individual accountability is prohibitively costly for corporate actors, a compromise could be to name the individuals involved even if the government brings its case against the institution as a whole. Reputation markets do not need formal enforcement to incorporate subpar conduct.

Further, in some instances, regulators decline to pursue discipline if the infractions appear too modest. Because even seemingly minor infractions, such as customer complaints, are significant predictors of bad acts in other areas,<sup>189</sup> it would be worthwhile for the SEC and PCAOB to amend these enforcement policies. When possible, regulators should pursue even modest infractions to provide a public record of these infractions, as they would still likely provide important information to the market.

### *C. Visibility and Presentation*

Finally, to spur the development of auditor reputation markets, the critical disclosures should be easily accessible. At present, auditor-relevant information is disclosed through issuer and auditor filings on the SEC and PCAOB's websites, disciplinary actions by any number of agencies, and company filings abroad. For example, as mentioned earlier, the identity of the audit partner is disclosed on the PCAOB's website in a form filed by the auditor, but it must be linked to

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186. Memorandum from Sally Quillian Yates, Deputy Att'y Gen., Dep't of Justice, on Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015), <https://www.justice.gov/archives/dag/file/769036/download> [<https://perma.cc/2JY6-97RD>].

187. Dylan Tokar, *The Department of Justice Is Turning Back the Clock on Corporate Accountability*, NATION (Mar. 6, 2019), <https://www.thenation.com/article/financial-crisis-justice-department-corporate-prosecutions-yates-memo/> [<https://perma.cc/Q6D2-FKAS>]. Consistent with the Yates memo, some disciplinary actions already name the auditor(s) involved. Others, however, are more generally against a firm even when the action concerns an individual. See PUB. COMPANY ACCT. OVERSIGHT BOARD, SETTLED DISCIPLINARY ORDERS 4 (Oct. 16, 2018), <https://pcaobus.org/Enforcement/Decisions/Documents/105-2018-020-Deloitte-Canada.pdf> [<https://perma.cc/S85G-H7HA>] (stating that Deloitte Canada violated independence rules, but not stating the name of the auditor in question).

188. Tokar, *supra* note 187.

189. Egan, Matvos & Seru, *supra* note 45, at 246, 248.

information disclosed through other sources (for example, disciplinary actions or audit failures) to be useful.

Market participants would benefit from straightforward disclosure in one location. Equity analysts have long created reports summarizing company performance and recommending whether to buy, sell, or hold the stock. Credit rating analysts use a similar system for company debt. And financial advisors provide their employment and disciplinary history online through websites maintained by FINRA and the SEC. Even scorecards on mutual funds are now available.<sup>190</sup>

Although the Auditor Scorecards would be most effective with the additional disclosures described previously, there is already sufficient information to provide a noisy signal of the audit partner's quality. However, with the additional information described, the Scorecard could be more similar to what is provided for financial advisors.<sup>191</sup> Providing all this information in a centralized location would greatly reduce the costs of acquisition and make the information more broadly accessible. Although there is reason to doubt the effectiveness of such disclosures in purely consumer contexts,<sup>192</sup> disclosures seem to drive behavioral changes in securities markets.<sup>193</sup>

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190. See e.g., *Mutual Fund Management Co*, INVESTOR, <https://investor.com/riias/mutual-fund-management-co-107538> (last updated Aug. 6, 2019) [<https://perma.cc/R2W9-5CFL>] (providing information about the mutual fund, including its assets under management and disciplinary history).

191. In particular, it could show the auditor's employment history (years of experience, clients, employers, education), clients, fees associated with prior audits, critical audit matters associated with prior audits, use of overseas auditors (if applicable), disciplinary history (if applicable), and any audit failures associated with his clients (if applicable).

192. See Daniel E. Ho, Zoe C. Ashwood & Cassandra Handan-Nader, *The False Promise of Simple Information Disclosure: New Evidence on Restaurant Hygiene Grading 4* (Stan. Inst. for Econ. Pol'y Res., Working Paper No. 17-043, Dec. 20, 2017), <https://siepr.stanford.edu/sites/default/files/publications/17-043.pdf> [<https://perma.cc/TM6K-H3XT>] ("These data lead to a simple conclusion: there is no evidence that LA's grading system reduced foodborne illness.").

193. See Colleen Honigsberg, *Hedge Fund Regulation and Fund Governance: Evidence on the Effects of Mandatory Disclosure Rules*, 57 J. ACCT. RES. 845, 884 (2019) ("My findings provide evidence that the mandatory disclosure requirements led funds to make changes in their internal governance . . ."); see also Hans B. Christensen et al., *The Real Effects of Mandated Information on Social Responsibility in Financial Reports: Evidence from Mine-Safety Records*, 64 J. ACCT. & ECON. 284, 290 (2017) ("Overall, the evidence in this section indicates that compliance with the Mine Act increased in response to MSD."); Nico Lehmann, *Do Corporate Governance Analysts Matter? Evidence from the Expansion of Governance Analyst Coverage*, 57 J. ACCT. RES. 721, 754 (2018) ("The results indicate that the initiation of ISS coverage causes firm-level improvements in governance quality, liquidity, financial analyst following, and investor breadth.").

*D. Private Actors*

Finally, Auditor Scorecards are most likely to be effective if developed by private actors. As noted previously, there are concerns that regulatory oversight is likely to be suboptimal due to limitations such as regulatory capture and lobbying. Rather than risk the Scorecard be implemented in a suboptimal fashion (or not at all), private actors could use the business model of proxy advisors to develop and sell the information.

There is one additional benefit to having private actors develop the Scorecard: these actors could serve as a counterweight to the influence of accounting firms. One reason that accounting firms are likely successful when lobbying to prevent disclosures is that there is not a comparable actor arguing in favor of these disclosures. With private actors running the Scorecard—and therefore using the disclosures and reaping the financial success—they would have incentives to counteract the accounting firms and demand additional disclosures that they believe would improve the accuracy of the Scorecard.

## CONCLUSION

Despite prior efforts by lawmakers and corporate fiduciaries, there remains reason to doubt that auditors have sufficient incentive to perform consistent, high-quality audits. Indeed, PCAOB inspections from 2005 through 2016 find that, on average, 25% of audits inspected were severely deficient. To induce higher audit quality, I propose to create a reputation market for individual auditors.

This approach would have four benefits. First, individual accountability would increase the audit partner's costs of audit failure, thus better aligning the incentives of the audit partner with those of the shareholders. Second, increased accountability could mitigate the increased audit risk associated with the use of overseas auditors. Third, with more information on the individual auditor, market participants would be able to select higher-quality auditors. Finally, individual accountability would plausibly increase competition in the accounting industry.

To achieve a reputation market for individual auditors, I propose the creation of Auditor Scorecards providing detailed information on each audit partner. Although the information already publicly available could provide a noisy signal of audit partner quality, the Scorecard would be more effective if regulators disclosed additional information. In particular, PCAOB disciplinary proceedings should be made publicly

available, more detail on the oversight of overseas auditors should be provided, and the auditor at fault should be named in regulatory enforcement actions. These sources of information would provide ongoing and valuable information regarding each partner's quality.

## APPENDIX A: PCAOB ANNUAL REPORT DATA

Inspection Year	Percent Not Sufficient Audits	Number of Audits Inspected
2005	31%	988
2006	20%	1080
2007	14%	1035
2008	16%	897
2009	19%	1080
2010	31%	950
2011	30%	825
2012	30%	910
2013	33%	865
2014	25%	780
2015	29%	810
2016	23%	780

This table presents data compiled from PCAOB Inspection Reports covering the years from 2005 through 2016. The “Percent Not Sufficient Audits” column represents the percentage of audit opinions the PCAOB believed should not have been issued because the audit itself was so poorly performed that the auditor did not have sufficient basis on which to issue an opinion. This percentage is calculated as the total number of “Not Sufficient” audits divided by the number of audits inspected by the PCAOB. The “Number of Audits Inspected” category represents the number of audits inspected annually by the PCAOB (note that the PCAOB frequently inspects only a portion of these audits, not the entire audit). The statistical analysis underlying these data are on file with the author, and are based on PCAOB Inspection Reports available at PUB. COMPANY ACCT. OVERSIGHT BD., FIRM INSPECTION REPORTS, <https://pcaobus.org/Inspections/Reports/Pages/default.aspx> (last visited Nov. 5, 2019).