

Strengthening Financial Reporting: An Essay on Expanding the Auditor's Opinion Letter

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ABSTRACT

Users of financial statements, foremost of which are investors, have a voracious appetite for information that better enables them to assess the financial position and performance of the reporting firm. Even though financial statements purport to address users' needs, the statements, which are prepared by the firm's managers, conceal a range of managerial estimates, assumptions, judgments, and choices. Investors are thereby deprived of the most fundamental kernel of information they seek, namely the overall quality of the financial reports themselves. This Article sets forth several modest steps that would enhance the overall quality of financial reporting by discretely tinkering with the outside auditor's opinion that accompanies the financial statements. Specific areas addressed are: (1) the auditor's engagement, if any, in evaluating management's mandated assessment of internal controls; (2) the duration of the auditor's relationship with the audit client; (3) whether the auditor concurs in management's assessment of the critical estimates, judgments, and assumptions that underlie the financial reports; and (4) the auditor's assessment of whether the firm is experiencing financial distress or the early signs of financial distress. The author then develops why each of these steps would greatly improve the quality of financial reporting so that all users of financial reports, including even the management team that prepared the reports, would be better served.

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INTRODUCTION

The auditor's opinion letter rivals watching paint dry for excitement. Only the audited client name changes on this standard form. The auditor glibly asserts that the audit firm, using generally accepted auditing procedures, has reviewed the financial statements prepared by the firm's management and confirms that the statements are consistent with generally accepted accounting principles.¹ The audit engagement partner does not sign his name to the letter, but rather signs the opinion letter on behalf of the auditing firm.² Thus, anonymity joins glibness in framing the opinion letter. Because the opinion letter is so standardized, investors must look, usually in vain, elsewhere for hints. Investors search to find just how aggressive management may have been in exercising the numerous assumptions, judgments, and estimates that are endemic to generally accepted accounting principles. That is, the opinion letter itself reveals nothing about the *quality* of the accounting reports, or for that matter, the *trustworthiness* of the reporting system management relied upon in preparing the financial reports. And the public financial statements do no better.

If one were to think about where to begin to improve financial reporting, the audit opinion letter would be a good place to start. Rather than reading like the instructions to a vacuum cleaner, the opinion letter could be transformed into a gripping tell-all tale. But in the citadels of policymaking, regulation has in the minds of many surpassed bad collateralized debt obligations and unscrupulous investment bankers as the cause of our ongoing economic doldrums. While bad investment products and worse bankers continue to be seen by most as the cause of the financial crisis, the growing impatience among politicians and the public with the slowness of the financial recovery has shifted blame increasingly to regulation.³ People see regulation not as the cause of the crisis, but the cause of the slowness of our recovery. This is best illustrated by the current Congress's single

¹ *Understanding the Auditor's Report*, CREDIT RES. FOUND., <http://www.crfonline.org/orc/cro/cro-11.html> (last visited Mar. 17, 2013).

² *Id.*

³ Jennifer Wishon, *Slow Economic Recovery: What's Taking So Long?*, CBN NEWS (Apr. 3, 2012), <http://www.cbn.com/cbnnews/finance/2012/April/Slow-Economic-Recovery-Whats-Taking-so-Long/>.

bipartisan effort, championed as well by the White House, the Jumpstart Our Business Startups Act of 2012 (“JOBS Act”).⁴ The JOBS Act stands apart from all prior financial regulatory enactments, as it represents a dramatic contraction of the scope of the U.S. securities laws.⁵ The legislation nonetheless gained resonance with a growing distrust of regulation, particularly the depression-era paternalism. While in prior times we wept for widows, widowers, and orphans, today the rhetoric calls increasingly for less government involvement and more private initiatives, even in the area of investor protection. In the spirit of the contemporary political climate, this Article explores optional steps that might be taken in this direction through a heretofore overlooked mechanism, the auditor’s opinion letter.

I. INTERNAL CONTROLS AND THE LESSONS FROM SARBANES-OXLEY 404(B)

A. *Tracing the Half-Life of Section 404(b)*

After nearly a quarter of a century of legislative efforts, section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”)⁶ introduced twin requirements that management assess and report on the firm’s internal controls,⁷ and that an independent auditor attest to management’s internal control assessment annually.⁸ Immediately after enactment, section 404(b) became the poster child for charges of Congress’s overreaction and overregulation of U.S. financial markets. Responding to the cries of the provision’s cost burdens, and more particularly that the costs disproportionately fell on small issuers, the Securities and Exchange Commission (“SEC”) repeatedly delayed implementing the provision for so-called nonaccelerated filers, reporting companies with a market capitalization below \$75 million.⁹ Section 404(b)’s imple-

4 Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, 126 Stat. 306 (codified as amended in scattered sections of 15 U.S.C.); see Jonathan Weisman, *Final Approval by House Sends Jobs Bill to President for Signature*, N.Y. TIMES (Mar. 27, 2012), <http://www.nytimes.com/2012/03/28/us/politics/final-approval-by-house-sends-jobs-bill-to-president-for-signature.html>.

5 *The Pendulum Swings*, ECONOMIST (Mar. 24, 2012), <http://www.economist.com/node/21551068>; Robert B. Thompson, *Securities Deregulation: The JOBS Act of 2012*, CONGLOMERATE (Apr. 23, 2012), <http://www.theconglomerate.org/2012/04/securities-deregulation-the-jobs-act-of-2012-robert-b-thompson-georgetown-university-law-center-less-than-two-years-after.html>.

6 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745).

7 Sarbanes-Oxley Act § 404(a), 116 Stat. at 789.

8 *Id.* § 404(b), 116 Stat. at 789.

9 See, e.g., Press Release, Sec. & Exch. Comm’n, Small Companies to Begin Providing Audited Assessment of Internal Controls over Financial Reporting in Nine Months (Oct. 2, 2009), <http://www.sec.gov/news/press/2009/2009-213.htm>.

mentation delays did not salve the unease of its critics.¹⁰ It did, however, buy them time to mount their case. Among the numerous provisions of the historic Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”),¹¹ an act that otherwise introduced the most sweeping regulatory change for financial markets since the Great Depression, Congress thus included section 989G permanently exempting all companies with a market capitalization less than \$75 million from section 404(b).¹² This provision removed nearly 6,000 reporting companies, representing about six percent of U.S. equity capital, from the internal control attestation requirement.¹³ Dodd-Frank also called on the SEC to study whether firms with a market capitalization of \$75–200 million should also be exempted.¹⁴ In carrying out the study, the SEC reached the following conclusions:

Investors generally view the auditor’s attestation on ICFR [internal controls over financial reporting] as beneficial;
Financial reporting is more reliable when the auditor is involved with ICFR assessments; and
There is not conclusive evidence linking the requirements of Section 404(b) to listing decisions of the studied range of issuers.¹⁵

Congress was unimpressed by the SEC’s thoughtful study. In 2012, with the JOBS Act, Congress returned to the topic again and further reduced the reach of section 404(b). First, and most directly,

¹⁰ See Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices*, 65 J. FIN. 1163, 1164 (2010).

¹¹ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376.

¹² Section 989G amended 15 U.S.C. § 7262 of Sarbanes-Oxley to include section 404(c); the other provisions related to internal controls remain, including section 404(a)’s requirement that the issuer’s annual report include a report of management on the issuer’s internal control over financial reporting and management’s assessment of the effectiveness of such internal controls. 15 U.S.C. § 7262. These changes were implemented by the SEC in Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 75 Fed. Reg. 57,385, 57,385 (Sept. 21, 2010). Although so-called nonaccelerated filers had not been subject to this requirement, the stream of delays in imposing section 404 appeared unlikely to be continued.

¹³ Cf. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-06-361, *SARBANES-OXLEY ACT: CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES* 6 (2006) (reporting on the findings and recommendations of the SEC’s Advisory Committee on Smaller Public Companies and noting that potentially exempt microcap and smallcap companies represent six percent of the U.S. equity market capitalization).

¹⁴ Dodd-Frank Act § 989G(b), 124 Stat. at 1948.

¹⁵ U.S. SEC. & EXCH. COMM’N, *STUDY AND RECOMMENDATIONS ON SECTION 404(B) OF THE SARBANES-OXLEY ACT OF 2002 FOR ISSUERS WITH PUBLIC FLOAT BETWEEN \$75 AND \$250 MILLION* 7 (2011) [hereinafter SEC STAFF 404(B) STUDY].

the JOBS Act lifts the auditor attestation requirements for emerging growth companies for five years after going public.¹⁶ This change ignored overwhelming evidence that the frequency of material internal control weaknesses are inversely related to firm size, i.e., investors in smaller issuers benefit more from auditor assessments of internal controls than investors in larger issuers.¹⁷ Second, Congress increased the threshold number of shareholders for which a company traded only over the counter becomes a reporting company from 500 to 2,000.¹⁸ This greatly reduced the scope of section 404(b), since it only reaches reporting companies.¹⁹

Nonetheless, the SEC's delay in extending section 404(b) to nonaccelerated filers provided conditions for a natural experiment in the value of the provision. While not mandatory for such small-cap firms, many choose to comply with its requirements.²⁰ Hence, studies abound documenting the multiple (indeed, favorable) impacts that the auditor's internal control assessments provide to the firm and its shareholders.²¹

B. *What Could Have Been from What Was*

Generally, nonaccelerated filers and smallcap companies (most market professionals consider a market capitalization of less than \$1 billion to be small²²), have more limited product lines, possess fewer financial resources, trade in thin markets like the nonregulated Over-The-Counter Bulletin Board market, and are followed by few, if any, analysts or institutional investors.²³ This group is also more likely to have internal control deficiencies; this is likely due to the absence of stronger corporate governance, more qualified, deeper managing teams, and expertise on its audit committee.²⁴ Not surprisingly, the

¹⁶ Jumpstart Our Business Startups (JOBS) Act of 2012 § 103, Pub. L. No. 112-106, 126 Stat. 306 (amending the Sarbanes-Oxley Act of 2002, 15 USC § 7262(b)).

¹⁷ See, e.g., Jeffrey Doyle et al., *Determinants of Weaknesses in Internal Control over Financial Reporting*, 44 J. ACCT. & ECON. 193 (2007).

¹⁸ JOBS Act § 501 (to be codified at 15 U.S.C. § 78l(g)(1)(A)).

¹⁹ Sarbanes-Oxley Act § 404(a), 116 Stat. at 789.

²⁰ See SEC STAFF 404(B) STUDY, *supra* note 15, at 42 (commenting that sixty participating nonaccelerated filers voluntarily complied with § 404(b)'s requirements).

²¹ See, e.g., *id.*; U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 13.

²² See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 13, at 2 n.3 (defining smaller public companies as having \$700 million or less in market capitalization).

²³ See *id.*, at 18–20; Ravi Bhushan, *Firm Characteristics and Analyst Following*, 11 J. ACCT. & ECON. 255 (1989); Russell Robinson, Comment, *Fraud-on-the-Market and Thinly Traded Securities*, 25 WAKE FOREST L. REV. 223, 230–31 (1990).

²⁴ SEC STAFF 404(B) STUDY, *supra* note 15, at 96 (citing studies).

shares for this group of firms are widely believed to be valued inefficiently.²⁵ Such inefficiency breeds opportunity, not just for investors, but also for insiders. On the positive side of this insight, returns for smallcap firms are historically higher, reflecting their need to yield greater financial rewards to investors to compensate for their greater risk.²⁶ On the negative side of the same calculus, pricing inefficiencies provide a fertile field for manager opportunism.

Section 404 was not without material social benefits.²⁷ For example, studies of accounting restatements consistently track significant increases in the number of accounting restatements following partial implementation of section 404. Material restatements peaked in 2006 with 1,564 reporting issuers and have declined each year since, reaching 630 restatements in 2009.²⁸ The numbers for nonaccelerated filers reporting material restatements was 888 in 2006 and 374 in 2009.²⁹ This reflects the well-documented phenomenon that the number of restatements is inversely related to market capitalization.³⁰ In 2007, nearly sixty percent of firms reporting material weaknesses in their internal controls that have *not* been remediated were firms with market capitalizations less than \$75 million.³¹ Moreover, in the years 2004–2007, the vast percentage of firms receiving a qualified audit

²⁵ See, e.g., Robinson, *supra* note 23, at 230–31 (describing factors that cause thinly traded securities to trade in an inefficient market).

²⁶ See e.g., FIDELITY INVESTMENTS, PROSPECTUS TO FIDELITY SMALL CAP STOCK FUND, FIDELITY MID-CAP STOCK FUND, AND FIDELITY LARGE CAP STOCK FUND 5, 9, 13 (June 29, 2012) (reviewing risks and returns of three major categories of indexed funds).

²⁷ The SEC's Chief Accountant during the early implementation period of the internal controls requirement observed, "I believe that, of all of the recent reforms, the internal control requirements have the greatest potential to improve the reliability of financial reporting. Our capital markets run on faith and trust that the vast majority of companies present reliable and complete financial data for investment and policy decision-making." Donald T. Nicolaisen, Chief Accountant, U.S. Sec. & Exch. Comm'n, Keynote Speech at 11th Annual Midwestern Financial Reporting Symposium (Oct. 7, 2004), *transcript available at* <http://www.sec.gov/news/speech/spch100704dtn.htm>.

²⁸ AUDIT ANALYTICS, 2009 FINANCIAL RESTATEMENTS: A NINE YEAR COMPARISON 18 (2010). See also the study commissioned by the U.S. Treasury, SUSAN SCHOLZ, U.S. DEP'T OF THE TREASURY, THE CHANGING NATURE AND CONSEQUENCES OF PUBLIC COMPANY FINANCIAL RESTATEMENTS 1997–2006, 1 (2008), http://www.treasury.gov/press-center/press-releases/documents/financialrestatements_1997_2006.pdf (reflecting that greatest percentage of restatements are for firms that do not trade on a major stock exchange and that restatements began to accelerate prior to the enactment of Sarbanes-Oxley).

²⁹ AUDIT ANALYTICS, *supra* note 28, at 18.

³⁰ See e.g., Mark Grothe, Glass, Lewis & Co., *The Tide Is Turning*, YELLOW CARD TREND ALERT, at 3 fig.3, 7 fig.9 (Jan. 15, 2008).

³¹ *Id.* at 8 tbl.2; see also AUDIT ANALYTICS, *supra* note 28, at 18 (showing that from 2003–2009, nonaccelerated filers accounted for over fifty percent of total U.S. financial restatements).

opinion on their internal controls were firms with a market capitalization below \$75 million, and this group also experiences the highest percentage of auditor changes among all reporting companies.³² Since there seems little basis to contest the notion that greater accuracy in financial reporting leads to improved pricing of the company's securities, reduction in the number of restatements should be viewed positively.³³

While the occurrence of significant numbers of restatements among nonaccelerated filers may suggest that restatements will occur even without mandatory compliance with section 404, there has long been a good deal of concern that absent formal independent assessment of a firm's internal controls, weak financial reporting systems exist and substantial numbers of reporting problems and internal control deficiencies are going undetected.³⁴ To be sure, not all reports of material weakness in internal controls elicit strong market adjustments. Markets more likely adjust negatively for matters that are less auditable, when the accompanying disclosures are vague, and when the reporting company is not audited by a Big Four auditor.³⁵

³² See Grothe, *supra* note 30, at 9 tbl.4, 11 chart 13.

³³ A related consideration is that "[i]ssuers that were in compliance with the Section 404 auditor attestation requirements were less likely to issue materially misstated financial statements than noncompliant issuers." SEC STAFF 404(B) STUDY, *supra* note 15, at 100 (citing Albert L. Nagy, *Section 404 Compliance and Financial Reporting Quality*, 24 ACCT. HORIZONS 441 (2010) and Tammy Whitehouse, *Internal Controls Audits Continue to Shine*, COMPLIANCE WEEK, Nov. 16, 2010).

³⁴ See SEC STAFF 404(B) STUDY, *supra* note 15, at 85–86 ("Auditor testing of accelerated filers' controls has generally resulted in the disclosure of internal control deficiencies ('ICDs') that were not previously disclosed by management, and the external auditor attestation appears to have a positive impact on the informativeness of internal control disclosures and financial reporting quality."); *id.* (noting that filers of only section 404(a) reports had a forty-six percent higher number of restatements during a four-year study period than issuers with auditor attestations under section 404(b)); Melissa Klein Aguilar, *404 Disclosures Show Dramatic Improvement*, COMPLIANCE WEEK, Nov. 27, 2007 (quoting Mr. Robert Benoit, partner at Lord & Benoit, an auditing firm that focuses on small issuers: "Almost none of the smaller public companies have done any SOX work."); Grothe, *supra* note 30, at 7 ("If microcap companies disclosed this many material weaknesses on their own—without having to comply with SOX 404—how many more material weaknesses would be discovered if independent accounting firms were required to conduct internal-control audits at these companies?").

³⁵ See Jacqueline S. Hammersley, Linda A. Myers & Catherine Shakespeare, *Market Reactions to the Disclosure of Internal Control Weaknesses and to the Characteristics of Those Weaknesses under Section 302 of the Sarbanes Oxley Act of 2002*, 13 REV. ACCT. STUD. 141, 144 (2008). Moreover, the strongest reaction appears to accompany disclosures of internal control weaknesses by smaller firms rather than larger firms. See Messod Daniel Beneish et al., *Internal Control Weaknesses and Information Uncertainty*, 83 ACCT. REV. 665, 666–67 (2008) (finding material weakness disclosures by nonaccelerated filers were accompanied by significant negative

Moreover, there is evidence that the SOX reporting requirements also reduced “financial slack” among complying firms; post-SOX implementation studies report that mandatory filers cut total CEO compensation (most through reductions in stock-based compensation), increased payouts to shareholders, and reduced investment and employment relative to what occurred with comparable non-404 filers.³⁶ After complying with section 404, mandatory filers experienced longer maturities for their debt than was the experience for non-filers.³⁷ Similarly, nonaccelerated filers who voluntarily comply with section 404(b) enjoy lower costs of capital.³⁸

But the benefits of improving the quality and trustworthiness of financial reporting came at a significant cost.³⁹ These costs were greater in the early years of section 404, reflecting not just the “deferred maintenance” that had to be addressed with the SOX-imposed requirements, but also the poor implementation of section 404 by regulators and auditors.⁴⁰ The significant costs all firms incurred in complying with section 404(b) fed the growing disquiet that these costs could have an even greater impact on nonaccelerated filers when they became subject to section 404(b).⁴¹ This fear is built on the fact that financial reporting costs invariably have a significant fixed cost com-

price reductions whereas 404 disclosures for larger filers were not, suggesting that the accelerated filers operate in a richer information environment than do the nonaccelerated filers).

³⁶ See Jun “QJ” Qian et al., *The Economic Benefits of the Sarbanes-Oxley Act? Evidence from a Natural Experiment 1*, 3–4 (Dec. 2009) (unpublished manuscript), available at <http://fic.wharton.upenn.edu/fic/papers/09/0941.pdf>.

³⁷ *Id.* at 4.

³⁸ SEC STAFF 404(B) STUDY, *supra* note 15, at 102.

³⁹ See e.g., CHARLES RIVER ASSOCS., *SARBANES-OXLEY SECTION 404 COSTS AND REMEDIATION OF DEFICIENCIES: ESTIMATES FROM A SAMPLE OF FORTUNE 1000 COMPANIES 2* (2005), <http://www.sec.gov/spotlight/soxcomp/soxcomp-all-attach.pdf> (reporting that firms’ average cost to comply with the internal control requirement, excluding audit fees, was \$5.9 million). Of interest here is the now much discredited SEC estimate of compliance cost averaging \$91,000 per issuer. Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636, 36,657 (June 18, 2003). Internal controls attestation contributes substantially to the audit fees during the first year of compliance, but on a declining basis. See R. Mithu Dey & Mary W. Sullivan, *Section 404 Audit Costs for Small Companies: The Benefit of Waiting* 8, 22 (April 16, 2009) (unpublished manuscript), <https://ritdml.rit.edu/bitstream/handle/1850/10522/MDeyConfProc04-16-2009.pdf?sequence=5> (noting the median cost of internal control assessment for previously nonaccelerated filers represented forty-two percent of total audit fees in 2006 and declined modestly to thirty-seven percent in 2007 with the introduction of Auditing Standard No. 5).

⁴⁰ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 13, at 18, 20–21. Or, stated more diplomatically, “[t]he decline in costs suggests that issuers and auditors are adapting to Section 404 and becoming more efficient at implementing and assessing” internal controls. SEC STAFF 404(B) STUDY, *supra* note 15, at 87–88.

⁴¹ See U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 13, at 5–6.

ponent that is not scaled to a firm's size.⁴² Early data among firms voluntarily complying with section 404(b) underscore the reality that regulation, and particularly financial reporting requirements, invariably have a disproportionate impact on smaller companies due to their substantial fixed cost component. For example, median audit fees in 2003 and 2004 for companies that implemented internal control reports were 1.14% of reported revenues for nonaccelerated filers but 0.13% of reported revenues for firms with a market capitalization greater than \$1 billion.⁴³ Note this is nearly a ninefold difference. Nonaccelerated filers who did not provide a report on internal controls had audit fees that were 0.35% *less* than their reporting cohort.⁴⁴ On the other hand, this difference was 0.06% for filers with a market capitalization greater than \$1 billion.⁴⁵ Thus, it was no surprise that while twelve percent of public companies cited the cost of being a reporting company as a reason for deregistering prior to SOX, that percentage jumped to sixty-two percent in 2005.⁴⁶ Interestingly, less than twenty percent of the companies deregistering were listed on either the New York Stock Exchange ("NYSE") or National Association of Securities Dealers Automated Quotations ("NASDAQ"); the largest percentage traded on the Over-The-Counter Bulletin Board (36.9%) or had no formal market (24.8%).⁴⁷

Of special concern for reporting in small companies is that among public companies with a market capitalization of \$125 million or less, the SEC Office of Economic Analysis reports that insiders own an

⁴² See *id.* at 14.

⁴³ *Id.* at 15–16. The study reflects ever-diminishing median costs as a percentage of revenues as company size increases. Cf. *id.* at 38 tbl.4 (reflecting the same relationship between size of revenues and direct IPO expenses). Equally important is that average section 404 compliance costs post-2007 reforms were greater for larger issuers (those with a public float greater than \$250 million) than for smaller issuers (those with a public float of \$75–\$250 million). See SEC STAFF 404(B) STUDY, *supra* note 15, at 53–54 tbl.1.

⁴⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 13, at 16.

⁴⁵ *Id.*

⁴⁶ *Id.* at 22. There is, however, a good deal of evidence that SOX was a rationalization for other reasons for companies going dark. See, e.g., Andras Marosi & Nadia Massoud, *Why Do Firms Go Dark?*, 42 J. FIN. & QUANTITATIVE ANALYSIS 421, 440 (2007) (gathering data that support the conclusion that going dark enables insiders to exploit future information asymmetries to capture the benefits of the firm's future cash flow); Christian Leuz, *Was the Sarbanes-Oxley Act Really this Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 J. ACCT. & ECON. 146, 162 (2007) (finding going-private trends in the United Kingdom equal to those in the United States in the years following SOX). The Leuz study's findings can be understood best in the context that the post-SOX years witnessed not only historically low interest costs but also the heyday of the private equity firms who exploited the low interest rates to leverage their returns.

⁴⁷ *Id.* at 25 fig.3.

average of thirty percent of the company's shares.⁴⁸ To the extent one of the goals of financial reporting is to diminish opportunities for opportunistic behavior by managers versus outside owners, the smaller firm may well be seen as posing greater risks because of the significant interest held by managers. There has long been concern in small companies that their large-block holders can reap rewards at the expense of outside owners through a variety of strategies.⁴⁹ One such strategy is going private. Many have reported that the number of going-private transactions increased following the passage of SOX.⁵⁰ Share prices increased for firms announcing in their section 13(e) filing that they would be going private.⁵¹ This prompted some to reason that the observed increase reflected, at least in part, the cost of being a public firm.⁵² Another interpretation is that part of the price change is the cost of so-called unresolved agency problems between the minority and controlling insiders.⁵³ In effect, the going-private transaction reverses the valuation discounts that were caused by unresolved agency problems.⁵⁴ There is a small but growing body of evidence that heightened reporting requirements post SOX have improved the quality of disclosure and reduced the negative effects of unresolved agency costs. Examples of this work include studies reflecting declines in earnings management⁵⁵ and reductions in the firms' costs of capital.⁵⁶

⁴⁸ *Id.* at 20.

⁴⁹ *See, e.g., id.* (noting that "minority shareholders [in small companies] who are not insiders may have a need for [significant investor SEC] protection").

⁵⁰ *E.g.,* Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON. 116, 143 (2007).

⁵¹ *See id.*

⁵² *See id.* There are other explanations, namely the increase in the number of private equity firms and the availability of low interest loans for such transactions. Moreover, the pattern observed in the U.S. began before SOX was passed and paralleled the trend in Europe. *See* Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 J. ACCT. & ECON. 146, 149 (2007). Professor Leuz makes the point that we need to distinguish going-dark transactions (deregistering but continuing to trade on over-the-counter markets) from going-private transactions (discontinuing trading and becoming a private company); going-dark transactions are really a response to heightened reporting costs, appear to be related to the passage of SOX, and occur among smaller, more distressed, firms with weaker performance and governance than firms going-private. *Id.* at 159. Indeed, the increase in deregistrations post SOX was primarily driven by going-dark rather than going-private transactions. *Id.* at 149.

⁵³ *See* Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 182–83 (2008).

⁵⁴ *See id.* at 205.

⁵⁵ *See e.g.,* Daniel A. Cohen et al., Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods 1–2 (Feb. 2005) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=658782.

C. *Filling the Gap*

The empirical evidence reviewed in the preceding Section documents section 404(b)'s multiple positive impacts on the firm, its owners, and investors generally. This evidence in the face of Congress's rollback of section 404(b) should shake our confidence in informed public policy. Even with overwhelming evidence of the benefits of section 404(b), both Dodd-Frank and the JOBS Act remove this very investor-friendly provision from the mandatory reporting process.⁵⁷ In a regulatory realm of less to no paternalism, the touchstone for securities regulation should nonetheless remain the information needs of investors. As seen in the case of section 404(b), many nonaccelerated filers voluntarily chose to comply with the internal control requirements.⁵⁸ Classic signaling theory suggests that firms subjecting themselves to the burdens of section 404(b) probably, on average, would have lower compliance costs than the firms that chose not to voluntarily submit to an external attestation of their internal controls. Thus, the benefits and costs among complying firms are likely not representative of what we would have expected of firms that stayed outside section 404(b). Therefore, it might be a serious overstatement to credit section 404(b) with the multiple benefits chronicled in the studies reviewed earlier.⁵⁹ Nonetheless, compliance effectively signaled the multiple distinguishing qualities of the firms that chose to voluntarily comply. Regulation would do well to nurture such signaling and the related hierarchy across firms that will arise from their efforts to signal more trustworthy management and reporting systems. As discussed in the final portion of this Article, expanding the audit opinion to state whether the audit client has asked the auditor to attest to management's own assessment of internal controls would highlight for investors those firms that have sought to voluntarily improve the quality of their financial reports. Investors would not overlook this signal. It would be consistent with a broader theme of private ordering, whereby firms not bound by mandatory rules can more clearly communicate management's private self-assurance regarding the trustworthiness of the firm's financial reporting system and resulting financial report.

⁵⁶ See e.g., Hollis Ashbaugh-Skaife et al., *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity*, 47 J. ACCT. RES. 1, 39 (2009).

⁵⁷ See *supra* Part I.A.

⁵⁸ See *supra* note 20 and accompanying text.

⁵⁹ See *supra* Part I.B.

II. AUDITOR TENURE

Professional skepticism is a characteristic of a good auditor. Management prepares financial statements, and it is the managers who bear responsibility for their content.⁶⁰ But auditors add authenticity to financial statements by verifying that they are supported by economic activities summarized in the statements and are reported according to generally accepted accounting principles (“GAAP”).⁶¹ Verifying both the existence of activities reported in the financial statements and compliance with GAAP calls for auditors to probe, test, and otherwise challenge the assertions set forth in management’s statements.⁶² This requires unquestioned independence on the part of the auditor.⁶³ Hence we find the expressions “outside” auditor or “public” accountant.

Over the last few years, multiple developments have made the auditor more independent. The NYSE and NASDAQ listing requirements mandate not only that listed companies have audit committees, but also that the committee be comprised of non-management directors.⁶⁴ SOX requires that the auditor’s selection, renewal, and termination must be made by the audit committee, not by the executive officers or, for that matter, the board of directors.⁶⁵ SOX also prohibits the auditor from providing an extensive range of nonaudit services, which avoids compromising the auditor’s sought-for skepticism with lucrative consulting work.⁶⁶ Nonetheless, there continues to be repeated instances of failed audits that are best explained by a lack of professional skepticism.⁶⁷

Auditor failure can be due to multiple contributing forces. Audit committee members, the auditor’s statutory bosses,⁶⁸ are themselves

⁶⁰ *Understanding the Auditor’s Report*, *supra* note 1.

⁶¹ *Id.*

⁶² *See id.*

⁶³ *See id.*

⁶⁴ NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL §§ 303A.06–07 (2012), available at <http://nysemanual.nyse.com/lcm/>; NASDAQ, EQUITY RULES § 5605 (2012), available at <http://nasdaq.cchwallstreet.com/NASDAQ/Main/>.

⁶⁵ Sarbanes-Oxley Act of 2002 § 301, Pub. L. No. 107-204, 116 Stat. 745, 776.

⁶⁶ *Id.* § 201, 116 Stat. at 771.

⁶⁷ *See, e.g.*, ERNST & YOUNG LLP, PCAOB RELEASE NO. 105-2012-001 (Feb. 8, 2012), http://pcaobus.org/Enforcement/Decisions/Documents/Ernst_Young.pdf (finding that auditors, inter alia, accepted managers’ assumptions about likely returns despite contradictory information).

⁶⁸ Sarbanes-Oxley Act of 2002 § 205, 116 Stat. at 773 (defining “audit committee” as bodies “established . . . for the purpose of overseeing the . . . audits of the financial statements of the issuer”).

time and information bound. Although the audit committee agenda is full, and its members' briefing books bulge, the committee's members are dependent on the candor of the auditor to identify areas of concern. Thus, the audit committee, charged with overseeing the auditor, is in turn dependent on the auditor. If there is a breakdown with the auditor, then there most certainly will be a breakdown with the audit committee. Likewise, any forces that compromise the auditor will necessarily compromise the audit committee's oversight of both the auditor and the financial reporting process.

Auditor tenure can be a conflicting force. An auditor-client relationship that has a life of ten years is likely to have less of a pull on the auditor than one believed to be in perpetuity. With a term relationship, the value of the relationship declines with each successive year; with a perpetual relationship, it never declines. Moreover, with the term relationship, the auditor is aware that another auditing firm will someday, perhaps soon, be retained and the new auditor can be expected to eagerly probe for lapses committed by the competitor who preceded it. Thus, we might expect outgoing auditors to be as diligent as the newly retained auditor. In the end, professional skepticism, the linchpin for a good audit, is strengthened by imposing limits on auditor tenure.

On average, the tenure of auditors is fairly stable among large public firms. One study reports that among Fortune 1000 firms, fifty-nine percent of the firms have had the same auditor for over ten years (thirty-seven percent have had the same auditor for over twenty years).⁶⁹ Despite these statistics, auditors do change, albeit among smaller firms, with some regularity. In the year following the disappearance of Big Five accounting firm Arthur Andersen, 2,304 companies changed auditors, representing 18.3% of registered public companies.⁷⁰ A more normal experience was the 11.3% and 10.5% changes in 2005 and 2006, respectively.⁷¹ Roughly half of all public companies changed their auditors in the five-year 2002–2006 time period.⁷² The irony of these statistics is that changes occur more fre-

⁶⁹ Kate Iannelli, *Mandatory Audit Firm Rotation: Explaining the Key Numbers*, NACD DIRECTORSHIP (Mar. 22, 2012), <http://www.directorship.com/mandatory-audit-firm-rotation-explaining-the-key-numbers>.

⁷⁰ See Mark Grothe & Thomas R. Weirich, *Analyzing Auditor Changes: Lack of Disclosure Hinders Accountability to Investors*, CPA J. (Dec. 2007), <http://www.nysscpa.org/cpajournal/2007/1207/infocus/p14.htm>.

⁷¹ *Id.*

⁷² *Id.*

quently for small than large firms;⁷³ despite the fact that among small firms the audit fees and the burdens of switching auditors are disproportionately larger.⁷⁴

Identifying the costs and benefits in this area is challenging. Auditor stability may well mean more than a quiet life for the auditor; there is the broadly held view that the lengthy tenure equates to lower auditor costs.⁷⁵ However, reporting companies must change audit engagement partners every five years.⁷⁶ With a new engagement partner unfamiliar with the intricacies of the audit client's operations and reporting systems, there is every reason to believe there are non-trivial costs associated with the current legal requirement that engagement partners be switched periodically. We might therefore conclude that this requirement could be relaxed if reporting companies were required to change audit firms periodically. Thus, the marginal cost of changing firms would be offset to some extent by the costs related to the current regime where audit engagement partners are switched. And how do you classify the fact that companies that switched auditors in 2006 had nearly triple the number of restatements as firms that did not change auditors?⁷⁷ To the extent that auditor rotation leads to greater accuracy and hence trustworthiness of the firm's financial reporting, the result of changing auditing firms should be counted, not as a cost of the change, but a measureable benefit in reducing the firm's cost of capital. Indeed, studies do reflect that a new audit firm

⁷³ *Id.* (companies with a market capitalization of less than \$75 million change auditors at a rate of sixty-three percent whereas companies with a market capitalization of at least \$2.5 billion change auditors at a rate of eight percent).

⁷⁴ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 13, at 46–47.

⁷⁵ See Letter from Robert B. Lamm, Soc'y of Corporate Secretaries & Governance Prof'ls, Response to PCAOB Rulemaking Docket Matter No. 37, to the Pub. Co. Accounting Oversight Bd. 4 (Dec. 13, 2011), *available at* http://main.governanceprofessionals.org/GOVERNANCEPROFESSIONALS/Member_Resources/Resources/ViewDocument/?DocumentKey=c5acc6d7-acc6-4b0d-9ce2-b4870c4a44dd (citing to survey of corporate secretaries where seventy percent of members estimate initial audit year costs would be 20 percent higher if mandatory rotation of auditors was required). Kate Iannelli, *supra* note 69 (“Data from Audit Analytics suggests these increased costs aren't isolated to the first year of an engagement: in both the Russell 1000 and the Russell 2000 companies with auditor tenure of five years or less paid substantially more in audit fees . . . than companies with longer tenure.”).

⁷⁶ Sarbanes-Oxley Act of 2002 § 203, Pub. L. No. 107-204, 116 Stat. 745, 773.

⁷⁷ Grothe & Weirich, *supra* note 70 (reporting that twenty-seven percent of the companies changing auditors in 2006 restated earnings within one year of the switch compared to ten percent of the companies not switching auditors). Another questionable cost is that sixty-nine percent of the firms changing auditors in 2006 were late in filing at least one SEC quarterly or annual report versus twenty-seven percent of all public companies. *Id.*

enhances audit quality and, hence, the trustworthiness of financial reports.⁷⁸

An independent audit committee's self-policing will not naturally lead to a practice of periodic rotation of auditing firms. In this connection, consider the research findings that upon undergoing a restatement it is one-and-a-half times more likely that a non-Big Four accounting firm will be terminated than if the need for the restatement is attributed to a Big Four accounting firm.⁷⁹ There are multiple explanations for why small audit firms are more likely to be terminated when a restatement flows from practices that occurred on the small audit firm's watch. First, small audit firms are most likely the auditors of smaller, less complex firms.⁸⁰ Hence, a small firm's absolute cost of switching auditors is not nearly as great as is the costs for the large client of a Big Four firm; albeit, as noted earlier, the costs relative to assets, revenues, and earnings are more significant than for a much larger issuer.⁸¹ Second, changing auditors after a restatement is associated with a favorable bounce in their cost of capital.⁸² The market's favorable reaction reflects the awareness that small firms generally have a weaker control environment such that a fresh set of eyes is more of a positive effect than in the more stable controls environment of larger firms. Third, Big Four audit firms already confer a halo on the audit client, so that shifting from one high reputation auditing firm to another is not likely to produce the same favorable impact on the firm's cost of capital as with the smaller firm shifting from

⁷⁸ See e.g., Ron Lazer et al., *Restatements and Accruals after Auditor Changes* 22–23 (Feb. 2004) (unpublished manuscript), <http://people.stern.nyu.edu/jlivnat/auditor.pdf> (finding that firms experiencing auditor changes in 1988–2002 reported significantly higher incidence and magnitude of quarterly restatements than firms that did not change auditors); Li Z. Brooks et al., *Audit Firm Tenure and Audit Quality: Evidence from U.S. Firms* 28 (Apr. 10, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2037659 (finding audit quality begins to degrade around twelve years so that the optimal tenure would be ten to fourteen years). Consider here, as well, the finding that, for firms that have terminated their auditors but the auditor continues to wrap up the ongoing audit, there are statistically smaller discretionary accruals than occur with non-lame-duck auditors. See Cory A. Cassell et al., *The Effect of Lame Duck Auditors on Management Discretion: An Empirical Analysis* 25 (Apr. 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1957323.

⁷⁹ See Karen M. Hennes et al., *Auditor Dismissals after Accounting Restatements* 20, tbl.4 (July 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1735675> (examining 2,101 restatements in the 1997–2006 period).

⁸⁰ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 13, at 48–50 (noting that, in 2004, mid-sized and small accounting firms audited only three percent of companies with revenues greater than \$500 million).

⁸¹ See *id.* at 46–47.

⁸² Hennes et al., *supra* note 79, at 29–30.

a non-Big Four accounting firm, which is seen as the board's commitment to improve financial reporting.⁸³

There is little doubt that the Public Company Accounting Oversight Board (PCAOB) enjoys the authority to mandate auditor rotation.⁸⁴ Created by SOX, the PCAOB enjoys broad authority over the professional standards governing auditors of reporting companies.⁸⁵ As seen earlier, professional skepticism is the bedrock of auditor independence; all standards guiding auditors rest upon the fundamental principle that the auditor is independent of its audit client.⁸⁶ This conclusion is dramatically underscored in the historic Dodd-Frank Act which amended SOX § 103 to expressly provide that professional standards include "independence standards."⁸⁷ The PCAOB is currently considering auditor rotation.⁸⁸ There are several possible courses of action it may take. One, of course, is to do nothing. The evidence collected above challenges such inaction. At the other end of the spectrum of choices is to mandate periodic auditor rotation.⁸⁹ A variance on this proposal is to require reporting companies to periodically place their audits up for competitive bidding, and allow the current auditor to bid against competitors.⁹⁰ Complementing this approach could be company disclosure requirements explaining its ultimate choice of auditors. A further approach is to view auditor rotation as part of the sanction imposed whenever the PCAOB discovers substantive violations of auditing standards. That is, upon finding a serious departure from auditing standards, particularly any failure of professional scrutiny, the PCAOB can require the auditor to cease

⁸³ *Id.* at 32.

⁸⁴ See Sarbanes-Oxley Act of 2002 § 203, Pub. L. No. 107-204, 116 Stat. 745, 773.

⁸⁵ *Id.* § 101, 116 Stat. at 750.

⁸⁶ See *supra* Part II.

⁸⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 982(a), (d), 124 Stat. 1376, 1927–31 (codified at 15 U.S.C. §§ 7220(5)(B), 7213(a) (2006)) (amending Sarbanes-Oxley Act § 110(5)(B) to add independence standards to the definition of "Professional Standards" and § 103(a) to include independence in auditing standards). Moreover, the recently enacted Jumpstart Our Business Startups Act (JOBS Act) further supports the presence of the authority to mandate auditor rotation; the JOBS Act expressly provides that "emerging growth companies" are immune for as long as five years from any requirement of mandatory audit rotation. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, § 104, 126 Stat. 306, 310 (to be codified at 15 U.S.C. 7213(a)(3)).

⁸⁸ See Pub. Co. Accounting Oversight Bd., Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Rulemaking Docket Matter No. 37, at 17 (Aug. 16, 2011), http://pcaobus.org/rules/rulemaking/docket037/release_2011-006.pdf.

⁸⁹ *Id.*

⁹⁰ *Id.* at 19.

work for a firm with whom it has had a long-term relationship.⁹¹ Finally, the PCAOB could use the auditor's tenure with a client as one of the heuristics to identify audit firms to inspect, and the particular audits to review. Indeed, auditor tenure can easily be seen as one of many risk factors to consider in any ex ante consideration of where an audit failure is likely to exist.⁹²

If the contemporary political climate, which has a marked reserve regarding the benefits of regulation, discourages mandatory audit rotation for reporting companies,⁹³ there is a further approach. The audit opinion letter may be required to disclose the length of time that the auditor has audited the firm's statements. This approach will be discussed further in the final portions of the Article.

III. CRITICAL ESTIMATES, JUDGMENTS, AND ASSUMPTIONS

The SEC's rules, as well as the listing requirements of the NYSE and NASDAQ, impose a dialogue between the audit committee and the outside accountants for the purpose of eliciting any warning signs in the reporting system or management's disclosure policies and practices. The auditor is to report, among other factors, on material issues that have surfaced in its assessment of the firm's internal controls and any discussions it has had with management regarding the firm's internal controls.⁹⁴ The auditors must also share with the audit committee written communications it has had with management regarding "critical" accounting decisions as well as identifying "critical" areas of the financial reports where an accounting estimate or principle change would affect the quality of the presentation.⁹⁵ The listing requirements also mandate a discussion between management and the audit committee covering a range of topics, including a review of the quar-

⁹¹ This approach likely would require legislation to expressly authorize the PCAOB to include this sanction among the remedies it might impose.

⁹² See, e.g., Joseph V. Carcello & Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 AUDITING: J. PRAC. & THEORY 55, 56 (2004) (citing a study's conclusion that audit quality is lower given longer auditor tenure).

⁹³ See ERNST & YOUNG, RESPONDENTS TO PCAOB OVERWHELMINGLY OPPOSE MANDATORY AUDIT FIRM ROTATION 2 (2012), [http://www.ey.com/Publication/vwLUAssets/TechnicalLine_BB2256_AuditFirmRotation_5January2012/\\$FILE/TechnicalLine_BB2256_AuditFirmRotation_5January2012.pdf](http://www.ey.com/Publication/vwLUAssets/TechnicalLine_BB2256_AuditFirmRotation_5January2012/$FILE/TechnicalLine_BB2256_AuditFirmRotation_5January2012.pdf) (reporting that ninety-four percent of the 595 letters sent to PCAOB in response to its concept release opposed mandatory audit firm rotation).

⁹⁴ E.g., 15 U.S.C. § 78j-1(k) (2006); 17 C.F.R. § 210.2-07 (2012); NEW YORK STOCK EXCHANGE, *supra* note 64, § 303A.07(b)(iii)(A).

⁹⁵ See 17 C.F.R. § 210.2-07.

terly and annual reports, earnings press releases, and earnings guidance given to analysts.⁹⁶

There can be little doubt that the conversations the auditor is required to have with the audit committee would be extremely useful to financial statement users. Accounting is more art than science, so that interpreting their message relies heavily on an understanding of the full array of assumptions, estimates, and judgments management has made in preparing the financial statements. Even more important is to understand which of the various assumptions, estimates, or judgments, if changed slightly, would produce a material effect on the firm's reported performance or financial position. This is the very disclosure that the auditor is to make and discuss with the audit committee with respect to identifying "critical" accounting decisions.⁹⁷ Because this information is already at hand—SEC rules and listing requirements mandate the auditor provide this information to the audit committee⁹⁸—there is no new cost associated with producing this information to share with the investors. However, there are indefinite costs associated with increased transparency, such as fear of liability, jeopardizing the auditor's and audit committee members' relationship with management, and uncertainty about whether such disclosure introduces more volatility in the firm's securities.

Fear of liability resulting from additional disclosures related to critical choices made in preparing the financial statements is likely overblown. Judgment errors in identifying critical choices are not a basis for fraud, unless identifying the critical accounting assumptions, estimates, and judgments were either baseless, so as to be a knowing falsehood, or arrived at with such careless disregard to constitute recklessness.⁹⁹ It is difficult to imagine either result being viable in the context of the auditor publicizing the insights currently required to be shared with the audit committee. Furthermore, it is not an unreasona-

⁹⁶ See e.g., NEW YORK STOCK EXCHANGE, *supra* note 64, § 303A.07(b)(iii)(B)–(C).

⁹⁷ See 17 C.F.R. § 210.2-07.

⁹⁸ See *supra* notes 94–96 and accompanying text; see also Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6006 (Feb. 5, 2003) (reviewing considerations to assure auditor independence and the role of audit committee).

⁹⁹ See, e.g., *N.M. State Inv. Council v. Ernst & Young*, 641 F.3d 1089, 1096–99 (9th Cir. 2011) (finding that reliance only on bald management assertions, despite repeated efforts by auditors regarding the grant date of options subsequently found to be purposely backdated, met strong inference pleading requirement for reckless disregard); *Stratte-McClure v. Morgan Stanley*, 784 F. Supp. 2d 373, 388–89 (S.D.N.Y. 2011) (finding failure to mark down subprime swap position in the face of distinct warning signs of market's deterioration met the standard for pleading recklessness); see also *Frank v. Dana Corp.*, 646 F.3d 954, 961–63 (6th Cir. 2011) (illustrating recklessness standard in the context of forward-looking statements).

ble stretch to deem the additional disclosure a forward-looking statement, because it is speaking of how future activities will produce dramatically different consequences if not consistent with management's set of assumptions, judgments, and estimates.¹⁰⁰ In any case, the statements could be defined by the SEC to be a forward-looking statement, thereby protected by the statutory safe harbor provision for forward-looking statements and actionable only if made with knowledge of their falsity.¹⁰¹

The combined efforts of the auditor and audit committee shining a brighter light on management's decisions in preparing the financial statements introduces greater tension into their relationships with management. The financial statements, after all, are management's report card, and it is a card completed by management.¹⁰² Because of the conflicts inherent in this self-reporting system, independent auditors, audit committees, independent directors on audit committees, and the mandated dialogue between the auditor and audit committee in combination provide a buffer to management's self-interested reporting.¹⁰³ Under the current approach, directors are better able to penetrate the financial reports to assess management's stewardship than before mandated independent audit committees and the related dialogue. But the current procedures do not entail sharing these internal assessments with investors; it only arms those within the corporation with this important information. Nonetheless, the auditor's and audit committee's greater independence fostered by the preceding developments has already sharpened the edge in their relationship with management. More dramatically yet, the auditor depends on the audit committee for selection and retention,¹⁰⁴ not on management.

¹⁰⁰ See *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 403 F.3d 1050, 1056–57 (9th Cir. 2005) (examining the difficulty of distinguishing representations of historical fact from forward-looking statements); *Graham v. Taylor Capital Grp.*, 135 F. Supp. 2d 480, 504–05 (D. Del. 2001) (finding that misstatements as to loan loss reserve were historical facts beyond the reach of the bespeaks-caution doctrine that applies to forward-looking statements, but statements about current financial position were forward-looking statement and thereby subject to protection by meaningful cautionary language).

¹⁰¹ See 15 U.S.C. § 78u-5(c) (2006) (explaining the safe harbor provision); *id.* § 78u-5(i)(1)(D), (F) (defining forward-looking statement to include “assumptions underlying or related to any” forward statement and authorizing the SEC to expand the definition through rulemaking).

¹⁰² See *Understanding the Auditor's Report*, *supra* note 1.

¹⁰³ See Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6007 (describing the “key aspects of auditor independence” targeted by Sarbanes-Oxley and rules enacted pursuant to the Act).

¹⁰⁴ Sarbanes-Oxley Act of 2002 § 205, Pub. L. No. 107-204, 116 Stat. 745, 773 (defining “audit committee” as responsible for auditor oversight).

Claims that reforms will drive a wedge between management and the auditor or audit committee therefore appear misplaced; the current regulatory regime embraces such a separation. Indeed, professional skepticism, discussed earlier, is enhanced by greater separation.

The classic argument against new disclosure requirements is that the cost to produce the information is greater than the expected benefits.¹⁰⁵ In the case of disclosing management's critical accounting choices, there is no new cost to produce the information since SEC rules and listing requirements require this information to be produced for the audit committee.¹⁰⁶ Any additional burden involves collateral costs associated with greater transparency. For some firms, perhaps all firms, heightened transparency resulting from disclosure of critical accounting assumptions, estimates, and judgments will introduce greater volatility in the firm's share prices.¹⁰⁷ Whether volatility increases depends directly on both the nature of the critical accounting choices and how the firm's operating environment impacts the results of those choices.¹⁰⁸ If this is indeed the case, then increased transparency through financial reporting would appear to enhance the efficient pricing of the firm's shares among investors.

The true challenge in publicizing information regarding management's critical accounting choices is how to operationalize the disclosure requirement. At one point, the SEC proposed mandating disclosure of critical accounting assumptions, estimates, and judgments as part of the Management Discussion Analysis's required disclosure of critical accounting *policies*.¹⁰⁹ The proposal never was acted upon. Instead, the SEC issued interpretative guidance on the disclosures that should be made in the context of discussing the firm's accounting policies.¹¹⁰ The guidance calls for issuers to disclose estimates and assumptions when the impact of the estimate or as-

¹⁰⁵ See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1595–96 (2005) (arguing that optional compliance would allow firms to opt out if the regulation is not cost-effective).

¹⁰⁶ See Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6006.

¹⁰⁷ Cf. Hammersley, Myers & Shakespeare, *supra* note 35 (examining the stock price reaction to management disclosure of internal control weaknesses).

¹⁰⁸ Cf. Beneish et al., *supra* note 35, at 666–67 (finding that the size of the disclosing firm affects the strength of the market reaction to material weakness disclosures); Hammersley, Myers & Shakespeare, *supra* note 35, at 144 (finding evidence that market reaction to disclosure of internal control weaknesses “varies with the severity of the internal control weakness”).

¹⁰⁹ See Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, 67 Fed. Reg. 35,620, 35,620 (May 20, 2002).

¹¹⁰ Mark P. Holtzman, *Reporting Critical Accounting Policies*, CPA J., Dec. 2007, at 42.

sumption on financial condition or operating performance is material.¹¹¹ Unfortunately, reviews of registrants' SEC filings document a spotty record for compliance with the interpretation, so that this information is largely lacking from the financial reporting process.¹¹²

One obvious approach is for the SEC to return to the subject and make its interpretive guidance mandatory. This approach places responsibility solely with management. This would be a good start; but the uneven record of compliance with the disclosures mandated for the Management Discussion and Analysis ("MD&A") suggests that too many company managers fail to comply with compelled MD&A disclosures.¹¹³ Thus, another approach would be to require auditors to include in their audit opinion, or some document collateral to the audit opinion, what the auditor believes are the critical assumptions, estimates, and judgments that underlie the financial statements. It is not likely this approach would be successful beyond eliciting boilerplate, and milquetoast boilerplate at that. That is, it is unlikely that auditors will engage in any free writing regarding management's critical accounting assumptions, judgments, and estimates. Indeed, requiring audit firms to duplicate the information shared with the audit committee in a public document signed by the audit firm would likely reduce whatever candor exists today between the auditor and the audit committee with respect to the quality of the financial reports. The auditor's reticence, notwithstanding complete independence from management, may well be a cultural hangover of focusing on factual presentations and not judgments regarding the quality of reporting standards. To the extent the auditor's reticence already compromises the requirements to discuss with the audit committee critical accounting assumptions, estimates, and judgments, it would likely be exacerbated if coupled with a requirement that this information also be more public.

However, we may accomplish more by requiring the auditor to only indirectly speak to the content of a firm's assumptions, estimates, and judgments. This may well be an area where lack of specificity could accomplish a good deal. The auditor could be asked to simply address, directly, two questions: (1) has the auditor reviewed the

¹¹¹ See Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, 68 Fed. Reg. 75,056, 75,057 (Dec. 29, 2003).

¹¹² See, e.g., Holtzman, *supra* note 110, at 43.

¹¹³ See, e.g., CHERYL DE MESA GRAZIANO & MARK P. HOLTZMAN, FIN. EXECS. RESEARCH FOUND., CURRENT FINANCIAL REPORTING TRENDS: A QUALITATIVE REVIEW OF SEC COMMENT LETTERS 1 (2006) (reviewing multiple SEC letters emphasizing deficiencies in describing critical accounting assumptions, estimates, and judgments committed by SEC registrants).

MD&A disclosures generally, and in particular, has the auditor reviewed management's description of critical accounting assumptions, estimates, and judgments; and (2) whether the auditor's opinion of the critical assumptions, estimates, and judgment discussed with the audit committee was materially different from that set forth in the MD&A. This approach would create a dynamic interaction between management and the auditors regarding the content of management's MD&A disclosures. Whether this process leads to better transparency then depends on the relative independence of the auditor, which itself rests on the performance and independence of the audit committee.

IV. REPORTING SIGNS OF FINANCIAL DISTRESS

Among the conventions that form the bedrock of GAAP is the going-concern assumption, whereby the firm is assumed to have a perpetual life.¹¹⁴ If the firm's life appears less than perpetual, the financial statement's method of measuring assets and matching revenues and expenses should be altered. For example, per accounting, an asset is nothing less than a current expenditure awaiting assignment as an expense to a future period. Thus, a building purchased for \$1 million, with a twenty-year life and no salvage value, is properly recorded as a \$1 million asset whose cost will be assigned as depreciation in each of the next twenty years. If, after three years, it appears that the firm will fail, so that the twenty-year life is no longer valid, new estimates are in order regarding the firm and building's future. For example, if the firm's financial problems pose a substantial likelihood it may have to sell the building for \$400,000, despite having an underappreciated balance of \$850,000, the firm would be required to recognize a loss of \$450,000. Absent the firm's failure, the building could otherwise be reflected as an asset at the much higher level, reduced by yearly assignments of its costs as a depreciation expense for the fiscal period. Thus, assumptions regarding whether the firm will continue as a going concern matter a good deal in accounting for assets and expenses.

Section 10A of the Securities Exchange Act requires that each audit of a reporting company must include "an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year."¹¹⁵ Currently, auditing

¹¹⁴ *Understanding the Auditor's Report*, *supra* note 1.

¹¹⁵ 15 U.S.C. § 78j-1(a)(3) (2006). This requirement is reflected in Interim Auditing Standard 341, Public Company Accounting Oversight Board, AU § 341 (2003), *available at* <http://pcaobus.org/Standards/Auditing/Pages/AU341.aspx>. Substantial doubt is not defined in either the Exchange Act or the implementing auditing standard.

standards do not require the auditor to: (1) gain information from management of the reasons their statements assume a going concern; (2) design the audit to assess the likelihood that the firm will continue as a going concern; (3) discuss with the audit committee anything regarding the firm's continuance as a going concern; or (4) express an opinion regarding whether there is substantial doubt regarding the going-concern assumption. Thus, we have a very incomplete mosaic on one of the most important assumptions that underlie all the firm's financial statements. The lacunae in prevailing auditing standards may well explain the poor record audit opinions enjoy in alerting investors of the firm's ongoing financial distress. Data reveal that during the ten-year period from 2000 to 2009 auditors failed to qualify their opinion on the going-concern basis in close to one half of the instances in which reported companies failed within one year of the financial statement date.¹¹⁶ We might also wonder whether auditors shy away from raising these issues in part because of a lack of professional skepticism, as discussed earlier in Part II.¹¹⁷

There is ample evidence that there are tools at hand, namely financial ratio analyses based on accounting statements, that are reasonably reliable predictors of financial distress.¹¹⁸ Because corporate failure is the culmination of successive years of adverse performance, observing deterioration of such ratios over time is an important warning sign to the auditor. To be sure, there is always the fear of a false positive, i.e., forecasting bankruptcy that does not occur. However, as seen above, the record today indicates false negatives are more common; failing to alert investors that the firm is subject to financial distress. Moreover, the fears of a self-fulfilling prophecy can be muted if the auditor's obligation is either to raise her concerns with the audit committee or to memorialize discussion of ratio deterioration that historically measures financial distress in the audit opinion itself.

¹¹⁶ Elizabeth Carson et al., Auditor Reporting on Going-Concern Uncertainty: A Research Synthesis 43 tbl.3 (Jan. 30, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2000496.

¹¹⁷ Carson et al., however, did find that auditor performance in issuing going-concern qualifications improved in the post-SOX era, supporting the view that improved auditor independence, one of the multiple contributions of SOX, improves audit quality. *Id.* at 37, 43 tbl.3.

¹¹⁸ Vineet Agarwal & Richard Taffler, *Comparing the Performance of Market-Based and Accounting-Based Bankruptcy Prediction Models*, 32 J. BANKING & FIN. 1541, 1550 (2008); Warren Miller, *Comparing Models of Corporate Bankruptcy Prediction: Distance to Default vs. Z-Score 10* (July 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1461704>.

There is the view that the various models for measuring financial distress are based on information readily available to third parties.¹¹⁹ As such, as long as the financial statements set forth the facts, investors and other financial statement users can interpret the data using the models of their choice and draw what conclusions they can regarding the firm's financial stability. The problem with this analysis is that accounting data are riddled with assumptions, judgments, and estimates, most of which are not transparent. Moreover, there is always the concern among outsiders that management uses these choices opportunistically to conceal failure signals.¹²⁰ The auditor has a more privileged view, being in a better position to identify the critical assumptions, judgments, and estimates by which a solvency determination is affected. Of all possible parties, the auditor is best situated to assess if there is substantial doubt as to whether the firm can continue as a going concern. This is particularly true for the smallcap issuers that are not followed by analysts or for which there is less third-party research analysis. In that context, providing some insight about the firm's status as a going concern would be most welcome information. Such disclosure could, like others reviewed above, occur through the auditor's opinion.

CONCLUSION: STEPPING AWAY FROM THE BINARY OPINION LETTER

Currently, the auditor's opinion letter is an up-or-down letter; the client receives either a clean opinion or a qualified opinion. There is no middle option between these two. The latter is so rare as to breed near financial calamity for the firm when received by its auditor. More importantly, the audit opinion conveys nothing on the important four above-reviewed topics. It is remarkable that financial reporting standards produce such limited message content ultimately delivered by the neutral referee in the reporting process.

I have developed elsewhere why the objectives of securities regulation are better served by uniform, rather than multiple disclosure practices across all issuers in the host market.¹²¹ The ideal of uniform disclosure across all participants, however, is invariably compromised

¹¹⁹ Thus, Miller discusses the bankruptcy prediction model used by the investor-advisor, Morningstar, Inc. Miller, *supra* note 118, at 1.

¹²⁰ See, e.g., Appiah Kingsley Opoku, *Predicting Corporate Failure and Global Financial Crisis: Theory and Implications*, 7 J. MODERN ACCT. & AUDITING 38, 44 (2011).

¹²¹ James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year Old SEC*, 95 VA. L. REV. 941, 951, 964–67, 978–87 (2009) (arguing that goals such as the efficient allocation of capital among competing investment choices, deterring fraud, and curbing managerial opportunism are eroded when issuers follow different disclosure standards within the host

by a host of political considerations that introduce varying requirements. Thus, in the real world disparate, not uniform, disclosure practices rule the day. In such a realm the role of the regulator is not to retire like the Maytag repairman; the role of the regulator is to wrap thoughtful regulatory responses around the practices in the marketplace. A leading edge to this response is for regulatory requirements to highlight differences that persist in disclosure practices followed by issuers.

Thus, as reviewed earlier, many nonaccelerated issuers voluntarily complied with the auditor attestation of management's assessment of internal controls when section 404(b) applied only to accelerated filers. In light of the multiple benefits many issuers derive from compliance with section 404(b), we can expect that many issuers will voluntarily comply with section 404(b) notwithstanding dispensations from the requirement introduced by Dodd-Frank and the JOBS Act. Since internal controls are so fundamental to the auditor's evaluation of whether the financial statements were prepared in accordance with GAAP, audit opinions for clients who have voluntarily subjected themselves to the section 404(b) assessment can be seen as more trustworthy and valuable to investors than audit opinions where the auditor's evaluation of internal controls was less complete. This consideration alone should justify amending the standard audit opinion to underscore this factor. Indeed, the data reviewed support going further: a reporting system for which there has been no independent internal control assessment is less reliable than one for which there has been. Hence, all audit opinions should affirmatively state whether the auditor was engaged and did carry out an assessment of the firm's internal controls consistent with Auditing Standard ("AS") No. 5, the governing audit procedure for evaluating management's assessment of the firm's internal control.¹²² In this way, differences between firms undertaking the section 404(b) review, whether required or doing so voluntarily, would be readily distinguished from firms not undertaking such an independent review.

In other areas of the law,¹²³ disclosure is the first line of defense to a potentially compromising relationship. The source of the malaise

market, even when markets can efficiently price the uncertainty posed by firms using the weaker disclosure standard).

¹²² For a close review of the content of AS No. 5, see Order Approving Proposed Auditing Standard No. 5, 72 Fed. Reg. 42,141, 42,141 (July 27, 2007) (approving the PCAOB's new standard for auditor's review of management's assessment of internal controls).

¹²³ See generally 2 JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS §§ 10.11–10.17, 11.8–11.10 (3d ed. 2010).

regarding the auditor's lengthy tenure is that the value of the relationship to the auditor compromises its professional skepticism. To be sure, this information can be derived, with some effort, from historical SEC filings. Nonetheless, the impact of such information is far more likely to be felt if set forth in the ultimate product, and a public product of that, of the relationship: the audit opinion itself. It is just as relevant to investors to understand that the same audit firm has been the firm's auditor for twenty years as it is to learn that this is the auditor's first year as the firm's outside auditor. As seen from the above data, each have substantial information value to those relying on the audited financial statements. Thus a brief statement of the history of the auditor's relationship with the firm would provide useful information to third parties and entail no significant additional costs to the issuer.

Finally, the audit opinion should be altered to encourage greater transparency with respect to the critical assumptions, estimates and judgments that underlie management's financial statements. As seen earlier, this objective can best be achieved by facilitating a more forthcoming conversation between the auditor and management. This dynamic would occur if the auditor opinion letter required the auditor to state (1) that the auditor has reviewed the MD&A disclosures generally, and in particular, the auditor reviewed management's description of critical accounting assumptions, estimates and judgments and (2) whether the auditor's opinions about critical assumptions, estimates, and judgments discussed with the audit committee were materially different from that set forth in the MD&A. Similarly, the auditor should briefly set forth what tests it performed to satisfy itself that there was no substantial uncertainty in applying to the firm the going-concern assumption.

The above suggestions are modest steps. Certainly the more robust response would be for the PCAOB to require mandatory rotation of auditors and the SEC to explicitly require greater detail in the MD&A regarding not only the critical accounting assumptions, estimates, and judgments but also management and in some detail management's going-concern judgments. Because the Congress has acted to remove auditor attestations of management's internal control assessment it would be difficult for the PCAOB to confront directly the gap that Congress has created in the financial reporting process. Nonetheless, the disclosures suggested can easily be justified as complementing the contemporary standards with respect to each of the

four areas discussed in this Article. The expanded audit opinion would thereby shine a light on areas where regulation has not yet caught up to the needs of financial statement users.