

The Relevance, Role, and Reliability of Audits in the Global Economy

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“Nothing has more strength than dire necessity,”¹ and so was formed the Public Company Accounting Oversight Board (PCAOB) in January 2003, in the aftermath of Enron’s and WorldCom’s dramatic demises. Since its formation, the PCAOB has been engaged in a detailed examination of the reliability of public company audits. This work is conducted for the benefit of the investing public subject to the Sarbanes-Oxley Act of 2002.² By the time I joined the PCAOB as Chairman in February 2011, it had amassed eight years of knowledge, based on examinations of more than 2,800 audits,³ about how audits are conducted and where they need improvement. Also at that time, the global financial crisis was in its fourth year.

I. Introduction

The PCAOB replaced the auditing profession’s self-regulation, which had been based on peer reviews against standards written by the firms themselves. In twenty-five years of operation, the profession’s self-regulatory system never issued an adverse or qualified report on a major accounting firm. In sharp contrast to the profession’s quarter century of self-examination, PCAOB inspections have identified hundreds of deficiencies by firms in each of the large accounting firm networks and other firms that audit public company financial statements adequately to support their audit reports.⁴

* Chairman, Public Company Accounting Oversight Board (PCAOB). This paper is based on speeches and testimony given by the author. See James R. Doty, Chairman, Pub. Co. Accounting Oversight Bd., Address at the Canadian Public Accountability Board’s Audit Quality Symposium: Auditing in the Decade Ahead: Challenge and Change (Dec. 1, 2011). The author is grateful to his special counsel, Samantha Ross, for her assistance. The views expressed in this paper are those of the author alone and should not be attributed to the PCAOB as a whole or any other members or staff.

1. EURIPIDES, HELEN (c. 412 B.C.E.), *reprinted in* THE COMPLETE GREEK TRAGEDIES: EURIPIDES 419, 433 (David Grene ed., Richmond A. Lattimore trans., Univ. Chicago Press 1960).

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

3. Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-006 (Aug. 16, 2011).

4. Audit failures identified in PCAOB inspections are described, without reference to the audit client, in the public portion of the inspection report on the relevant registered public accounting firm. An audit failure—that is, a failure to obtain reasonable assurance about whether the financial statements are free of material misstatement—does not mean that the financial statements are, in fact, materially misstated. When an issue is described in the public portion of a PCAOB inspection report as an instance of the firm failing to obtain sufficient evidence to support its opinion, it means

The PCAOB inspection process does not stop there; it focuses firms on the need to do something to correct deficient audits.⁵ The PCAOB does not oversee or interact with public companies themselves,⁶ but in numerous instances, the audit firm's response to these deficiencies has included additional procedures to complete the audit and, in some cases, restatements or other corrections to financial statements.⁷ These are big differences from the pre-Enron days.

What is not different from the pre-Enron days, though, is that public companies still appear to press strained or otherwise overly rosy results, and auditors are pressured to sign off on those accounts. Those pressures can and do undermine an auditor's objectivity and, consequently, the quality of the audit. The absence of the requisite skeptical mindset can affect the auditor's ability to detect a material misstatement, whether caused by fraud or error, as well as the auditor's resolve to demand that the client correct a misstatement that has been detected.

Auditors acknowledge these challenges. Indeed, since joining the PCAOB, I have been struck by auditors' heightened self-awareness that the world is changing and that we are again at a point where new reforms are needed to strengthen investor protection. Every firm I see appears to appreciate that the profession is in the middle of a process that will not be reversed. This self-awareness may be new, but the challenges are not. They are inherent in the client-pays model of auditing.⁸ Left to fester, they have

that the inspection staff has determined that, because of a concretely identifiable error or omission, the firm failed to perform an audit that provides reasonable assurance about whether the financial statements are free of material misstatement. In other words, the inspection staff has determined that the audit failed. See *Firm Inspection Reports*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/Inspections/Reports/Pages/default.aspx> (describing the process of issuing audit reports and explaining when and under what circumstances an audit deficiency becomes public).

5. See Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis, PCAOB Release No. 2010-006 (Sept. 29, 2010) (reporting that the PCAOB intends to focus on whether firms "have, in fact, reduced or eliminated subsequent occurrences" of deficiencies).

6. Cf. Sarbanes-Oxley Act §§ 103–105 (establishing PCAOB authority to registering and inspecting accounting firms, conducting investigations and disciplinary proceedings of accounting firms, and establishing audit standards for accounting firms).

7. See, e.g., *Ticks and Crosses*, ECONOMIST, Jan. 28–Feb. 3, 2006, at 74–75 (reporting that "a few clients" of each of the biggest four accounting firms restated their financial statements as a result of PCAOB inspections); Sarah Johnson, *PCAOB Audit of Deloitte Causes Restatement, Again*, CFO.COM (July 31, 2007), <http://www.cfo.com/article.cfm/9572145> (stating that a public company's client announced it would issue restated financial statements to correct deficiencies identified by the PCAOB).

8. As U.S. Representative Richard H. Baker, former Chairman of the House Subcommittee on Capital Markets, said during hearings in the U.S. Congress on the Sarbanes-Oxley Act, "After all, should we really be surprised when you pay the piper, the piper plays your tune?" *The Enron Collapse: Impact on Investors and Financial Markets: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. & the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, 107th Cong. 15 (2001) (statement of Rep. Richard Baker, Chairman, H. Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters.).

threatened the very investor protections that the federal securities laws intended to provide in requiring audits.

In the United States, we take it as an article of faith that with growth and economic prosperity come freedom and a self-confident civil society. Many factors contribute to American prosperity, but a significant one is that our public securities markets provide a reliable funding mechanism for American and, increasingly, foreign businesses.⁹ More than half of American households invest their savings in securities to provide for retirement, education, and other goals.¹⁰ Our economy is strong, even in the face of the financial crisis, because millions have been willing to invest their savings in business enterprises to fuel growth—growth that results in more workers, more savings, and more investment.¹¹ This cycle promotes economic wealth. It is so accepted in U.S. culture that, decades ago, it allowed the United States to move away from the use of defined-benefit pension systems that weigh on the economies of some nations.¹²

But to sustain our model of using grand-scale popular investment to fuel our economy, we have—in some ways more explicitly than others—made a compact. We do not regulate to constrain business. We regulate to champion business by honoring a compact that our markets will be fair and transparent. Regulators must do what they can to enable free markets to provide investors with reliable information upon which to make their own investment decisions.

We must elicit investment by providing a basis for confidence in the legitimacy of the markets' judgments, and that may only be done by

9. See, e.g., Hendrik Bessembinder & William Maxwell, *Markets: Transparency and the Corporate Bond Market*, 22 J. ECON. PERSP. 217, 217 (2008) (listing the value of the U.S. corporate bond market as \$5.37 trillion as of the end of 2006); Jay R. Ritter, *Initial Public Offerings: Tables Updated Through 2011*, at 22 (Dec. 31, 2011), <http://bear.warrington.ufl.edu/ritter/IPOs2011Statistics123111.pdf> (finding that foreign companies make up between 23.7% and 35.2% of offerings in the United States between 2007 and 2011); William H. Donaldson, Sec. & Exch. Comm'n, Speech by SEC Chairman: U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers (Jan. 25, 2005) (describing the "dramatic expansion" of foreign business moving to U.S. exchanges and attributing it, in part, to the need to access greater capital).

10. See Dennis Jacobs, *In U.S., 54% Have Stock Market Investments, Lowest Since 1999*, GALLUP (Apr. 20, 2011), <http://www.gallup.com/poll/147206/stock-market-investments-lowest-1999.aspx> (reporting that 54% of Americans had investments in stocks as of April 2011); *Frequently Asked Questions About Mutual Fund Shareholders*, INVESTMENT COMPANY INST. (Sept. 2009), http://www.ici.org/faqs/faqs_mf_shareholders (reporting that saving for retirement and saving for education are financial goals for a substantial portion of households with investments in mutual funds and listing other financial goals for households investing in mutual funds).

11. Cf. Robert M. Solow, *Technical Progress, Capital Formation, and Economic Growth*, 52 AM. ECON. REV. 76, 76 (1962) (asserting that "a high rate of capital formation is required if the growth of aggregate productivity and output is to accelerate").

12. See Dallas L. Salisbury, *Benefit Trends: Change Is Now Constant*, WALL ST. J. (2008), http://online.wsj.com/ad/employeebenefits-benefit_trends.html (observing that, in contrast to other developed countries, private sector employers in the United States "started moving away from traditional defined-benefit (DB) pension plans decades ago, and toward the defined-contribution (DC) retirement plan model, typified by the 401(k)").

establishing and enforcing appropriate standards to satisfy investors' need for confidence that savings applied to a purpose will not be squandered. Investors take risks, but they need to know that they will not be the last to learn that the risk has sunk the endeavor. And they should not be asked to assume the risk of management fraud.

The financial audit is the linchpin for this confidence. In a world of hyper-charged incentive compensation to ignite management initiative—a strategy fraught with the risk of self-promotion, if not outright self-dealing—the auditor stands apart: independent, objective, and skeptical. If the story and the numbers are too good to be true, the auditors are supposed to call it. And they do. For all the reports of colossal investor damage that could have been avoided but for a missed opportunity, auditors do enforce the rules. They do avoid disasters. They do protect investors. The PCAOB's job is to make sure that auditors do so reliably and consistently.

If investors lose confidence in financial reporting, they will demand prohibitively high returns as a condition of investing, or they may withdraw from the capital markets altogether. The result would be to make it more difficult and expensive to finance the businesses on which our economy depends. Moreover, inaccurate financial reporting can mask poor business strategies or fraud that, if left uncorrected, may result in the misallocation of capital, business failures, and layoffs.¹³

PCAOB inspections suggest there is considerable need for improvement in public company audits. For example, in an area critical to public concern during the financial crisis, inspectors have found instances where firms failed to understand the assumptions and valuation methods used by their clients to determine the fair value of financial instruments.¹⁴ In some cases, they have failed to consider the effects of significant differences between the fair-value measurements they obtain themselves and the issuer's recorded fair-value measurements.¹⁵

Internal-control audits are not always the leading indicators of the risk of misstatements in financial reporting that they are meant to be. Too often, auditors rely on imprecise business processes that are inapt as financial-reporting controls. Or, they fail to understand the flow of transactions in

13. See, e.g., C. William Thomas, *The Rise and Fall of Enron*, J. ACCT. (Apr. 2002), at 41–48, available at <http://www.journalofaccountancy.com/Issues/2002/Apr/TheRiseAndFallOfEnron.htm> (reporting on the collapse of Enron, noting that the “[m]ethods the company used to disclose (or creatively obscure) its complicated financial dealings were erroneous and, in the view of some, downright deceptive” and that Enron’s “lack of transparency in reporting its financial affairs, followed by financial restatements disclosing billions of dollars of omitted liabilities and losses, contributed to its demise”).

14. See *Adjudicated Disciplinary Orders and Opinions*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/ENFORCEMENT/ADJUDICATED/Pages/default.aspx> (reporting seven adjudicated disciplinary orders); *Settled Disciplinary Orders*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx> (reporting forty-two settled disciplinary orders).

15. *Id.*

order to identify the points within a client's processes where a material misstatement could arise.

These are important examples of where audits need to improve, but there are others. In many cases, these flaws were found at firms that are clearly comprised of highly competent and ethical professionals.¹⁶ From my perspective, based on decades of admiring auditors' skill and professionalism, I point to two great impediments. There are more. But these two are formidable—as formidable as any—and they are two that audit regulators can and should do something about.

The first challenge is to counteract the bias of the payment model: the auditor is hired and fired by the company itself.¹⁷ The payment model forces auditors into a difficult position of having to serve two masters—company management and investors—at the same time. This creates perverse incentives for the auditor not to call the fouls. The second challenge is to deal with the global nature of the audit when, notwithstanding what auditors' marketing materials say, audit firms and audit regulators are local.

I applaud Professor Henry Hu's initiative in convening the *Texas Law Review's* RESHAPING CAPITAL MARKETS AND INSTITUTIONS: TWENTY YEARS ON. To advance the Symposium's debate, in this paper I will describe changes that have occurred and are now occurring in the audit arena, as well as other changes I believe require careful consideration and widespread debate. In Part II, I will provide background on the PCAOB's work and authority. I include it in order to establish that (1) independent oversight of public company auditing is a critical counterweight to client pressures, and (2) it is by no means sufficient to outweigh those pressures. Structural reform is needed. In Part III, I will discuss certain potential structural reforms that are aimed at shifting the auditor's mindset from one of client service to one of public service. These reforms should be debated, and I am grateful for the opportunity to further the debate through the Symposium. In Part IV, I will discuss the implications of globalization, which compound the challenges I have described by introducing different business cultures, different audit traditions and purposes, and other risks.

16. See, e.g., Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES.COM (Aug. 26, 2002, 5:30 PM), <http://www.forbes.com/2002/07/25/accountingtracker.html> (listing several of the once-renowned corporations and accounting firms whose executives have been implicated in auditing scandals).

17. David B. Kahn & Gary S. Lawson, *Who's the Boss?: Controlling Auditor Incentives Through Random Selection*, 53 EMORY L.J. 391, 404 (2004); see also Theodore Eisenberg & Jonathan R. Macey, *Was Arthur Andersen Different?: An Empirical Examination of Major Accounting Firms' Audits of Large Clients* 7 (Cornell Law Faculty Working Papers, Paper 14, 2003) (“[A]uditors’ careers increasingly came to depend entirely on the ‘care and feeding’ of single clients.”).

II. PCAOB Oversight

A. *PCAOB Functions*

The PCAOB exercises its auditor oversight through four basic functions. All of the Board's responsibilities are discharged under the oversight of the Securities and Exchange Commission (SEC).¹⁸

1. *Registration of Accounting Firms.*—No accounting firm may prepare or substantially contribute to an audit report for a public company that files financial statements with the SEC, or for a broker-dealer, without first registering with the PCAOB.¹⁹ As of April 2012, 2,377 accounting firms were registered with the Board.²⁰ This includes 912 non-U.S. firms.²¹ Of the total number of registered firms, 496 firms reported that they did not audit issuers or play a substantial role in the audit of issuers, but audited broker-dealers in their most recent annual reports. Registered firms must file annual and other reports that provide the Board and the public with updated information about the firm and its audit practice.²² It is important to note that mere registration with the PCAOB does not reflect an examination of the firm's audit quality, which does not happen until the PCAOB inspects the firm.²³

2. *Inspection of Firms and Their Public Company Audits.*—Since 2003, the PCAOB has conducted more than 1,800 inspections of firms' quality controls and reviewed aspects of more than 7,800 public company audits. The audit engagements the PCAOB reviews are not selected at random. To make the most effective use of its resources, the PCAOB uses a variety of analytical techniques to select high-risk engagements and audit areas that are likely to raise challenging or difficult issues.²⁴ PCAOB inspections have identified numerous audit deficiencies, including failures by the largest U.S. and non-U.S. firms.²⁵ These findings have led to changes in firms' auditing processes and, in some cases, more audit work performed after the fact.

When PCAOB inspectors identify significant audit deficiencies, they describe their concerns in detail to the auditor.²⁶ If the auditor disagrees, the

18. Sarbanes-Oxley Act § 107, 15 U.S.C. § 7217 (2006).

19. *Id.* § 7212(a).

20. For a current listing of accounting firms registered with the PCAOB, see *Registered Firms*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/Registration/Firms/Pages/default.aspx>.

21. *Id.*

22. 15 U.S.C. § 7212(d).

23. *Id.* § 7214.

24. *Id.*

25. See *Adjudicated Disciplinary Orders and Opinions*, *supra* note 14; *Settled Disciplinary Orders*, *supra* note 14.

26. See generally *Firm Inspection Reports*, *supra* note 4.

auditor has ample opportunity to demonstrate to the inspection team any oversight or error in the inspection team's analysis or in its understanding of the facts.²⁷ The inspection team's conclusions are reviewed by PCAOB staff at multiple levels in light of the input the auditor provides, including any response to a draft of the inspection report. Because skepticism is a state of mind and objectivity a silent success, their absence is rarely documented and can be particularly difficult to detect. But too often, audit failures identified by PCAOB inspectors do not appear to be explainable by any lack of knowledge on the auditor's part about what audit steps are required in the circumstances.

Audit oversight bodies in other countries, such as Australia, Canada, and the United Kingdom, have reached similar findings.²⁸ As the Canadian Public Accountability Board recently reported in a summary of worldwide inspection findings, "[i]nsufficient [p]rofessional [s]kepticism . . . is undoubtedly the most common finding—that auditors are too often accepting or attempting to validate management evidence and representations without sufficient challenge and independent corroboration."²⁹

Skepticism can fail in spite of both fundamental competence and high ethical standards. Inspections are an important tool to identify ways that audits can be improved. There is no telling how many more failures there would have been had auditors not felt the scrutiny of the PCAOB's fresh set of eyes. Nevertheless, I believe the record requires the PCAOB to consider structural changes.

3. *Investigation and Disciplinary Proceedings.*—The Board has broad authority to impose sanctions on registered firms and associated persons that have violated applicable laws and standards.³⁰ The PCAOB has publicly announced the resolution of fifty-one enforcement proceedings.³¹ These proceedings include forty sanctions on firms, including twenty-six revocations of firms' registrations (preventing them from auditing public companies in the future) and fifty-three sanctions on individuals.³² Sanctions

27. 15 U.S.C. § 7214(f).

28. See AUSTL. SEC. & INV. COMM'N, AUDIT INSPECTION PROGRAM PUBLIC REPORT FOR 2009–2010, at 13–14 (2011) (finding that many auditors had not demonstrated sufficient professional skepticism in key areas); CAN. PUB. ACCOUNTABILITY BD., AUDITING IN THE DECADE AHEAD: CHALLENGE AND CHANGE, AUDIT QUALITY PRE-READING MATERIALS 36 (2011) (same); U.K. PROF'L OVERSIGHT BD., AUDIT INSPECTION UNIT: ANNUAL REPORT 2010–2011, at 6, 21 (2011) (same).

29. CAN. PUB. ACCOUNTABILITY BD., *supra* note 28, at 36.

30. 15 U.S.C. § 7215(c)(4).

31. See *Adjudicated Disciplinary Orders and Opinions*, *supra* note 14; *Settled Disciplinary Orders*, *supra* note 14 (reporting forty-two settled disciplinary orders).

32. See *Adjudicated Disciplinary Orders and Opinions*, *supra* note 14 (reporting sanctions on firms, revocations of firms' registrations, and sanctions on individuals arising from adjudicated disciplinary orders); *Settled Disciplinary Orders*, *supra* note 14 (reporting sanctions on firms,

have also included significant monetary penalties.³³ The announced decisions do not, however, reflect the full extent of PCAOB enforcement activity. Under the Sarbanes-Oxley Act, all Board investigations and all contested proceedings (cases in which the Board files charges and the respondent elects to litigate, rather than settle) are nonpublic.³⁴

The PCAOB closely coordinates its enforcement efforts with the SEC. In certain instances, the PCAOB investigates the auditor's conduct, and the SEC focuses its investigation on the public company, its management, and other parties. In other cases, the SEC's Division of Enforcement takes

revocations of firms' registrations, and sanctions on individuals arising from settled disciplinary orders).

33. *See, e.g.*, Order Making Findings and Imposing Sanctions: In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA, PCAOB Release No. 105-2012-001 (Feb. 8, 2012) (imposing over \$2 million in civil penalties).

34. Adjudicatory proceedings to determine whether an auditor or audit firm should be sanctioned for violating applicable rules or standards are an important component of the Board's oversight authority. Unlike the disciplinary proceedings of other comparable regulators, including the SEC, the Board's cases are nonpublic by law, at least until they are appealed to the SEC. Specifically, Section 105(c)(2) of the Sarbanes-Oxley Act provides that hearings associated with PCAOB disciplinary proceedings "shall not be public, unless otherwise ordered by the Board for good cause shown, with the consent of the parties to such hearing." Sarbanes-Oxley Act § 105(c)(2), 15 U.S.C. § 7215(c)(2) (2006). To date, no auditor in a PCAOB disciplinary proceeding has consented to a public hearing.

The nonpublic nature of Board disciplinary proceedings has serious adverse consequences for the investing public, audit committees, the auditing profession, the Board, and other interested parties, such as Congress. Even after the Board has found sufficient cause to initiate formal proceedings and a disinterested hearing officer has found that the alleged violations occurred, the matter may still remain unknown to the public, at least until the case is appealed to the Commission. As a result, investors are unaware that companies in which they may have invested are being audited by accountants who have been charged, even sanctioned, by the Board. Letter from Daniel L. Goelzer, Acting Chairman, Pub. Co. Accounting Oversight Bd., to Barney Frank, Chairman, House Comm. Fin. Servs., and Spencer Bachus, Ranking Member, House Comm. Fin. Servs., Transparency of PCAOB Disciplinary Hearings and Related Proceedings (Aug. 24, 2010) (on file with author).

In addition, respondents have an incentive to litigate Board cases, regardless of whether they believe they will ultimately prevail. Contesting the allegations rather than seeking a settlement allows respondents to continue with their public company audit practice without any disclosure to clients or investors of the Board's charges for as long as the litigation is ongoing. The nonpublic nature of proceedings also gives an incentive to litigate rather than settle and has the effect of consuming PCAOB resources, which could be deployed to investigate other potential audit failures. The nonpublic nature of the contested disciplinary proceedings also limits the Board's ability to use enforcement authority as a tool to improve audit quality and deter violations of the Board's rules and limits the public, including Congress, from properly evaluating the Board's enforcement program.

In August 2010, the PCAOB asked Congress to change the law to allow the Board to make its contested disciplinary proceedings public. *Id.* On November 18, 2011, bipartisan legislation was introduced in both the House and Senate that would provide transparency to PCAOB disciplinary proceedings. *See* PCAOB Enforcement Transparency Act of 2011, H.R. 3503, 112th Cong. § 1907 (2011).

responsibility for an auditor investigation and requests that the PCAOB defer to that investigation.³⁵

4. *Establishing Auditing, Quality Control, Ethics, Independence, and Other Standards.*—The Board is responsible for establishing the auditing and related professional practice standards under which public company audits are performed.³⁶ Prior to the Sarbanes-Oxley Act, professional associations convened committees of auditors to agree on standards to impose on members.³⁷ On April 16, 2003, as a transition measure consistent with the Sarbanes-Oxley Act, the PCAOB adopted the leading professional association's existing auditing standards as interim auditing standards.³⁸ Since then, the PCAOB has adopted fifteen new auditing standards.³⁹ Some of those standards relate to new requirements of the Sarbanes-Oxley Act, including an audit of internal control over financial reporting.⁴⁰ Others replaced interim standards in various respects.⁴¹

PCAOB standards-setting projects focus on audit weaknesses identified in inspections or other oversight activities.⁴² When an inspection identifies noncompliance with an existing standard, the inspections staff brings it to the firm's attention and describes it in the firm's inspection report.⁴³ In egregious cases, staff or the Board may refer the matter to the SEC's Division of Enforcement and Investigations.⁴⁴ The PCAOB uses new standards to enhance existing requirements when it appears that auditors have failed to take steps that, while not required, should have been performed

35. See 15 U.S.C. § 7202(c) (preserving the SEC's authority to conduct its own investigations notwithstanding any investigative power granted to the PCAOB).

36. *Id.* § 7211(c).

37. See generally AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AUDITING, ATTESTATION AND QUALITY CONTROL STANDARDS SETTING ACTIVITIES: OPERATING POLICIES 15–19 (discussing the history of auditing standards before and after the passage of Sarbanes-Oxley).

38. Compliance with Auditing and Related Professional Practice Standards, PCAOB Release No. 2003-009 (June 30, 2003).

39. See *Auditing*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/Standards/Auditing/Pages/default.aspx> (listing fifteen auditing standards that have been adopted by the PCAOB and approved by the SEC).

40. Auditing Standard No. 5—An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements, PCAOB Release No. 2007-005A (June 12, 2007).

41. See, e.g., Auditing Standards Related to the Auditor's Assessment of and Response to Risk, PCAOB Release No. 2010-004 (Aug. 5, 2010) (announcing the PCAOB's decision to adopt eight new auditing standards to supersede interim standards); Audit Documentation and Amendment to Interim Auditing Standards, PCAOB Release No. 2004-006 (June 9, 2004) (superseding interim audit documentation rules).

42. See OFFICE OF THE CHIEF AUDITOR, PUB. CO. ACCOUNTING OVERSIGHT BD., STANDARD-SETTING AGENDA: NOVEMBER 2011, at 1 (2011) (describing the process of identifying standard-setting projects).

43. PUB. CO. ACCOUNTING OVERSIGHT BD., BYLAWS AND RULES OF THE PUBLIC ACCOUNTING OVERSIGHT BOARD 68 (2011), available at <http://pcaobus.org/Rules/PCAOBRules/Pages/default.aspx>.

44. *Id.*

to protect the investing public's interest in informative, fair, and accurate audit reports.

The most basic audit objective is to provide reasonable assurance, based on having obtained sufficient evidence, that the financial statements are free of material misstatement.⁴⁵ Procedures required by PCAOB audit standards are intended to make it more likely that an auditor will detect a material misstatement and make it more difficult for an auditor to dismiss a misstatement once detected.⁴⁶ Better standards have indeed improved the rigor of auditing, and this is manifested in inspections, in my view and notwithstanding the continuing deficiency rate. Although it is impossible to identify the financial reporting failures that did not occur because, under the PCAOB's new standards, the auditor detected and demanded correction of a material misstatement, undoubtedly such failures were averted.⁴⁷

At the same time, adding required procedures is not necessarily the most effective way to address conflicts and behavioral biases. If the auditor's mindset is focused on performing required procedures without jeopardizing the client relationship, then the auditor may not achieve the goal of the procedures. The more significant impact of new audit standards on the auditee should be that the auditor's mindset and behavior are expected to change, such that the auditor will approach management's assertions with skepticism, demand appropriate confirming evidence, look for and act on disconfirming evidence, and qualify or disclaim an opinion on the fairness of the financial statements where the evidence does not support the opinion sought.⁴⁸ Such a mindset would constrain management from making unfounded assertions about financial results and could risk a reduction in management remuneration if true results were unfavorable. While constraining to management, such a change would be beneficial to investors.

45. See Sarbanes-Oxley Act § 103(a)(2)(A)(iii)(II)(aa), 15 U.S.C. § 7213(a)(2)(A)(iii)(II)(aa) (2006) (mandating that the PCAOB pass rules requiring auditors to evaluate company records to assure they "accurately and fairly reflect" company transactions).

46. *PCAOB Adopts New Auditing Standards on Risk Assessment*, PUB. COMPANY ACCT. OVERSIGHT BOARD (Aug. 5, 2010), http://pcaobus.org/News/Releases/Pages/08052010_AuditingStandardsRiskAssessment.aspx.

47. Nor is it possible to quantify precisely the effect that PCAOB standards-setting and enforcement have had on audit firm self-improvement; however, the firms themselves acknowledge the connection. The Center for Audit Quality, in a recent comment letter to the PCAOB, notes: "Since the adoption of SOX, audit firms have continued to improve their internal quality control systems, which are critical in reinforcing auditor independence, and the exercise of objectivity and professional skepticism." Letter from Cynthia M. Fornelli, Exec. Dir., Ctr. for Audit Quality, to Office of the Sec'y, Pub. Co. Accounting Oversight Bd. (Dec. 14, 2011). The Center is a public interest body organized and funded by the profession. *About Us*, CENTER FOR AUDIT QUALITY, <http://www.theqaq.org/about/index.htm>.

48. See Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7919 (Feb. 5, 2001) (advocating that auditors should approach audits with "professional skepticism" so as to avoid the common failures "to challenge a management assertion" or "to consider the quality" of financial reporting).

Had that auditor mindset been demonstrated in Enron and WorldCom audits, our world might be very different today.

Some standards address the auditor's mindset more directly than others. For example, restrictions on the scope of services and other independence rules are intended to address both perceived and real failures to maintain objectivity.⁴⁹ Other standards add rigor to basic audit steps in order to force the auditor to ask questions, gather and confront evidence, and record how issues presented in that evidence were resolved. For example, the PCAOB adopted a suite of eight new standards on risk assessment to replace existing standards on various components of the audit, such as standards on audit risk; audit planning; supervision of the engagement team; consideration of materiality; identifying, assessing, and responding to the risk of material misstatement; and evaluating audit results and evidence.⁵⁰

Both types of standards are necessary in my view. Independence standards strive to change the auditor's market incentives.⁵¹ If auditors cannot perform additional, non-audit services for an audit client, they will not be concerned about losing fees from those services when they need to take a strong position in the audit. (Of course, the concern that the audit engagement itself could be terminated continues to present an inherent conflict.) Independence allows the auditor to approach management's assertions with skepticism.⁵² In a conflict-free environment—if an audit-fee model could be devised to align auditors directly with the interests of the investing public, and if accountability to the public could thus be assured—we might not need to require any specific audit steps.

Some have proposed abandoning the client-pays model to achieve such an environment.⁵³ Indeed, such a structural reform—to separate the company from the fee—may yet be demanded and take hold if new scandals continue

49. See Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, Exchange Act Release No. 53,677 (Apr. 19, 2006) (describing the recently adopted PCAOB rule that restricted the tax services that an auditor could provide to its audit clients on independence grounds). See also GREENBERG TRAUIG, NEW PCAOB RULES LIMIT THE TAX SERVICES ACCOUNTING FIRMS MAY PROVIDE TO PUBLIC COMPANY AUDIT CLIENTS 2 (2006) (explaining that these regulations “addressed concerns about auditor independence when auditors [became] involved . . . [in promoting] aggressive tax shelter schemes”).

50. See *PCAOB Adopts New Auditing Standards on Risk Assessment*, *supra* note 46.

51. See Revision of the Commission Auditor Independence Requirements, *supra* note 48 (discussing the adoption of rules promoting auditor independence in order to counteract the economic incentives created by non-audit services).

52. See *id.* (arguing that independence serves the important public policy goal of minimizing the influence of “external factors” and allowing the auditor to “approach each audit with professional skepticism”).

53. See, e.g., Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels*, 106 COLUM. L. REV. 1698, 1738 (2006) (proposing a move from a client-pays model to one where clients buy audit insurance, and then the insurance company hires and supervises the auditors); Ronald Brownstein, *Post-Enron, Congress Must Reassure Investors*, L.A. TIMES, Feb. 11, 2002, at A7 (discussing a proposal that stock exchanges hire and pay the auditor).

to erode lawmakers' confidence in auditors' abilities to maintain independence. As yet, however, none of the alternatives propounded can credibly claim to fully align auditors with the interests of the investing public. Moreover, as judges and legislators have restricted auditor liability for perhaps valid legal or policy reasons unrelated to audit quality, the public's ability to hold auditors accountable has weakened.

Although true independence in fact may not be achievable without a wholesale revision of the audit model, there may be measures that would improve auditor independence. Further, as auditor independence improves, it may be possible to reduce the granularity of performance standards and introduce more flexibility. Today, PCAOB standards-setting initiatives reflect a perception rooted in experience: without specific requirements, auditors have often omitted steps required to obtain sufficient evidence and determine with reasonable assurance whether the financial statements are free of material misstatement. If auditors' interests were aligned with those of investors, they might not need to be told specifically what steps to perform.

III. The PCAOB's Policy Agenda to Enhance the Relevance, Credibility, and Transparency of Audits

To address these issues, the PCAOB has been deeply engaged in considering ways to enhance the relevance, credibility, and transparency of audits through some important policy initiatives. Three major projects are underway.

A. *The Auditor's Reporting Model*

First, the PCAOB has initiated a broad debate on the form and content of the standard auditor's report. In June 2011, the PCAOB issued a concept release on potential changes to the auditor's reporting model to respond to investors' calls for more insights based on the auditor's work.⁵⁴ There are many practical challenges to changing the auditor's perspective of who the client is so that auditors' reports are more informative for investors. For example, the PCAOB will need to consider what auditors are capable of producing for general use within the short filing periods now required. The PCAOB will also need to consider ways to enforce consistency of reporting. At the same time, investors ought to be able to expect that differences in reports reflect differences in the quality of the financial reporting subject to audit, not differences between engagement partners.

The PCAOB's concept release presented several alternatives for possible changes to the auditor's report, among other reasons, to provide investors with more transparency into the audit process and more insight

54. Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, PCAOB Release No. 2011-003 (June 21, 2011).

about audit matters and results. The alternatives presented were (1) an auditor's discussion and analysis (AD&A); (2) required and expanded use of emphasis paragraphs; (3) auditor assurance on other information outside the financial statements; and (4) clarification of the standard auditor's report.⁵⁵ All of the alternatives presented in the concept release retained the pass-fail opinion of the standard auditor's report, and none were intended to alter the auditor's ultimate responsibility to obtain sufficient evidence to support the audit opinion.⁵⁶ Thus, the alternatives would not change the fundamental role of the auditor to perform an audit and attest to management's assertions as embodied in management's financial statements.⁵⁷ They were not intended to put the auditor in the position of reporting financial information for management.⁵⁸

The PCAOB has received more than 150 comment letters to date.⁵⁹ In addition, the PCAOB held a public meeting in September 2011 to foster further discussion among auditors, investors, financial statement preparers, and others.⁶⁰ The comment letters reflect diverse views among different interest groups. Preparers and audit committee members claim to see little need for change in auditor reporting and see dangers in auditors reporting information about the company's financial statements to financial-statement users.⁶¹ Preparers and audit committee members also suggest that, if financial-statement users need additional information, the Financial Accounting Standards Board or the SEC should be the ones to require it.⁶² On the other hand, many auditors support certain changes to the auditor's report but believe any additional reporting must be objective and factual, not

55. PCAOB Release No. 2011-003, *supra* note 54, at 2.

56. *Id.* at 11–12.

57. *Id.* at 3, 12.

58. *See id.* at 3 (“[T]hese alternatives are focused primarily on enhancing communication to investors through improving the content of the auditor’s report rather than on changing the fundamental role of the auditor”); *see also id.* at 12 (indicating that alternatives requiring an expansion of auditor responsibilities “would likely necessitate the development of a management reporting framework”).

59. *See Comment Letters for Docket 034*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/Rules/Rulemaking/Pages/Docket034Comments.aspx> (listing 155 submitted comment letters at the close of the comment period).

60. To access the webcast and other information about this meeting, see *PCAOB Roundtable on Auditor’s Reporting Model*, PUB. COMPANY ACCT. OVERSIGHT BOARD, http://pcaobus.org/News/Events/Pages/09152011_Roundtable.aspx.

61. *See, e.g.*, Letter from Robert P. Bedwell, Chair, Fla. Inst. of Certified Pub. Accountants, Accounting Principles & Auditing Standards Comm., to Office of the Sec’y, Pub. Co. Accounting Oversight Bd. 1 (July 15, 2011) (“[A]uditors should not become a source of disclosure The auditor’s role should remain that of an independent auditor attesting to the fairness, in all material respects, of the financial statements presented.”); Letter from Fin. Exec. Int’l, Comm. on Corp. Reporting, to Office of the Sec’y, Pub. Co. Accounting Oversight Bd. 3 (Sept. 30, 2011) (“We believe these alternatives would result in more confusion and have unintended adverse effects on the auditor–client relationship, auditor independence and audit costs, and give certain information undue prominence.”).

62. *See, e.g.*, Letter from Fin. Exec. Int’l, *supra* note 61, at 2.

subjective.⁶³ This is what I mean when I say that auditors acknowledge that reforms are necessary.

The views of investors vary. Many investors support a narrative by the auditor, such as an AD&A.⁶⁴ Investors have also suggested additional auditor reporting on the following information:

- Areas of high financial-statement and audit risk;⁶⁵
- The most important matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty, including sensitivity analysis;⁶⁶ quality, not just acceptability, of accounting policies and practices,⁶⁷ which is generally understood to mean an auditor's assessment of where the company stands on the continuum of conservative-to-aggressive application of accounting policies and practices;⁶⁸
- Significant changes in or events impacting the financial statements, including unusual transactions;⁶⁹ and
- Identification of where significant matters are disclosed in the financial statements for investors' further information.⁷⁰

Commenters who support auditor assurance on other information outside the financial statements most frequently suggest auditor association with the critical accounting estimates disclosed in Management's Discussion

63. *See, e.g.*, Letter from Richard E. Piluso, President, N.Y. State Soc'y of Certified Pub. Accountants, to Office of the Sec'y, Pub. Co. Accounting Oversight Bd. 4 (Sept. 27, 2011) ("Any auditor reporting . . . to investors or other users should be based on objective criteria; not subjective views.").

64. *See, e.g.*, Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Office of the Sec'y, Pub. Co. Accounting Oversight Bd. 3 (Sept. 19, 2011) ("An AD&A is an ideal approach to improving the current auditor's report so that it provides information more responsive to investors' needs.").

65. *Id.*

66. *Id.*; *see also* Letter from PCAOB's Investor Advisory Grp. to Office of the Sec'y, Pub. Co. Accounting Oversight Bd. 12 (Sept. 29, 2011) (specifying auditor discussions of "sensitivity analyses in significant areas of judgment" as a change supported by respondents in a survey of investors).

67. Letter from Jeff Mahoney, *supra* note 64, at 3.

68. *Id.* at 6–7.

69. *Id.* at 3.

70. *Id.*

and Analysis.⁷¹ Further, the majority of commenters support certain clarifications in the auditor's report.⁷²

The next step is for the PCAOB to consider these comments and propose potential changes to existing auditing standards on the audit report.

B. Auditor Independence

The PCAOB is also focused on auditor independence. In August 2011, the Board issued a concept release to seek public comment on how to enhance independence, including whether audit firms should be subject to term limits.⁷³ The project on independence is focused on ways to relieve auditors of the pressure to maintain a long-term relationship with the audit client when making tough decisions on an audit.⁷⁴ In this regard, I am concerned about both the relatively new audit that the auditor may hope to turn into a long-term engagement, as well as the very long engagement that no partner wants to be the one to lose. The release asked particularly for comment on terms of more than ten years and on the suitability of rotation for the largest issuers.⁷⁵

Audit firm term limits present considerable operational challenges, but these challenges are overcome routinely by companies that choose to change auditors, for good or bad reasons. Opponents of mandatory term limits cite practical difficulties some companies could face in finding a new independent auditor competent in the relevant industry or, once found, educating them in the company's business and financial reporting systems.⁷⁶ Yet these same difficulties exist today when companies *choose* to change auditors.

Client acceptance standards and policies are meant to prevent firms from taking on engagements they are ill-equipped to handle.⁷⁷ If these need to be

71. See, e.g., Letter from Jeff Mahoney, *supra* note 64, at 16; Letter from Cleary Gottlieb Steen & Hamilton to Martin F. Baumann, Chief Auditor, Pub. Co. Accounting Oversight Bd. 6–8 (Oct. 14, 2011).

72. See *Auditor's Reporting Model—Preliminary Overview of Comments*, PUB. COMPANY ACCT. OVERSIGHT BOARD, http://pcaobus.org/News/Events/Documents/11092011_SAGMeeting/Auditors_Reporting_Model_Slides.pdf (reporting that the comments received by the PCAOB supported clarifications in auditors' reports).

73. Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-006 (Aug. 16, 2011).

74. See *id.* at 2–3 (reviewing the concept of audit firm rotation as one way to relieve pressure on auditors and soliciting comments on the issue).

75. PCAOB Release No. 2011-006, *supra* note 73, at 20–21.

76. See Laura Hay, *Would Mandatory Audit Firm Rotation Improve Audit Quality?*, OHIO SOCIETY OF CPAS (Oct. 21, 2011), <http://ohioscpa.com/publications/news/2011/10/21/would-mandatory-audit-firm-rotation-improve-audit-quality/> (reporting that opponents of mandatory audit firm rotation consider it costly and impractical because of training demands and anticipate increases in financial restatements due to new auditors' lack of knowledge of the client).

77. See Kevin Prendergast, *Client Acceptance Procedures: Best Practices Among Accounting Firms*, RESEARCH ASSOCIATES, INC., <http://www.researchassociatesinc.com/documents/>

improved, they can be. Weaknesses in this area can hardly justify putting off independence concerns. I am interested in arguments that the PCAOB should encourage audit committees to enhance auditor skepticism instead of imposing term limits, but I do not know whether that could be enough.⁷⁸

We are dealing with the subtle effects of human nature. What motivates the auditor to exercise skepticism? What pulls him back from it? How do we free him from that influence? This is not an easy subject, and the potential costs of term limits require due consideration.⁷⁹ The PCAOB received 620 comment letters. In addition, in March 2012, the PCAOB convened a public meeting to hear from interested parties and to further discuss the subject.⁸⁰ Forty-seven panelists appeared at the two-day public meeting, offering varied perspectives as investors, senior executives and audit committee chairs of major corporations, chief executive officers of audit firms, academicians, and other interested parties. The PCAOB plans to hold additional such meetings around the country, in an effort to obtain public comment from a wide and diverse set of interested parties on this important topic before proposing any changes.

C. *Audit Transparency*

The third policy initiative the PCAOB has mooted relates to audit transparency. In October 2011, the Board proposed amendments to its auditing standards to improve audit transparency by enhancing disclosure about the participants in audits, including disclosure about the partner in charge of the audit, as well as other firms involved in the audit.⁸¹

This proposal stems from a concept release that the Board issued in July 2009 to obtain comment on whether the Board should require engagement partners to sign audit reports.⁸² The names of key management executives, in addition to the names of corporate board members, have long been

BestPracticesClient.aspx (discussing client acceptance procedures and the importance of ensuring that clients meet the audit firm's professional obligations).

78. There is evidence that, even after the Sarbanes-Oxley reforms, management continues to dominate the company's relationship with the auditor. Jeffrey Cohen et al., *Corporate Governance in the Post-Sarbanes-Oxley Era: Auditors' Experiences*, 27 CONTEMP. ACCT. RES. 751, 752 (2010).

79. Although cost is a frequently cited factor raised against term limits and requires evaluation, companies do change auditors today voluntarily. In recent testimony, I stated as much, and committed to considering any relevant information about cost before proposing any requirement for mandatory firm rotation. See generally *Hearing on Accounting and Auditing Oversight Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. (2012).

80. The agenda and a webcast of the meeting are available at http://pcaobus.org/News/Events/Pages/03212012_PublicMeeting.aspx.

81. Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2, PCAOB Release No. 2011-007 at 3 (Oct. 11, 2011).

82. *Id.* at 3-4.

disclosed.⁸³ The names of audit engagement partners are also disclosed in many countries, but as of yet they are not disclosed in the United States.⁸⁴ The proposal would also provide investors with disclosure about other accounting firms and certain other participants in the audit. Enhanced transparency into the composition of cross-border audits should help investors gain a better understanding of how an audit was conducted and make more informed decisions about how to use the audit report.⁸⁵ Investors will see, for example, the significant participation of audit firms from jurisdictions that we cannot inspect.⁸⁶

The PCAOB received forty-two comment letters on this proposal and is considering them with a view to finalizing the change.

IV. Joint Inspections, Investor Protection, and the Future

I now turn to the second impediment to audit quality that I cited at the outset: the fact that while audits are global, audit firms and regulators are not. Audits are global both because companies are multinational and because, whether multinational or not, companies increasingly seek capital by listing outside their home market.⁸⁷ Foreign company listings in the United States have dramatically increased. Fifteen percent of the companies listed on the New York Stock Exchange (NYSE) hail from abroad.⁸⁸ Roughly half of the 100 largest companies listed on the NYSE are foreign.⁸⁹ Indeed, listings by foreign companies on exchanges outside their home country are up everywhere.⁹⁰ There are many reasons that a company may list outside its

83. *See id.* at 6 (noting that the Sarbanes-Oxley Act of 2002 requires the chief executive officer and chief financial officer of a company to make certifications about the company's financial statements).

84. *Id.* at 2 n.2.

85. *See id.* at 20 ("The proposed disclosure would provide investors and other users of the audit report with the ability to evaluate other participants in the audit in the same manner that they evaluate the auditor.").

86. *See id.* at 19 ("The auditor would be required to disclose the *name* and *location* of another independent public accounting firm that audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements of the company . . .").

87. *See* Craig Doidge et al., *The U.S. Left Behind: The Rise of IPO Activity Around the World* 4 (Fisher Coll. of Bus. Working Paper Series, Working Paper No. 2011-03-008, 2011) (observing that finance has become much more global in recent years).

88. *See Non-U.S. Listed Company Directory*, N.Y. STOCK EXCHANGE, http://www.nyse.com/international/nonuslisted/int_listed.html?ListedComp=All (stating there are 421 non-U.S. companies listed on the NYSE); *Frequently Asked Questions*, N.Y. STOCK EXCHANGE, <http://www.nyse.com/content/faqs/1050241764950.html> (stating there are about 2,800 companies listed on the NYSE).

89. *See NYSE Composite Index Fund*, iSHARES, http://us.ishares.com/product_info/fund/holdings/NYC.htm (listing all companies on the NYSE by market share).

90. *Cf.* Doidge et al., *supra* note 87, at 4 (observing that firms from countries with weaker institutions are more likely to go public with a global IPO).

home market, such as to link to an established market index.⁹¹ When foreign companies list in the United States, they earn a documented cross-listing premium for bonding themselves to U.S. institutions and committing to U.S. compliance activities aimed at protecting minority investors.⁹² The bonding effect—that is, the commitment to abide by the standards and laws of a strict investor-protection regime—rewards companies located in markets without developed investor-protection regimes.⁹³ Indeed, the rewards include a better cost of capital even in their home markets.⁹⁴ Companies from countries with established markets also benefit from, and thus choose to engage in, cross listing,⁹⁵ as economists who have studied the price differentials such dual-listed companies experience at home and in their adoptive markets have observed.⁹⁶

While audit reports for multinational companies are signed by one audit firm, that firm will generally refer relevant work to its local affiliates in countries where the audit client has operations.⁹⁷ Those affiliates are typically themselves separate legal entities.⁹⁸ And if they audit or play a substantial role in an audit of an issuer, they will be separately registered with the PCAOB.⁹⁹ It has been suggested since the recent financial crisis that the global audit-firm networks pose systemic risk to the various economies in which they operate.¹⁰⁰ I do not believe they do. I am not in favor of efforts to shrink the global networks because that would likely further weaken their ability to audit the large, multinational companies that may themselves be

91. *The Exchange: Foreign Firms Cross-Listed in U.S. Valued Higher*, N.Y. STOCK EXCHANGE (Oct. 2005), www.nyse.com/about/publication/1127731093408.html.

92. See Craig Doidge et al., *Has New York Become Less Competitive than London in Global Markets: Evaluating Foreign Listing Choices Over Time*, 91 J. FIN. ECON. 253, 255 (2009) (showing that the premium of cross listing in the United States is “significantly positive every year”).

93. See *id.* at 274 (citing a study showing that the bonding effect increases equity issues for firms most significantly in countries with weak protections for investors).

94. See *id.* (“[M]ost interestingly . . . the increase arises for equity issues in [firms’] home market as well as in the US market, the original target market for the listings.”).

95. See *id.* at 262 (citing previous research that some of the largest and most sophisticated firms from countries with strong financial and legal institutions are likelier to pursue listings in the United States).

96. See, e.g., Louis Gagnon & G. Andrew Karolyi, *Multi-Market Trading and Arbitrage* (July 1, 2004) (unpublished manuscript), available at http://www.rotman.utoronto.ca/finance/seminars/050311_karolyi.pdf (studying the differences in stock prices for companies traded simultaneously around the world).

97. See Samuel J. Winer et al., *Recent Developments in Vicarious Liability of Global Audit Firm Networks*, 1772 PRACTISING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 175, 177–78 (2009) (discussing global audit firms).

98. *Id.* at 177.

99. See *id.* at 198 (citing various PCAOB rules that apply to foreign audit companies).

100. See SELECT COMMITTEE ON ECONOMIC AFFAIRS, AUDITORS: MARKET CONCENTRATION AND THEIR ROLE, 2010-11, H.L. 119-I (U.K.) (discussing the flaws of the current audit firm network, in particular the facts that a very small number of audit firms have all the power and that the audit regulatory structure is “complex and unclear”).

systemically important. The global networks are not too big to fail, but they are too important to leave unmonitored. The PCAOB's joint inspection arrangements strive to be a model of investor protection because they allow intersecting and overlapping regulatory oversight of global audits.

This model is beginning to take hold elsewhere in Europe, Asia, and Africa.¹⁰¹ The PCAOB has made substantial progress in helping other jurisdictions see the benefits of rigorous and joint auditor oversight.¹⁰² The PCAOB has conducted inspections in thirty-seven non-U.S. jurisdictions since non-U.S. inspections began in 2005. In ten of those jurisdictions, PCAOB inspectors work side by side with local inspectors.¹⁰³

I am confident that more joint inspection arrangements with European authorities are on the way. As has been widely reported, though, the PCAOB remains unable to inspect auditors that perform or participate in audits of companies that access capital through U.S. markets but reside in China or some parts of Europe.¹⁰⁴ I am hopeful that we will be able to resolve concerns raised by authorities in these countries. Some jurisdictions have resisted joint inspections, professing preference for a policy of "mutual" or "full" reliance.¹⁰⁵ Investor protection is put at risk, not advanced, by such an approach. Audits do not stop at borders, and neither can effective cross-border audit regulation. As in the case of global audits themselves, reliance on high-level summaries of work performed by another regulator presents an unmitigated hand-off risk. Leaving oversight of the components of cross-border audits to the inconsistencies of separate regulatory processes should not be a goal. New research on the effect of the U.S. Supreme Court's

101. See INT'L FORUM OF INDEP. AUDIT REGULATORS, ACTIVITY REPORT 2010 2, 10–12 (2010) (describing the International Forum of Independent Audit Regulators (IFIAR), a multinational organization designed to promote international collaboration between auditors, which includes member states from Asia, Africa, and Europe). See also, e.g., EUROPEAN GROUP OF AUDITORS' OVERSIGHT BODIES (EGAOB), ON THE COOPERATION BETWEEN COMPETENT AUTHORITIES WITHIN THE EU 7–8 (2009), available at [http://ec.europa.eu/internal_market/auditing/docs/relations/08122009_egaob_report_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/rerelations/08122009_egaob_report_en.pdf) (outlining the requirements for cooperation in inspections and investigations between member European Union states).

102. See *PCAOB Meets with Asian Counterparts to Discuss Cooperation on Auditor Oversight*, PUB. COMPANY ACCT. OVERSIGHT BOARD (Mar. 23, 2007), http://pcaobus.org/News/Releases/Pages/03232007_AsianCounterparts.aspx (announcing a meeting between PCAOB members and their counterparts in Japan and China to discuss cooperation and developments in auditor oversight).

103. See, e.g., *PCAOB Enters into Cooperative Agreement with the Netherlands*, PUB. COMPANY ACCT. OVERSIGHT BOARD (Dec. 5, 2011), http://pcaobus.org/News/Releases/Pages/12052011_Netherlands.aspx (reporting that the PCAOB reached agreements with the Netherlands, Norway, and Switzerland); *PCAOB Chairman Calls for More Global Cooperation on Audit Regulation*, J. ACCT. (July 1, 2011), <http://www.journalofaccountancy.com/Web/20114318> ("[E]arlier this year the PCAOB began joint inspections with U.K. authorities.").

104. The countries are Germany, Korea, Norway, Singapore, Taiwan, South Africa, Switzerland, the United Kingdom, Australia, and Canada.

105. Letter from Jorgen Holmquist, Eur. Comm'n, Internal Mkt. and Serv. DG, to Office of the Sec'y, Pub. Co. Accounting Oversight Bd. (Mar. 14, 2008).

decision in *Morrison v. National Australia Bank*¹⁰⁶ shows that investors value U.S. enforcement of its laws against cross-listed companies.¹⁰⁷ Indications that U.S. enforcement may not extend to certain investors are reflected in the spread between the price of a cross-listed company's shares traded in U.S. markets versus the price of shares traded at home.¹⁰⁸

I hope Chinese authorities will follow the example of other countries and also embrace joint inspections. This is an urgent matter. Although more than 100 firms from China and Hong Kong have registered with the PCAOB, only a handful claim to perform or play a substantial role in audits of U.S. issuers.¹⁰⁹ But they audit some of the largest companies in the world.¹¹⁰ Chinese businesses, including state-owned businesses, have voluntarily offered their securities in U.S. markets, presumably because they believe they benefit from our markets and securities institutions. They must comply with the rules of those markets and institutions, or they, the markets, and the institutions will lose their credibility. Indeed, markets are already speaking. I believe Chinese authorities will see that businesses that want to remain in foreign markets benefit from the credibility that joint inspections bring.

V. Conclusion

Around the world, we are occupied with the question of what will restore and advance the health of our economies. As we rebuild our economy, we must consider reinforcing the audit and using it as a tool to provide for better decisions. Skepticism is affected by culture. It does not thrive on its own. If it is discouraged, it will recede and with it transparency and truth. The PCAOB's oversight work is critical to enforcing high-quality audits that apply appropriate skepticism. That work involves careful consideration of ways to reduce the incidence of failure, including structural

106. 130 S. Ct. 2869 (2010).

107. See Louis Gagnon & George Andrew Karolyi, *The Economic Consequences of the U.S. Supreme Court's Morrison v. National Australia Bank Decision for Foreign Stocks Cross-Listed in U.S. Markets* 17 (Johnson Sch. Research Paper Series, Paper No. 50-2011, 2011) (showing that the Court's decision in "*Morrison v. National Australia Bank* in June of 2010 was associated with a statistically significant 37 basis point increase on the day in the price deviation between the U.S. cross-listed shares trading in U.S. markets and the underlying home market shares").

108. See *id.* at 1–2 (using the price deviations between cross-listed shares and their respective home-market shares to study "whether market participants reacted in a way that reflects that they care about how the laws of securities fraud are *differentially* enforced for internationally cross-listed securities").

109. See *List of Issuer Audit Clients of Non-U.S. Registered Firms in Jurisdictions Where the PCAOB Is Denied Access to Conduct Inspections*, PUB. COMPANY ACCT. OVERSIGHT BOARD, <http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccessList.aspx> (identifying issuers that file with the "SEC financial statements audited by a PCAOB-registered firm located in a jurisdiction where the PCAOB is currently prevented from conducting inspections, or located in Hong Kong, where the PCAOB may be prevented from inspecting a firm's audit work related to a company's operations in China").

110. Compare *id.*, with *The World's Biggest Public Companies*, FORBES (April 2011), <http://www.forbes.com/global2000/list/>.

reform. The PCAOB is now considering such reforms with a view to shifting the auditor's mindset from one of client service to one of public service. The globalization of audits has only compounded the challenges. As I have said, these reforms should be debated, and I am grateful for the opportunity to further the debate at this Symposium.