Independence, Professional Skepticism, and the Financial Statement Audit

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Abstract

Financial statement audits of public companies were first mandated in the United States by the Securities Exchange Acts of 1933 and 1934. The idea behind mandating these audits was that an *independent* review of financial statements was the only way to reassure investors that they could trust public company financial disclosures. Eighty years and numerous accounting scandals later, investors and regulators are still struggling to determine how they ensure auditors maintain an independent and professionally skeptical mindset while conducting an audit. This paper reviews and assesses several proposals that have been made to enhance professional skepticism. Some of these proposals would make only minor adjustments to the current audit model, such as strengthening the required qualifications to sit on an audit committee. Other proposals would have a dramatic impact on the public company audit market, such as switching to a "financial statement insurance" model. This paper argues that most ideas currently under discussion are either too difficult to implement or fail to address the root cause of the auditor independence problem. Rather, regulators can improve the independence and professional skepticism of auditors (and thus the overall quality of these audits) by combating investor apathy towards, and ignorance of, the role of external auditors. Finally, this paper makes several recommendations for mitigating investor apathy and strengthening the relationship between auditors and stakeholders.

I. Background

> *"By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing*

public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust (United States v. Arthur Young & Co. 1984).*"*

The first known US corporate audit report was issued in 1827 for the Baltimore and Ohio Railroad Company (Carcello, et al. 2011). At that time, auditors were hired on a voluntary basis to provide a company's stakeholders with comfort regarding the business' financial statements. Early auditors were only accountable to whomever hired them. Auditors and their employers would retain this simple employment relationship for the next one hundred years.

The US securities markets were fundamentally transformed with the signing of the Securities Exchange Acts of 1933 and 1934. While writing the laws, Congress chose to include a requirement that all companies with securities publically traded in the United States submit *audited* financial statements to the newly formed Securities and Exchange Commission ("SEC") on an annual basis. Each public company was now obligated to hire an independent accounting firm to ensure that its balance sheet, income statement, cash flow statement, and statement of shareholder's equity (as well as the accompanying notes) were free of material misstatements. This requirement ensured that all stakeholders (e.g., investors, creditors), as well as potential investors, would have access to reliable financial information about the companies they were providing with capital. Armed with reliable financial information, stakeholders could make more informed investment choices, which in turn lowered the cost of capital for well-run businesses.

Congress' decision to require the submission of audited financial statements to the SEC also revolutionized the relationship between auditors and the companies they examined. As the Supreme Court eloquently stated in 1984, auditors took on a public responsibility that transcended any employment relationship with the client. By passing the Securities Exchange Acts, Congress had handed auditors a franchise, effectively guaranteeing future demand for financial statement audits. In exchange, auditors had assumed a duty to protect all stakeholders and potential stakeholders (the investing public) by providing an independent and objective audit. Thus, any time a company's management seeks to mislead investors by manipulating its financial reporting (in order to conceal fraud, earn performance bonuses, etc.), the auditor has a responsibility to detect, correct, and if necessary, expose the issue. Truly objective auditors serve as a check against the principal-agent problem as it relates to investors and public company managers.

Unfortunately, auditors have struggled at times to fulfill their duty to investors. Since the 1930's, there has been no shortage of cases in which public company managers mislead investors (either intentionally or through incompetence) and auditors failed to intervene. Periodically, a sudden spike in audit failures will trigger a public outcry that forces regulators, investors, and auditors to reassess whether the current audit model is effective. This occurred in 2002 following the highly publicized failures of public companies such as Enron and WorldCom, in addition to the collapse of one of the five largest US audit firms, Arthur Andersen. Responding to public outrage, Congress passed the Sarbanes-Oxley Act of 2002 ("SOX"), which instituted a number of reforms to improve financial reporting and auditing. The bill created the Public Company Accounting Oversight Board ("PCAOB" or "the Board") to oversee the auditors of public issuers[1]. The bill also created a requirement that public companies have their internal controls over financial reporting audited annually by an external auditor.[2] This controversial and costly provision further enhanced the quality and thoroughness of the external audit.

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[1] Issuers refers to public companies that have securities registered in the US under Section 12 of the Securities Exchange Act of 1934 (or must file reports under Section 15(d) of that Act), and thus must file financial statements with the SEC (Securities and Exchange Commission 2002).

[2] An "internal control" is defined as "A process, effected by the entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (1) reliability of financial reporting; (2) effectiveness and efficiency of operations; and (3) compliance with applicable laws and regulations (Whittington and Pany 2010).

However, it also proved to be a boon for auditing firms, who were able to greatly increase their fees in exchange for providing this additional service.

Ten years later, it appears SOX has failed to fully resolve the issues facing the external audit. In the wake of the 2008 financial crisis, some investors and regulators are questioning how so many seemingly healthy companies could fall into bankruptcy and/or be forced to accept government bailout money without any warning from auditors. To some, the failure by auditors to issue "going concern opinions" for virtually all of these companies is further proof that the current audit model is deeply flawed and must be adjusted, or even completely overhauled.[3] These criticisms are rooted in the notion that external auditors have failed to remain independent of the companies they audit.

In 2011, the PCAOB responded to investor criticism of auditors' handling of the financial crisis by issuing its Concept Release on Auditor Independence and Audit Firm Rotation ("the Release"), which sought public comment on "ways that auditor independence, objectivity, and professional skepticism could be enhanced (PCAOB 2011)." The Release states that while many of the reforms contained in the Sarbanes-Oxley Act of 2002 have significantly improved the quality of public audits, the Board's inspections of public accounting firms continue to uncover deficiencies relating to a lack of professional skepticism by auditors. The PCAOB received over 600 comment letters responding to the Release, the second most to any publication in the Board's brief history . The Board also hosted a public roundtable in March of 2012, in which it sought to learn more about the costs and benefits of various potential measures to enhance auditor independence. Commenters were generally able to agree on the importance of auditor independence, and little else. The PCAOB now finds itself at a crossroads. Having publically called out the auditing profession for its lack of professional skepticism, the Board must now

[3] Paragraph .12 of AU sec. 341 states that "If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion."

find a way to improve auditor independence that won't be blocked by powerful business lobbies. This is not an enviable task.

This paper will first define and discuss the importance of auditor independence and professional skepticism. Next, it will discuss whether auditor independence is truly lacking, and if so, identify several factors that are likely contributing to this issue. It will also discuss some of the potential reforms that have been suggested by financial experts to bolster the independence of external auditors. This paper will then present its own model for enhancing the independence of auditors, in which regulatory reforms are used to diminish investor apathy towards, and ignorance of, the external audit. It will also use this model to demonstrate how increasing auditor independence will positively impact a number of other major audit issues the PCAOB is currently addressing. Finally, this paper makes several recommendations for addressing investor apathy and improving auditor independence.

II. Independence and Professional Skepticism

Defining Independence, Professional Skepticism , and Objectivity

Before discussing the importance of independence, objectivity, and professional skepticism to the external auditor model, it is important to understand the slightly different connotations these three terms have. David Becker, former General Counsel and Senior Policy Director of the SEC, best articulated the relationship between these three terms in a 2012 statement to the PCAOB, in which he wrote that "Skepticism denotes a questioning mind; independence denotes a freedom from bias; and objectivity denotes a capacity to arrive at judgments within the range of those a reasonable auditor would hold (Becker 2012)." Under this definition, the independence of an auditor is contingent on mitigating and/or eliminating external sources of bias. For example, independence rules forbid an auditor from owning a stake in the company he/she is auditing, because this could create a conflict of interest that might ultimately lead the auditor to a different conclusion than he/she may have otherwise reached.

Conversely, professional skepticism is contingent upon an auditor's state of mind. Auditors have a responsibility to verify the representations of management, rather than merely accepting their claims at face value. An auditor must be independent in order to be professionally skeptical. However, independence does not guarantee professional skepticism, as other factors (ex. audit firm culture) can rob an auditor of her professional skepticism (Becker 2012). Objectivity, on the other hand, requires that the auditor be both independent and professionally skeptical. However, it also requires the auditor to have the talent, knowledge, and judgment necessary to arrive at reasonable conclusions. While this paper will focus primarily on independence and professional skepticism, an understanding of all three terms is critical for anyone attempting to reform the external audit.[4]

The Importance of Independence and Professional Skepticism

Independence and professional skepticism are the cornerstones on which the external auditing model is built. The Supreme Court acknowledged this in 1984, stating that "independence is the essential attribute of the auditor because, absent independence, the auditor's skills and services are of little value (United States v. Arthur Young & Co. 1984)." This is because auditors are essentially selling their objectivity to their clients. Investors are willing to absorb the costs of the external audit because auditors have both the ability (skills, knowledge, etc.) and the willingness (independence and professional skepticism) to ensure a company's financial reporting is as accurate as possible. Investors view the audit as a necessary cost because it places a check on management, which likely has the ability to provide accurate financial statements, but may not always be willing to do so.[5] If the auditor ceases to be independent, then he becomes virtually indistinguishable from management, and thus his product

[4] Objectivity will be largely omitted from this discussion because the recruiting and training of auditors to arrive at reasonable conclusions is beyond the scope of this paper's focus.
[5] Management may attempt to mislead stakeholders for numerous reasons, including meeting earnings targets, obtaining performance bonuses, and concealing fraud.

loses its value. Therefore, the quality and relevancy of financial statement audits is at least partially dependent upon the ability of the auditing profession to remain independent, both in appearance and mindset.

III. If and why Independence and Professional Skepticism are Lacking

Is Auditor Independence and Skepticism Truly Deficient?

One of the main criticisms of the PCAOB's efforts to address auditor independence has been the lack of evidence presented by the Board to substantiate its claim that a problem actually exists. There is some publically available data that supports the idea that lack of professional skepticism continues to hamper audit quality. For example, of the 47 enforcement actions that the PCAOB has settled since its inception, 27 have involved violations relating to professional skepticism (Carcello, et al. 2011). A number of foreign audit regulators have also made similar claims that a professional skepticism problem exists, giving the Board's claim some legitimacy (PCAOB 2011).

Unfortunately, the PCAOB has generally struggled to create a compelling narrative on professional skepticism because it is handcuffed by its strict interpretation of confidentiality rules that were included in Sarbanes-Oxley. The rules themselves are rather restricting; for example, they prevent the PCAOB from making public any enforcement proceedings until the case has been decided and all appeals can be settled, a process that can take years. However, critics such as Bloomberg columnist Jonathan Weil argue that the PCAOB has been overly conservative in its interpretation of SOX's confidentiality requirements (Weil 2011). For example, when the Board's inspection of an auditor's work uncovers deficiencies, the Board does not disclose the identity of the public company that received the audit. Thus, stakeholders rarely, if ever, find out that their company received a faulty audit. Considering the fact that SOX permits the PCAOB to "disclose such confidential and proprietary information as the board may determine to be appropriate in the public portions of its inspection reports," Weil feels the PCAOB's policies needlessly place investors at risk (Weil 2011). These policies also make it more difficult to support its actions with concrete evidence that a problem exists.

Faced with these limitations, the Board has mainly relied upon providing individual examples in order to support its claims that independence and professional skepticism need to be enhanced. This anecdotal evidence is somewhat effective at conveying that a problem exists. For example, the Release describes the inspection of an unnamed "large accounting firm," in which inspectors found that the firm was making audit proposals using language such as:

- "Your auditor should be a partner in supporting and helping [the issuer] achieve its goals, while at the same time helping you better manage risk;
- Support the desired outcome where the audit team may be confronted with an issue that merits consultation with our National Office; and
- Stand by the conclusions reached and not second guess our joint decisions (PCAOB 2011)."

This language clearly conveys a lack of professional skepticism by the audit firm, and should be cause for concern for investors. However, the PCAOB cannot establish a pattern solely by providing individual examples.

Given this spotty evidence, many proponents of reform have been forced to argue that auditors cannot be truly independent under the current system, and that any increase in independence and skepticism is good. This is true to a point; there are in fact several structural issues with the current external audit model that severely hamper independence (these will be addressed in the next section). Furthermore, the beneficial nature of increasing auditor independence is undeniable. However, this argument only applies to the extent that the costs of reform would be minimal. If the PCAOB hopes to implement more substantial (and costly) reforms to auditing standards, as some are advocating for, it must present a more complete case to the public demonstrating the necessity of reform.

In the “Recommendations” section, I elaborate on how the PCAOB can make a stronger case for substantial audit reform by publishing a report aggregating its inspection findings that relate to professional skepticism. However, absent such a report, this paper embraces the argument that the investing public would benefit from reforms that enhance the independence and skepticism of auditors, *as long as those reforms entail minimal costs.*

Factors that may Affect the Independence and Professional Skepticism of Auditors

In order to understand why many regulators and investors believe auditor skepticism should be improved, one must first understand the structural features of, and trends in, the external audit market that can cast doubt on how independent auditors really are. Recently, long auditor-issuer relationships, the rise of consulting practices within accounting firms, and the client-pay model have all motivated some stakeholders to question the extent to which companies can influence their auditors’ decisions.

Long Auditor-Issuer Relationships

Some stakeholders contend that when an accounting firm serves as an issuer’s auditor for a long period of time, the firm’s ability to remain independent is diminished. As Appendix A shows, some of America’s most iconic companies, such as General Electric and Coca-Cola, have been audited by the same accounting firms and their predecessors for over 80 years (Le Vourc'h and Morand 2011). Some investors and regulators fear that auditors who have maintained these long relationships with clients will fall victim to the halo-effect. Defined as the human tendency to like or dislike everything about a person (even the unobserved), the halo effect could cause an auditor to unconsciously give management the benefit of the doubt because of their long-term relationship (Selling 2012).

While the halo effect could conceivably impact and auditor’s judgment, the relationship between auditor tenure, professional skepticism, and audit quality is quite complex. The traditional argument for reducing the length of auditor-issuer relationships is that doing so will increase skepticism and thus improve audit quality. However, decreasing the length of these relationships could also result in the loss of a great deal of institutional knowledge by auditors. Auditors that have examined a given issuer for many years will have a much greater understanding of the ins and outs of that client, potentially allowing them to more efficiently and effectively conduct the audit. As a result of this conflict between independence and experience, reducing audit tenure may not actually enhance audit quality. A review of 49 empirical studies of mandatory firm rotation by audit firm Deloitte found that 76% of the studies reached conclusions that were generally unfavorable for mandatory rotation (Echevarria 2011). One study conducted by Professor Joseph Carcello, a University of Tennessee professor known for investor advocacy, concluded that fraud was most likely to occur within three years of the engagement of an auditor (Carcello, Audit Firm Tenure and Fraudulent Financial Reporting 2004). Given these findings, audit reforms that target long-term relationships between auditors and issuers may not be the best way to enhance auditor independence and skepticism.

Consulting Services

Another perceived threat to the independence of external auditors is the performance of non-audit services by accounting firms for their audit clients. Although accounting firms have historically offered an array of services beyond auditing to their clients, the largest accounting firms began building their consulting practices at a rapid rate during the 1990's, as shown in Appendix B (General Accounting Office 2003). A 2001 study found that large companies were paying their audit firms an average of $2.69 for every $1 spent on auditing fees. The study also found several more extreme examples including Motorola, who paid KPMG $3.9 million for its audit and $62.3 million for other services (Carcello, Harrison, et al. 2011).

Stakeholders and regulators worried that audit firms might be more likely to accept aggressive (and even deceptive) accounting practices by their audit clients if the firms feared losing far more lucrative consulting contracts. Thus, few were surprised by the spate of accounting scandals that began in the late 1990's, when consulting fees were peaking as a percentage of revenue for the largest firms

(General Accounting Office 2003). Concerned by these trends, the SEC set out to create new rules limiting the services that firms could provide to their audit clients. Although fierce lobbying by the profession helped water down these rules, all but one of the five largest accounting firms had sold off their consulting practices by 2001 (General Accounting Office 2003). Furthermore, additional restrictions regulating non-audit services were implemented by SOX in 2002 and by the PCAOB in 2006 (Carcello, Harrison, et al. 2011).

Despite the numerous restrictions on the types of non-audit services that accounting firms can provide their audit clients, accounting firms have begun rebuilding their consulting practices under the label "advisory services." This trend is particularly concerning to stakeholders given what PCAOB inspectors have found in recent years. In a 2011 speech, Chairman James Doty described how inspectors had found examples of "seemingly unrestrained enthusiasm — in partners' self-evaluations, in their supervisors' evaluations of their performance, and in agreed performance goals — for selling services to audit clients (Doty 2011)." Given findings such as these, some stakeholders have suggested the strengthening of restrictions on non-audit services as a means of improving auditor independence.

Client-Pay Model

Many financial experts believe the greatest threat to the independence of the external audit isn't long audit tenures or the increased provisioning of non-audit services, but rather the pay structure of the external audit itself. Since the inception of the external audit, many investors, regulators, and academics have argued that auditors cannot truly be independent of their clients, because auditors are hired and paid by the people whose work they are auditing. This isn't technically true; as per SOX, the hiring, firing, and compensation of auditors is controlled by the audit committee of each company's board of directors (rather than the company's management), a body that represents the interests of investors. Furthermore, the appointment of the auditor must be ratified each year by the majority of shareholders. In reality, however, audit committees usually rely heavily on management to inform their decision, since it is management that works with the auditors on a day-to-day basis. For the same reason, ratification of the auditor by shareholders is considered a routine vote, and management's recommendation is rarely challenged. Thus, management is widely considered to exert considerable influence over the appointment and compensation of external auditors.[6]

The predicament this arrangement places an auditor in is obvious: an auditor may be more willing to accept questionable accounting practices for fear of losing the client. Restrictions have been put in place in an attempt to prevent companies from firing auditors with whom they don't agree. For example, when a company changes auditors, it must disclose whether there were any accounting disagreements between the two groups. However, few doubt the ability of a company's management to navigate these regulations and fire an auditor that objects too much to the company's accounting. Numerous investors and academics have identified the client-pay system as the fundamental flaw in the external audit model, and contend that auditors cannot be truly independent unless the audit model is drastically reformed to more closely align the interests of auditors and investors.

Many stakeholders believe these three factors represent the greatest threats to auditor independence and skepticism. In order to mitigate these factors and improve auditor independence, these critics contend that reforms must be made to the current audit model. These reforms can generally be divided into two categories: evolutionary and revolutionary. As the names suggest, evolutionary changes would involve making minor adjustments to current auditing standards in order to improve quality and boost skepticism. Conversely, revolutionary changes would fundamentally alter the market for external audits, the incentives faced by major accounting firms, or the structure of the external audit model.

IV. Potential Evolutionary Changes to the External Audit Model

[6] For example, a 2011 article in CFO magazine instructed CFO's on how they could bargain their auditors down to lower prices, a clear indicator that most CFO's can influence the compensation of their company's auditors (Driscoll 2011).

Numerous proponents of audit reform, particularly public company managers and public accountants, argue that only minor changes to current regulations are needed to promote independence and skepticism amongst auditors. Since the Board issued its June 2011 concept release on independence, numerous parties have weighed in to suggest potential tweaks to the current audit model. In general, the reforms described below entail minimal costs, and so the PCAOB would likely be able to justify implementing them without providing additional evidence on lack of auditor independence. However, each of these reforms is too limited in scope to make an appreciable difference in auditor independence on its own. That being said, this paper's final recommendation does include elements of many of these reforms.

Mandatory Retendering

Under mandatory retendering, public companies would be required to put their audits out for bids after a fixed time period (the proposed time frame typically runs between 5 and 20 years). Such a policy would force audit committees to consider changing auditors more often, and make it more difficult for an audit committee to keep their current auditor if a lower bid was submitted by another firm. A mandatory retendering policy attempts to enhance skepticism by increasing the frequency with which public companies change their auditors, thus reducing the average tenure of auditors. There would likely be some additional costs to issuers and public accounting firms associated with the tendering process (it takes time and money to prepare and choose an audit bid). However, mandatory retendering would be far less disruptive and expensive than mandatory firm rotation, a potential reform that would also limit audit firm tenure, and is currently being considered by regulators in the US and Europe.[7] Furthermore, regulators could limit the costs of mandatory tendering by granting an exemption to smaller public companies, which would be most burdened by the retendering requirement. As Appendix C shows, the market for small public company audits is far less concentrated

[7] Mandatory firm rotation is discussed at greater length in Section V. of this paper.

than the market for audits of the largest public companies (General Accounting Office 2003). As a result, small companies have far more audit firms to choose from, and so they are the least likely to form long relationships with their auditors.

Strengthening the Audit Committee

As per the requirements of SOX, auditor selection and compensation is the responsibility of a public company's audit committee. Audit committees are made up of three non-executive members of a company's board of directors, all of which must be financially literate, and one of which must be a "financial expert" as defined by the SEC. As members of the board of directors, audit committee members have a duty to act in the interests of the company's shareholders.

Because audit committees represent the interests of investors, many stakeholders have proposed the strengthening of the committee's role as a means of enhancing auditor independence. One means of doing this is strengthening the education and expertise requirements for audit committee members. For example, the SEC could require that all three members of the audit committee meet the qualifications for financial experts. Were the SEC to require companies to appoint more knowledgeable individuals to their audit committees, the committees would likely have to rely less on the counsel of management. Thus, more informed audit committees would reduce management's influence over the auditor selection process, mitigating the effects of the client-pay model and forcing auditors to be more accountable to investors.

Regulators could also choose to empower audit committees to hire consultants that would serve as independent financial experts (Carcello, Harrison, et al. 2011). These experts would help audit committees objectively evaluate the performance of auditors from an investor perspective. As was the case with raising audit committee education standards, the hiring of expert consultants would reduce the ability of management to pressure auditors, thus improving auditor independence.

Regulators could also enhance audit committee oversight (and thus the overall independence of auditors) by improving communication between audit committees and other parties with a stake in the audit. For example, the PCAOB recently proposed a rule that would strengthen the standards dictating what information auditors must communicate to audit committees (PCAOB 2011). The PCAOB could take such efforts a step farther by meeting with audit committees to discuss the results of inspection findings (which would require changes to SOX by Congress). Measures such as these would empower audit committees, limit the influence of management over auditors, and ultimately improve the independence and skepticism of external audits.

Strengthen Existing Independence Rules

Currently, there are a number of rules in place to prevent CPAs from serving as auditors in cases where potential sources of bias clearly exist. Such rules are mainly prophylactic; this is necessary since it is virtually impossible to measure whether a person is actually biased by a situation. Thus, arbitrary rules have been established to prevent situations in which an auditor would likely be biased (e.g., one cannot audit a company in which they own a stake). Some stakeholders have suggested strengthening these rules as a means to further bolster independence and skepticism.

One path regulators could take to strengthen independence rules would be to expand the number of auditors covered by individual tenure restrictions. Currently, audit engagement partners (the CPA in charge of a public company audit) cannot lead the audit of the same issuer for more than 5 consecutive years. Several commenters to the PCAOB's independence release have suggested expanding this requirement to include additional high-level members of an audit team (Frank and Heintz 2011). This solution attempts to improve independence by limiting long-term relationships between a company's management and individual CPAs. However, as was stated earlier, the connection between independence and tenure is tenuous at best, casting doubt on how effective this measure would be.

Alternatively, the PCAOB could expand the list of non-audit services that accounting firms are prohibited from providing to their audit clients. Currently, SOX rules and PCAOB standards prevent accounting firms from providing a number of non-audit services to their audit clients, including internal audit services, bookkeeping services, and tax shelter advice (Carcello, Harrison, et al. 2011). However, accounting firms still can and do provide numerous non-audit services to their audit clients. Several parties that commented on the PCAOB's independence release have argued that a broad ban on accounting firms providing "advisory" services to audit clients may be justified.[8] Such a ban could reduce the conflicts of interest faced by auditors fearful of losing their firms large amounts of revenue in the form of lucrative consulting contracts. However, given the response of the accounting profession to past attempts to restrict non-audit services, any attempt to push through such a reform would likely be met with fierce lobbying.

Expand and Improve the PCAOB's Inspection Program

Some auditors, public company managers, and stakeholders have also suggested enhancing the PCAOB inspection program as a means to improve auditor skepticism.[9] By expanding the scope, depth, and frequency of inspections, the Board could incentivize CPAs to take a more skeptical approach to auditing. The Board could also tailor some of its inspections to focus more closely on the role played by professional skepticism in certain audits. While improving the Board's inspection program wouldn't necessarily address any of the underlying issues that hamper auditor independence, it could have the desired effect of improving audit quality by calling out auditors for a lack of skepticism.

Summary of Minor Reforms

Ultimately, while each of these reforms would have the potential to increase auditor independence and skepticism, it is unlikely that any of them individually would make an appreciable

[8] For examples of such comments, see comment letters 465, 500, and 552 to the PCAOB's concept release on independence, at http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx.
[9] For examples of such comments, see comment letters 295, 405, and 434 to the PCAOB's concept release on independence, at http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx.

difference in audit quality. Proponents of rule changes such as these also tend to ignore the inherent flaw of the client-pay model when explaining why only minor tweaks to the external audit are necessary. This has driven some critics to support far more extensive reforms to the external audit model.

V. Potential Revolutionary Changes to the External Audit Model

While many auditors, audit committee members, and public company managers insist that only minor improvements are needed to ensure the effectiveness of the external audit, some investors and regulators are not convinced. Discouraged by numerous bankruptcies of seemingly healthy companies, as well as the poor findings of regulatory inspections of audit firms, these critics contend that a lack in professional skepticism among auditors is putting investors at risk. In order to combat this perceived lack of professional skepticism, some groups and individuals are calling for drastic reforms to the external audit model. Many of these reforms are aimed at altering the market for external audits or more-closely aligning the interests of auditors with investors. While some of these measures have the potential to improve auditor independence, all of them have serious flaws that would limit their effectiveness.

Mandatory Audit Firm Rotation

The most well-known and seriously discussed potential remedy for overhauling the public company audit market is mandatory audit firm rotation. Under a mandatory rotation rule, an accounting firm would not be considered independent of its client if it had provided audits to that company for a certain number of consecutive years. Following a series of high profile accounting scandals in the early 2000’s (Enron, WorldCom, etc.), Congress considered and ultimately rejected the idea of mandatory audit firm rotation in favor of a rule requiring the lead partner of an audit engagement to be rotated every five years. Recently, however, firm rotation has again become a hot-button issue in the accounting world.

The debate surrounding mandatory rotation was reignited in the US by the PCAOB's 2011 Concept Release on Auditor Independence and Audit Firm Rotation, which sought public comment on "ways that auditor independence, objectivity, and professional skepticism could be enhanced (PCAOB 2011)."[10] The Release states that while many of the reforms contained in SOX have significantly improved the quality of public audits, the Board's inspections of public accounting firms continue to uncover audit deficiencies relating to a lack of objectivity by auditors (PCAOB 2011). For example, Ernst & Young was recently fined $2 million for accepting a client's faulty revenue recognition policy, eventually forcing the client to restate its earnings. The Board issued the Release in order to better understand the costs and benefits of audit firm rotation as a potential remedy to these deficiencies, as well as to solicit comment on alternate remedies.

Thus far, the PCAOB has received an overwhelmingly negative response to its release. Over 600 comment letters were received by the Board, 94% of which opposed a mandatory firm rotation rule (Ernst & Young 2011). This is not surprising, given the questionable benefits and massive costs that would result from such a policy. Firm rotation seeks to improve independence and skepticism by limiting long-term auditor-issuer relationships. Given the tenuous nature of the connection between tenure and independence, it is uncertain whether the quality of external audits would improve at all.

While the benefits of firm rotation are difficult to measure and highly questionable, its costs are far more tangible. Many critics of rotation argue that first year audit costs are significantly higher due to the learning curve associated with auditing a company's books. Evidence suggests that the additional time needed by auditors to understand the structure of a new client and adapt their testing can lead to significant cost increases. A GAO survey found that initial year audit costs would increase by at least 20% under mandatory firm rotation. Furthermore, while most audit firms currently absorb higher audits

[10] Mandatory firm rotation has also become a hot button issue in Europe, where it has been proposed by the European Commission. However, this discussion will focus primarily on rotation in the US market.

associated with the first year of a new engagement, 87% of surveyed accounting firms stated that they would be forced to pass these costs onto clients if faced with limited tenure periods (General Accounting Office 2003).

Rotation is also problematic because of the lack of auditor choice already faced by large public companies. The US market for large public company audits is notoriously concentrated; a 2008 analysis by the GAO found that the four largest accounting firms controlled 98% of the audit market for public companies more than $1 billion in revenue (Government Accountability Office 2008).[11] The "Big Four" firms, as they are known, are generally considered to be the only firms with enough resources to audit the largest multi-national companies.[12] Thus, any large company being forced to select a new auditor would automatically be limited to three choices. Even this situation may be optimistic, however, as any company would likely have its list of potential replacement auditors shortened by a number of other factors. Most large public companies rely on several Big Four firms to provide them with tax and consulting services. Due to the regulations limiting the types of non-audit services that accounting firms can provide their audit clients, public companies would likely have to cancel consulting contracts or risk having their choice of auditor further restricted.

Another factor limiting the number of choices available to a company being forced to rotate auditors is specialization. Auditing a large investment bank requires vastly different knowledge than auditing a manufacturer such as Caterpillar, and so the Big Four firms have selectively invested in expanding their capabilities in certain sectors. This specialization allows the firms to provide higher quality audits, but further limits the degree of choice available to large public companies. For example, a 2003 GAO analysis found that 81.4% of assets in the industry machinery and equipment sector are

[11] This figure defines market share based on the percentage of the total market revenue being audited. Thus, if Auditor A only audits Company A, and Company A's revenue is equal to 3% of the total revenue earned by companies with over $1 billion in revenue, then Auditor A controls 3% of the market.
[12] The "Big Four" firms are Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP ("PwC").

audited by two firms, KPMG and PwC (General Accounting Office 2003). Forced to rotate auditors, public companies might have to settle for an auditor with little experience auditing companies in the issuer's field.

Finally, some large public companies could see their costs increase and audit quality decrease due to logistics of changing auditors. While a company headquartered in New York City would likely have little difficulty bringing in a new team of auditors, companies with more remote operations might have greater difficulties. As is the case with industry specialization, different Big Four firms effectively control different geographic markets in order to operate as efficiently as possible. Often times, these firms have planned their expansion to accommodate their largest clients. For example, PwC has an office in Peoria, Illinois, the same city where its client Caterpillar Inc.'s headquarters is located, whereas no other Big Four firm has an office within three hours of Peoria. Were Caterpillar to voluntarily choose to switch auditors, another firm could likely be enticed to open an office in Peoria and absorb the costs, since that firm would have an opportunity to recover its investment by auditing Caterpillar for many years. However, if Caterpillar was required to rotate its auditor periodically, it is unlikely that another firm would be willing to build an office in Peoria given the fact that Caterpillar would simply be forced to rotate auditors again in another 5-10 years. Given this scenario, audit teams would regularly have to travel long distances to cover new clients, and issuers would have to absorb the higher costs of putting audit teams up in hotels for months at a time. Accounting firms would also face difficulties, namely the logistical nightmare of constantly shipping their employees to new cities for extended periods of time, a situation that would likely drive many talented accountants out of auditing all together.

Overall, it appears that the benefits of mandatory firm rotation are highly questionable, while the costs are clear and significant. Given the tenuous connection between skepticism and tenure, as well as potential cost increases and market distortions that rotation would cause, it would be wise for the PCAOB to pivot its efforts away from exploring rotation and towards other means of promoting independence.

Financial Statement Insurance

One of the most revolutionary but little discussed options for enhancing auditor independence and skepticism is the concept of financial statement insurance. In his paper "Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited," Professor Joshua Ronen lays out the case for overhauling the way in which auditors are hired and compensated. Ronen argues that auditors cannot truly be independent as long as they are hired and paid by the companies they audit. Thus, he proposes a new model for auditing financial reporting, whereby public companies have the option of purchasing financial statement insurance from insurance companies. This insurance would insulate investors in these companies from loses due to financial misstatements, and auditors would be hired by the insurance company to give the insurer comfort (Ronen 2002).

Ronen sees this process unfolding in five steps. First, the potential insured requests a proposal from an insurer. The insurer would have a risk assessor (perhaps an audit firm) review the company's financial condition of the company, and then prepare a schedule detailing the different levels of coverage that insurer is willing to offer, along with the associated premiums. Next, shareholders would vote on whether they want to accept the maximum coverage offered, the level of coverage recommended by management, or have no insurance. Third, assuming some level of insurance was approved, an insurer-hired auditor would plan and perform an audit of the potential insured. Fourth, the rendering of a clean opinion by the auditors would result in the issuance of the policy. Alternatively, if the report is not clean, the insurer and the insured would renegotiate the policy terms. Finally, the auditor would issue a report that disclosed the coverage and premium agreed upon, as well as the extent to which the policy was renegotiated, if applicable (Ronen 2002).

The primary benefit of a financial statement insurance system is that it aligns the interests of auditors, investors, insurers, and public company managers. The insurer wishes to minimize its claim losses, which is directly linked to limiting shareholder losses due to financial misstatements (Ronen 2002). This will motivate the insurer to hire the most capable auditor possible. Auditors will also face new incentives; currently, auditors effectively serve public company managers, who might prefer that the auditor not question aggressive or fraudulent accounting. Insurers, however, have a financial interest in finding and correcting all misleading financial reporting. Thus, auditors that fail to challenge management and uncover all material misstatements will lose their clients money and risk being fired. Public companies would also have an incentive to clean up their financial reporting. More honest companies would be able to obtain better coverage at lower prices, whereas companies with weak financial reporting would be forced to choose between obtaining little coverage and paying higher premiums. Lower coverage and higher premiums would both signal to investors that the company's financial reporting was suspect, and the company's securities would struggle as a result. Thus, public companies would have an incentive to improve their internal controls and accounting. Overall, this system would have the potential to eliminate the premiere source of bias for auditors (the client-pay model), while incentivizing other market actors to behave more honestly.

Although the financial statement insurance model provides an ingenious solution for aligning the interests of auditors and investors, there are several aspects of the plan that would likely complicate implementation. The biggest potential stumbling block would be whether the insurance industry would be willing and able to assume such a role. In order to meet demand for coverage, the nation's largest insurers would need to find a way to cover the financial statements of numerous large public companies, including a number of companies with market capitalizations over $1 billion. Apple, the world's largest company by market capitalization, is currently worth over $550 billion. In addition, insurers would need funds to pay their auditors. With insurance companies' resources stretched so thin, it seems likely that coverage levels would be too low and/or premium levels would be too high to satisfy investors.

Insurers would find themselves exposed to far greater amounts of risk than they currently are. Given a situation like the 2008 financial crisis, a number of insurers could be driven out of business due to the unforeseen bankruptcies of many of their clients. This scenario is particularly frightening when one considers the important role insurers play in other industries, such as banking. Many insurance companies went bankrupt or were forced to accept TARP money during the 2008 financial crisis, due in large part to their close ties to the banking sector. If insurance companies were asked to insure the financial statements of all public companies, the systemic risk posed to these companies (and the economy as a whole) would be enormous. These risks would also impact the auditing profession, since the insurers would employ the auditors. Ultimately, an economic crisis could create dangerous feedback loop in which deteriorating financial conditions forced insurers out of business, leaving many businesses with no way to assuage the fears of their investors, leading to more financial deterioration.

Ronen insists that insurers could limit their risk exposure by purchasing special put options from investment funds, which they could exercise if the stocks of the companies they insured decreased in value due to misleading financial statements (Ronen 2002). However, this leads us to the question of who makes the determination that a stock price decline was caused by a misstatement. In all likelihood, insurers would find themselves tied up in constant ligation, either arguing against shareholders that a stock price decline wasn't caused by a misstatement in order to avoid paying claims, or arguing with investment funds that a stock price decline was caused by misstatements in order to exercise put options. Such determinations are rarely black and white, and the courts would likely find themselves overwhelmed with large and complicated insurance cases.

Ultimately, few financial actors would be willing to accept such a drastic overhauling of the financial reporting system in order to improve auditor independence. Such a system would be so unprecedented that auditors, insurers, public company managers, regulators, and even many investors would likely be unwilling to take the plunge. It would likely require a scandal far more egregious than even the Enron debacle for financial statement insurance to receive any serious consideration. Given drastic and uncertain impact such a system could have on the insurance market, the court systems, and the economy as a whole, financial statement insurance does not appear to be the best way to enhance auditor independence.

Auditor Liability Reform

Perhaps the most thoughtful and intriguing proposal to date for improving auditor independence and skepticism comes from Professor John C. Coffee, Jr. of Columbia University. In his paper *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, Professor Coffee argues that by altering the legal incentives faced by auditors, regulators can incentivize them to perform more vigorous and skeptical audits. Ideally, in cases in which investors sustain loses due to misstatements that auditors failed to detect, the US court system should enable investors to sue auditors in a way that deters future poor auditing, without putting the auditor out of business (unless the auditor is truly incompetent and makes numerous mistakes) (Coffee Jr. 2003).

In actuality, our legal system functions the opposite way. First, auditors face far more lenient liability rules than they should. Professor Coffee lists several events in the 1990's that have made it exceedingly difficult for investors to successfully sue auditors, including several Supreme Court decisions, the passage of the Private Securities Litigation Reform Act of 1995, and the passage of the Securities Litigation Uniform Standards Act of 1998 (Coffee Jr. 2003). One defense frequently and successfully used by auditors to avoid liability in the courts is the argument that the auditors were deceived by management. Even if this is sometimes the case, the courts' willingness to accept this defense creates a disincentive for auditors to thoroughly and skeptically examine a company's books. Faced with stricter liability standards, auditors would be more likely to expend their resources helping their employees discover whether management is deceiving them, rather than hiring stables of lawyers to argue in court that they were deceived (Coffee Jr. 2003). Thus, stricter liability would incentivize auditors to take a more skeptical approach to auditing.

Second, our legal system currently does not protect auditors from "mega-litigation" that could drive capable accounting firms out of business. According to the GAO, between 1998 and 2008, there were 10 cases in which auditors publically settled lawsuits for over $100 million (Government Accountability Office 2008).[13] Whether or not litigation of this size poses a threat to the audit market depends on how big of "hit" it would take to bring down a large firm. This has been notoriously difficult to determine, as firms have been reluctant to share a great deal of financial information with people outside their partnerships. However, it is widely accepted that accounting partnerships are run with "razor-thin levels of capital," thereby making them more vulnerable in litigation (Peterson 2011). Jim Peterson, a lawyer and professor with experience in a large accounting firm, estimates that a Big Four accounting firm could potentially be brought down by a penalty ranging from $2.2 billion to $6 billion if it received support from its global affiliates[14]. However, a US firm's global affiliates aren't required to honor its liabilities, and as the Arthur Andersen case showed, affiliates will often flee a global network if the flagship member (for all top tier firms, this is the US member firm) is facing substantial legal or civil penalties (Peterson 2011). Assuming the US firm is left to pay the settlement itself, Peterson predicts

[13] The details of settled lawsuits are often kept confidential, so many more "mega-settlements" may have occurred outside the public eye.

[14] The Big 4 firms each use a complicated system to run their various international affiliates as a single global entity while protecting each affiliate from litigation threats originating in other countries. For example, Ernst & Young is a global network which does not perform any client services itself. All services are provided by EY member firms, including the US affiliate Ernst & Young LLP. Although the management of the global network sets standards and policies for all member firms, each member firm is an independent entity, and cannot be held accountable for the liabilities of other affiliates.

that a firm could be brought down by a ruling for as little as $675 million (Peterson 2011). This amount is not very far from the settlements already being agreed to by top firms, and suggests that one or two successful lawsuits (which would be unlikely but not impossible) could effectively cripple even a Big Four firm, limiting choice in the already heavily concentrated large firm audit market.

In his paper, Coffee suggests that regulators address the perverse legal incentives faced by auditors in order to promote skepticism and prevent further concentration of large firm audit market. Auditors would be held strictly liable for any material misrepresentations and omissions made by their clients, but the damages that investors could sue for would be capped at some multiple of the auditor's revenues from the audited company (Coffee uses ten times the fee as the example in his paper, but doesn't support a specific number) (Coffee Jr. 2003). In such a system, auditors become a sort of financial statement insurer. However, liability reform with a fee-based cap avoids the systemic risks to markets seen in both the current legal framework and the true financial statement insurance model, because liability reform would focus on deterrence over compensation. Currently, the legal system attempts to both deter poor auditing and compensate investors for losses resulting from misstatements. However, the system fails on both counts because investors are so rarely successful in securing judgments against auditors. True financial statement insurance also attempts to achieve both deterrence (auditors will be fired by insurers if they do a poor job) and compensation (investors can recoup a certain amount if the company issues misleading misstatements), but would likely subject insurers to exceedingly high levels of legal exposure. Conversely, by capping liability, Coffee's model recognizes the futility of insuring investors against large declines in market capitalization and instead focuses on deterring auditors from acquiescing to questionable accounting practices by their clients. Thus, liability reform poses far less systemic risk to the economy than financial statement insurance (Coffee Jr. 2003).

While Professor Coffee's proposal has the potential to greatly improve auditor skepticism and the overall quality of external audits, implementing his plan would be easier said than done. As he acknowledges in his paper, achieving the proper balance of stricter liability and capped judgments would be exceedingly difficult given the tumultuous nature of the US legal system (Coffee Jr. 2003). If liability rules aren't strengthened enough and/or judgment caps are set too low, the threat of legal liability would become even less effective at deterring poor audits than it currently is. Conversely, if liability rules become too strict and/or judgment caps are set too high, competent audit firms could be driven from the audit market all together. Public companies would be left with no choice but to hire fly-by-night audit firms, which would perform poor quality audits and attempt to make a quick buck before being destroyed by litigation (Coffee Jr. 2003). This is not to say liability reform would be impossible to implement. Rather, it is a bold but risky plan that would require careful planning by policymakers and legal experts in order to succeed.

Given the risks and uncertainties associated with implementing liability reform, it's unlikely that auditors and investors would be willing to accept such a plan at this time. If, in the future, another string of accounting scandals triggers public outrage similar to that generated in the wake of the Enron fiasco, liability reform could potentially be viewed as a bold, palatable and effective means of promoting auditor independence and restoring public confidence in financial markets. Absent such a scandal, however, regulators should pursue less risky avenues for incentivizing auditors to perform independent and skeptical audits.

VI. A New Model for Enhancing Auditor Independence and Professional Skepticism

Although the PCAOB's June 2011 Release on independence is flawed due to its preoccupation with an unsound solution (mandatory firm rotation), the Release accurately identifies improving independence and professional skepticism as essential to protecting investors and improving audit quality. Unfortunately, the Board has recently focused much of its efforts on treating the symptoms of this problem, rather than its root cause.

Client-Pay vs. Investor Apathy

Many investors and accounting scholars have identified the client-pay model as the ultimate explanation for why many auditors are subject to management's influence. However, the truth is that we do not technically have a client-pay system at all. As was previously stated, decisions regarding the hiring, firing, and compensation of auditors are made by the audit committee (which is made up of non-executive directors and represents investors) and ratified by investors. However, as critics of the current system point out, audit committees and investors often base their decisions on the recommendations of management, thus giving management de facto control over the auditors. Faced with these facts, many conclude that we have a client-pay audit model that is hampering auditor independence, and that regulators should either change the model or treat the symptoms. In actuality, it appears the root cause of the independence problem is that investors are too ignorant of, and apathetic towards, the external audit to make informed decisions regarding auditor selection.

Investor Apathy: An Actual Problem?

Before examining this paper's model connecting investor apathy, lack of independence, and the overall state of the external audit, it's important to review the evidence proving that the vast majority of investors neither know nor care a great deal about the external audit. Some may object to the labeling of investors as apathetic, and certainly this is not true of all investors. For example, the members of the PCAOB's Investor Advisory Group have helped improve audit quality by advising the Board on a number of issues that weigh on audit quality, including the effectiveness of the auditor's reporting model. This paper also does not intend to place the blame for insufficiently independent auditors squarely at the feet of investors. The actions of auditors, public company managers, and regulators have clearly limited the ability of investors to understand and influence the nature of the external audit. This fact is reflected in the "Recommendations" section of this paper, which largely consists of actions that regulators can take to inform and empower investors.

Although investors are not solely, or even primarily, responsible for the disconnect between themselves and auditors, the evidence that investor apathy and ignorance are real problems is strong. The PCAOB observed this trend when it sought public comment on it independence Release in 2011. The Release, controversial because of its lengthy discussion of mandatory firm rotation, has been hotly debated since its issuance. However, investors represented less than 1% of commenters (Ernst & Young 2011).

Even more telling are recent events demonstrating how easily poor auditors can be reelected by shareholders. In 2011, Bloomberg reporter Jonathan Weil allegedly deduced from a PCAOB inspection report that Alterra Capital had received a faulty audit from KPMG's affiliate in Bermuda[15]. Based on this information, two proxy firms recommended to Alterra shareholders that they vote against ratifying KPMG Bermuda as the auditor for the following year. Nonetheless, the contract was approved with 73.6% of the vote. Even more startling, one of the proxy firms reported that of 835 auditor approval votes tracked in 2011, only one vote had resulted in a lower percentage voting in favor of ratification (Thomson Reuters/RIA 2011).

It now appears as though this story is set to reoccur in 2012, albeit on a much larger stage. Using court records, Weil has identified Motorola as a company that received a faulty audit in 2006. Based on that report, it appears KPMG allowed Motorola to record revenue in the incorrect quarter, thus allowing the company to meet its third-quarter earnings target (Weil 2012). Once again, a proxy

[15] Although the PCAOB, as a matter of policy, does not reveal the names of clients who received deficient audits, the affiliate firm had few enough public US clients that the reporter believes he was able to deduce the company's identity based on information in the report.

firm has recommended that investors vote against rehiring KPMG. However, Weil (an experienced reporter that specializes in covering fraud and accounting stories) ultimately concludes that "It's unlikely that a majority of Motorola's shareholders will vote against KPMG," and hopes "a large vote against KPMG, say 20 percent or more, might get the board's attention and force directors to consider whether a change is overdue (Weil 2012)." Given the circumstances, the fact that KPMG stands a chance of being rehired at all clearly reflects an investing public that is unaware of the importance of effective auditing. Having made the case that investors pay little attention to the actions of external auditors, we now turn to a model that demonstrates how reducing investor apathy can improve auditor skepticism and total audit quality.

The Investor Apathy Model

Appendix E of this paper presents a model explaining how mitigating investor apathy can improve auditor independence and ultimately address many of the issues facing the audit market. Starting at the top of the diagram, investor apathy/ignorance leads to a disconnect between auditors and their true clients, investors. This disconnect enables management to exert considerable influence on the auditor selection process, as investors and audit committee members will have little choice but to rely on management's expertise. The result is a system that operates like a client-pay model and enables management to pressure auditors into accepting questionable accounting practices. As numerous stakeholders have argued, auditor's cannot be independent under such a system.

As Appendix E shows, increasing the role investors play in the auditor selection process could positively impact a number of the issues currently faced by the PCAOB. If engaged investors pressure auditors to perform more skeptical and thorough audits, CPAs will perform higher quality audits, be more resilient against the halo-effect (and thus less biased by long audit tenures), and be less driven by fear of losing consulting contracts. Regarding long audit tenure, if investors become confident in the skepticism of auditors, they are less likely to worry about long auditor-client relationships. As a result, the negative impacts of market concentration (a major contributor to low auditor turnover rates among large public companies) would be diminished. Improved independence and skepticism would also improve audit quality, thus ensuring the relevancy and usefulness of the financial statement audit. Faced with pressure from passionate investors, auditors would adapt their product to better meet investor needs. Such improvements could include enhanced "going concern" disclosures to warn investors when a company is in financial trouble, as well as more informative audit reports.[16] Improved quality due to heightened independence would also mitigate concerns regarding how audit firms run their practices (including Board concerns that many firms financially motivate their partners to focus on cross-selling non-audit services rather than properly overseeing audit engagements), as well as reduce the risk of a firm being destroyed by "mega-litigation" (Public Comnpany Accounting Oversight Board 2011). Finally, it's worth noting that as audits improve in terms of independence, quality, and relevance, a feedback loop between relevancy and investor apathy is likely to occur. The more relevant the audit becomes to the concerns of investors, the more investors will pay attention to the audit function.

Given this model, the best course of action for regulators to improve auditor independence is to mitigate investor apathy. Toward that end, the final section of this paper recommends a series of incremental and cost-effective steps that will educate, motivate, and empower investors to exert greater influence over the auditor selection process.

VII. Recommendations

Recommendation 1: The SEC should require audit committees to retender the external audit every 10 years, or release a report justifying their decision not to do so.

[16] The lack of "going concern" disclosures during the 2008 financial crisis was widely debated topic at a recent PCAOB Investor Advisory Group meeting, and the improvement of the auditor's report is one of the PCAOB's major goals for the coming year.

This paper's first recommendation is that public companies be required to either retender their audit every 10 years, or explain why they aren't retendering. By forcing audit committees to periodically perform and disclose an analysis of whether their audit should be put out for bid, investors will become more interested in the selection of auditors. An investor would be far more likely to consider voting against the current auditor if they are provided with an audit committee report finding that their auditors missed material misstatements and competitors are offering to perform the review for less. Even if the audit committee ultimately decides not to retender, the audit quality information that they will have to provide to investors will put pressure on auditors to maintain a skeptical mindset and perform high quality audits. An exemption for small public companies (ex. companies with revenue below $75 million) would help protect small businesses from the costs of the retendering process.

Recommendation 2: The PCAOB should publish a report on its findings relating to professional skepticism, as well as annual reports on its aggregated findings.

This paper recommends that the PCAOB undertake a project to author a comprehensive report on its inspection findings as they relate to professional skepticism. This report would provide statistics about, and examples of, audits that were deficient due in part to a lack of skepticism. The Board could also tie these failed audits to enforcement actions, financial statement restatements, and other negative events in order to demonstrate the risks posed to investors by a lack of skepticism. The Board could write such a report even while maintaining its strict confidentiality policies (though later recommendations of this paper advise against this). The Board has written similar aggregated reports before, though never on a specific type of audit deficiency. By omitting the names of the auditors and issuers, as well as aggregating the information in a way that prevents anyone from deducing their identities, the Board can write a report to raise investor awareness and justify other reforms.

Recommendation 3: The PCAOB should relax its strict interpretation of SOX's confidentiality requirements, and lobby Congress to loosen these restrictions further.

While the PCAOB has helped strengthen auditor independence a great deal since its formation, its confidentiality rules have prevented it from making an even bigger impact. There are two main areas in which the PCAOB should strive for additional disclosure. First, the Board should disclose the identities of public companies that received deficient audits. As the Alterra case demonstrated, some shareholders are more likely to vote against the reappointment of auditors if a PCAOB inspection reports finds deficiencies in their company's previous audits. If the Board were to disclose the identities of all pubic companies that received faulty audits, investors would likely pay much closer attention when the time came to ratify auditor selections. Disclosing this information would possibly enable the Board to discuss inspection findings with the audit committees of companies that received faulty audits. Currently, the Board withholds this information based on its interpretation of SOX. However, there is nothing in SOX's language that expressly forbids the Board from releasing this information (Weil 2011). Of course, any attempt by the PCAOB to loosen its interpretation of SOX's confidentiality rules would likely be meant with a legal challenge. However, given the potential benefits to audit quality, defending such a lawsuit would be an effective use of the PCAOB's resources.

The PCAOB should also continue to lobby Congress to amend SOX so that the Board can publically announce the initiation of an enforcement action against an accounting firm. Currently, the PCAOB cannot disclose the existence of an enforcement case until the case and all appeals have been settled. As a result, it will sometimes take more than 5 years for the public to learn of wrong-doing by auditors. Concerns that early disclosure could unnecessarily harm an auditor's reputation are overblown: the SEC is empowered to bring the exact same types of cases without being subject to confidentiality restrictions. If the Board succeeds in having SOX modified, investors will learn much sooner if their auditors have been grossly negligent, and thus will be less apathetic about their next auditor ratification vote.

Recommendation 4: The PCAOB should explore ways to educate investors about the external audit

In 2009, the Board created its Investor Advisory Group ("IAG") "to provide views and advice to the Board on broad policy issues, and other matters that affect investors and are related to the work of the PCAOB (PCAOB n.d.)." Since then, the IAG has advised the PCAOB on issues ranging from improving the auditor's report to enhancing professional skepticism. Because the members of the IAG are investors and investor advocates who have demonstrated an interest in audit policy, they are well positioned to advise the PCAOB on how it can educate investors and mitigate apathy. Working with the IAG, the Board should determine how best to communicate with investors about the importance of holding auditors accountable. For example, the Board could prepare periodic electronic newsletters with information that could be pertinent to investors (for example, the newsletter could make investors aware of a recent penalty that had been levied against an accounting firm). Alternatively, the Board could hold investor forums, similar to the small business auditor forums which the Board already holds, in which PCAOB staff could educate investors and audit committee members about the responsibilities of the external auditor and the nature of the PCAOB's oversight activities. Regardless of the format the Board chooses, pairing with the IAG to educate auditors is a relatively inexpensive means of mitigating investor apathy.

Recommendation 5: The SEC should empower and encourage audit committees to hire audit experts as consultants.

Public company managers are often able to exert considerable influence over the auditor selection process because they are more familiar with the external audit than audit committee members and investors. Audit committees should be empowered and encouraged to hired "audit experts," such as former audit partners or former PCAOB inspections leaders, to advise them on matters relating to the audit. Such consultants would enable the audit committee to make informed judgments about the audit with less input from management, improving auditor independence. More informed audit committees could also provide investors with more detailed and accurate reports, which would draw greater investor attention to the question of whether the auditor deserves to be rehired.

Recommendation 6: The SEC should allow investors to force shareholder votes on mandatory rotation policies.

Currently some investor advocates, such as the United Brotherhood of Carpenters, are pushing public companies they have invested in to hold votes on whether to adopt mandatory firm rotation as company policy (Aubin 2012). Although this paper dismissed mandatory firm rotation as an ineffective means of improving auditor independence, such initiatives are encouraging because they demonstrate investor interest in holding external auditors accountable. Unfortunately, the SEC has set a bad precedent by allowing public companies to deny holding rotation votes, relying on the logic that such decisions fall under the normal course of business (Aubin 2012). By denying investors the opportunity to vote on mandatory rotation, the SEC has limited the ability of investors to hold auditors accountable.

The SEC must reverse its decision and compel public companies to hold rotation votes if their investors wish them. Although these votes will likely fail, they will set a precedent that will enable investors to exert more influence on a company's audit policies in the future. If regulators want to mitigate investor apathy toward the external audit, it must empower investors to influence decisions about the audit.

VIII. Conclusion

This paper has argued that auditors must maintain an independent and professionally skeptical mindset if the external audit is to remain an effective deterrent against misleading financial reporting. Unfortunately, there are currently numerous threats to auditor independence, chief among them the ability of management to influence the hiring, firing, and compensation of external auditors. In an attempt to address these threats, this paper has analyzed numerous solutions that have been proposed by stakeholders, and provided a new model that identifies investor apathy as the root cause of poor auditor independence and audit quality. Finally, this paper recommends several actions that regulators can take to educate, motivate, and empower auditors to exert influence over the auditor selection process. While none of the recommendations made in this paper represent a silver bullet, all would address investor apathy and entail relatively small costs to businesses. Hopefully, the types of incremental improvements recommended here will help foster the growth of an investor culture that emphasizes holding auditors accountable for the quality of their work, the benefits of which cannot be overstated. The day investors succeed in asserting their authority over the engagement of external auditors is the day lack of auditor independence and professional skepticism ceases to be a problem.

Appendices

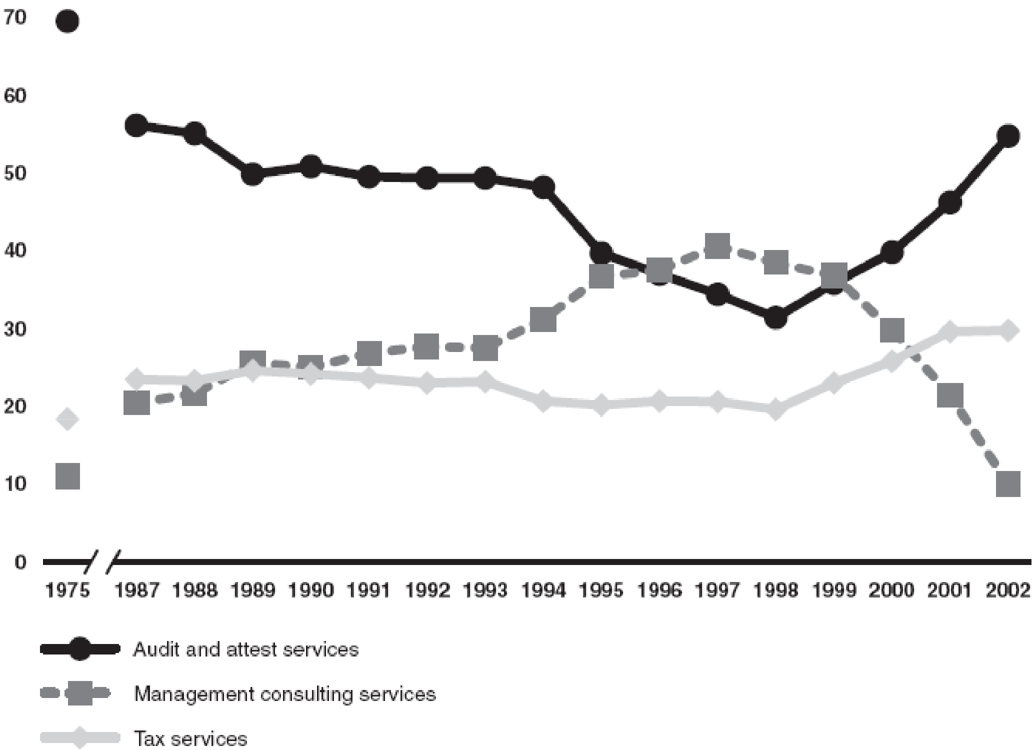
Appendix A: Auditor-Issuer Relationships in the US that have Lasted more than 80 Years

(Le Vourc'h and Morand 2011)

Company	Auditor	Auditor since year:
Procter & Gamble	Deloitte	1890
Goodyear Tire & Rubber	Pricewaterhouse Coopers	1898
Radioshack Corp.	Pricewaterhouse Coopers	1899
Beamis	Pricewaterhouse Coopers	1907
General Electric Co.	KPMG	1909
Dow Chemical Co.	Deloitte	1910
American Electric Power	Deloitte	1911
J. C. Penney Co.	KPMG	1916
Ball Corp.	Pricewaterhouse Coopers	1920
Coca Cola Co.	Ernst & Young	1921
Caterpillar Inc.	Pricewaterhouse Coopers	1925
Kroger Co.	Pricewaterhouse Coopers	1925
Sherwin Williams Co.	Ernst & Young	1925
Goldman Sachs	Pricewaterhouse Coopers	1926
Schlumberger Ltd	Pricewaterhouse Coopers	1927
Dean Food Co.	Deloitte	1927
Kimberly Clark Corp.	Deloitte	1928
General Mills	KPMG	1928
FMC Corp.	KPMG	1928
Progress Energy Inc.	Deloitte	1930

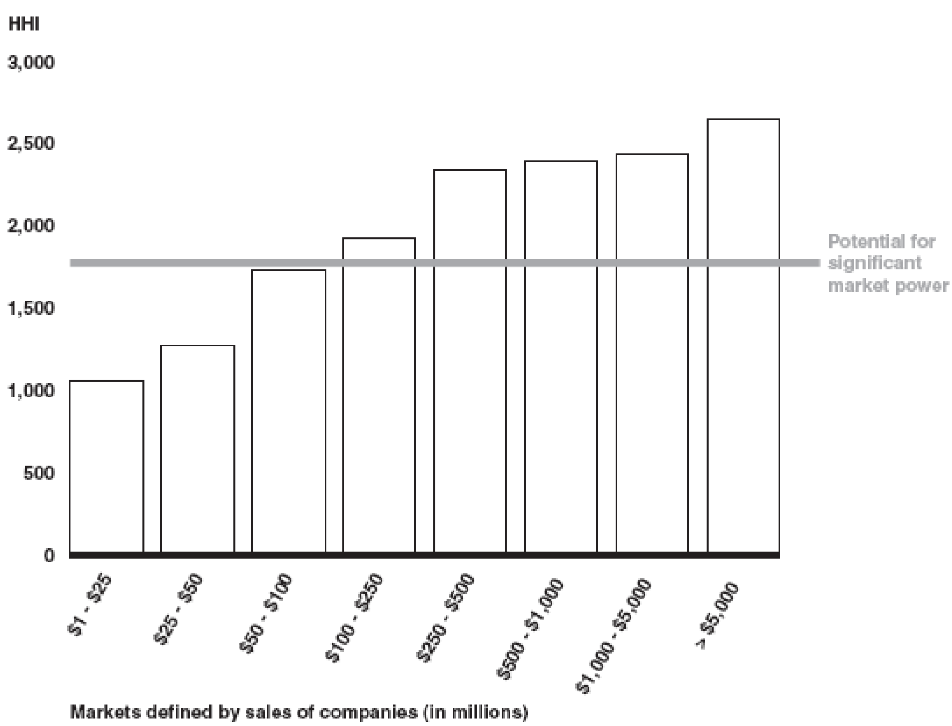
Appendix B: Accounting Firm Services as a Percentage of Revenue, 1975, 1987-2002

(General Accounting Office 2003)



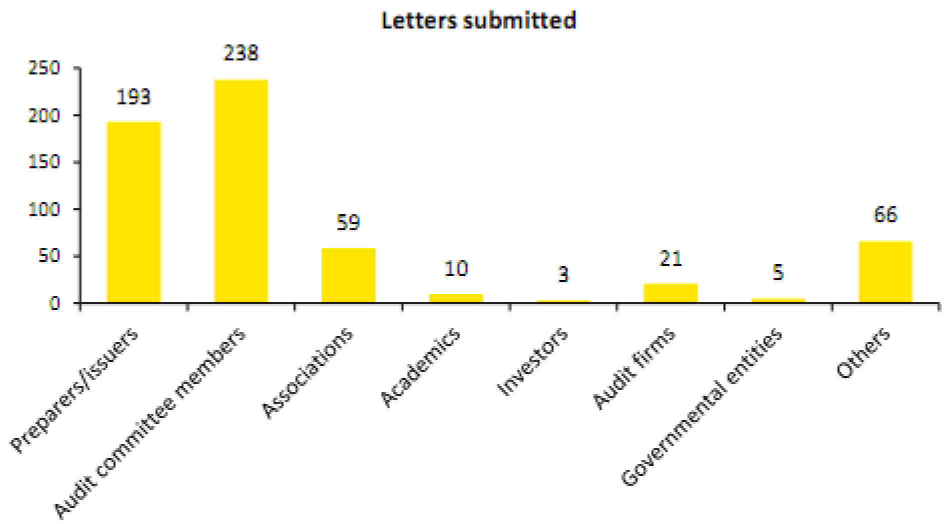
Appendix C: Hirschman-Herfindahl Index (Based on Number of Clients), 2002

(General Accounting Office 2003)



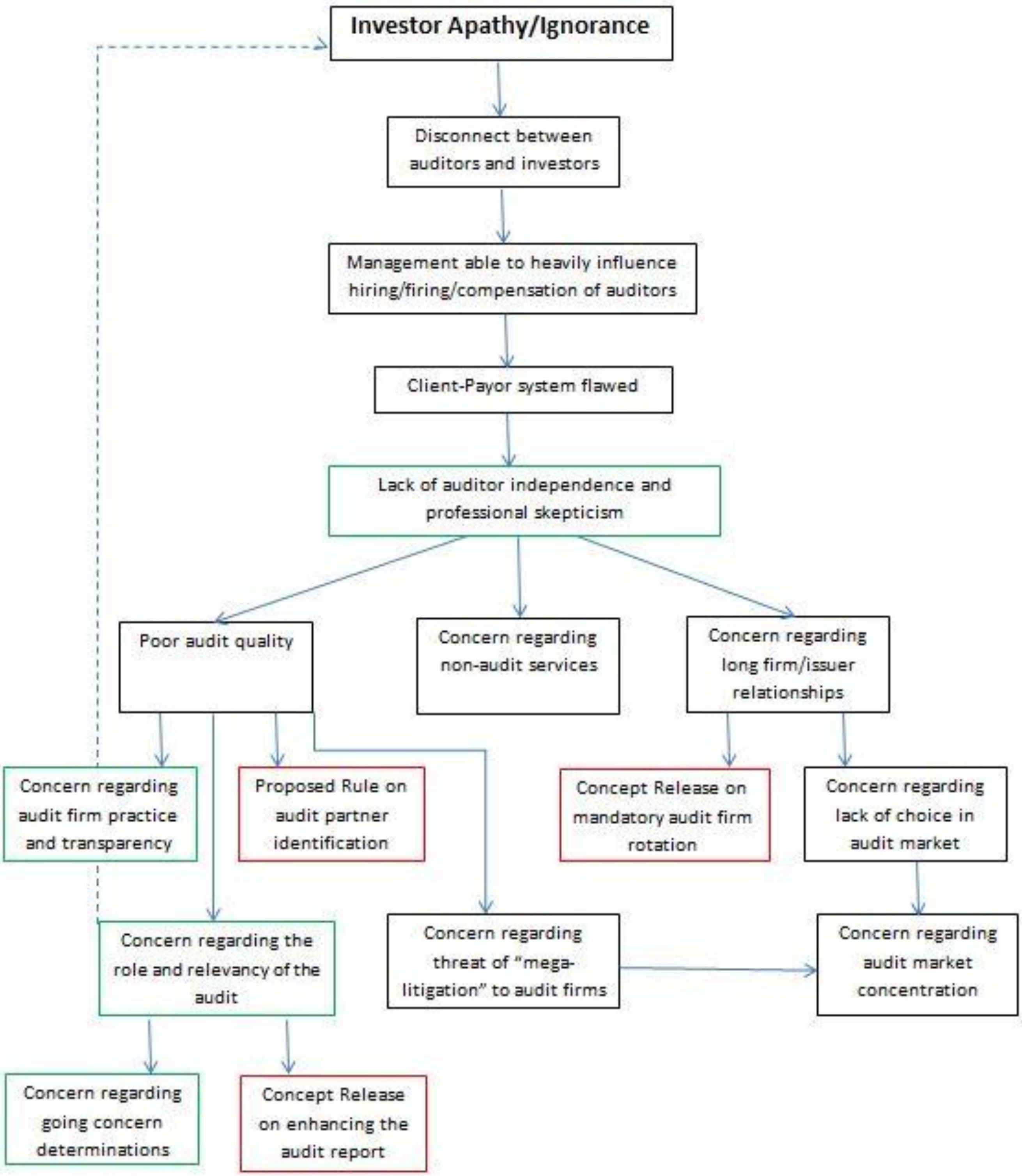
Appendix D: Summary of Commenters to the PCAOB's 2011 Concept Release on Auditor Independence and Mandatory Firm Rotation

(Ernst & Young 2011)



Appendix E: How Investor Apathy and Ignorance Impact Independence and Audit Quality

Red Boxes: Recently proposed rules or concept releases, Green Boxes: Topics for the PCAOB's 2012 Investor Advisory Group Meeting



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