

## **Audit Partner Accountability and Audit Transparency: Partner Signature or Disclosure Requirement**

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*In 2011, the Public Company Accounting Oversight Board issued for public comment proposed amendments to auditing standards that would require the engagement partner's name to be disclosed in the audit report. Re-proposal of this rule is included on the Office of Chief Auditor's agenda for late 2013 or early 2014. This paper focuses on the general rationales provided for requiring either disclosure of the audit partner's name or the audit partner signature in the audit report, identifies the major concerns raised by commenters, and discusses some relevant recent research.*

### **INTRODUCTION**

In 2011, the Public Company Accounting Oversight Board (“PCAOB” or the “Board”), proposed an amendment to the auditing standards to require disclosure of the audit engagement partner’s name in the audit report (PCAOB, 2011).<sup>1</sup> In September 2013, the proposed amendment was included on the Office of Chief Auditor’s standards-setting agenda with re-proposal suggested for late 2013 or early 2014 (PCAOB, 2013a). The disclosure proposal represents the most recent iteration of a PCAOB standards-setting project that began in 2009 with a concept release focusing primarily on requiring an engagement partner’s signature in the audit report in addition to that of the audit firm (PCAOB, 2009). While this project has been delayed by other standards-setting initiatives, there appears to be continued support for the disclosure proposal among financial statement users groups and in Office of the Chief Auditor.<sup>2</sup> In addition, there may be increased momentum for adopting an engagement partner disclosure rule in the United States due to the recent issuance of an exposure draft on international audit reporting standards by the International Auditing and Assurance Standards Board (“IAASB”) (2013b) that also includes an engagement partner disclosure requirement.

The PCAOB’s standard’s setting project on the engagement partner signature or disclosure requirement grew in part from the recommendations of the U. S. Treasury Department’s Advisory Committee on the Auditing Profession (2008) (PCAOB, 2009). Interest in such a project was likely heightened by related international developments. In 2006, the European Union (“EU”) adopted a partner signature requirement by issuing the 2006 Eighth Company Law Directive that states: “[w]here an audit firm carries out the statutory audit, the audit report shall be signed by at least the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm” (EU, 2006, Article 28).<sup>3</sup>

While the PCAOB’s 2009 concept release emphasizes a partner signature requirement, the PCAOB’s 2011 proposed amendment would instead require disclosure of the engagement partner’s name in the audit report. In explaining this change, the PCAOB references comments received on the 2009 concept release expressing concerns about “minimizing the role of the firm or suggesting that the engagement

partner is solely responsible for the audit engagement and its performance” (PCAOB, 2011, p. 9). The Board may also have changed to a disclosure requirement because of concerns about increasing audit partners’ legal liability if a signature were required. In a statement on the 2011 proposal, one PCAOB Board member indicates that the Board has attempted to limit the possibility of increased liability by requiring disclosure rather than a signature (Ferguson, 2011). Further, in the 2011 proposing release, the PCAOB expresses a view that the “[disclosure] approach has most of the same potential benefits as the signature requirement” (PCAOB, 2011, p. 10).

The primary benefits the PCAOB expects from adopting either a signature or disclosure requirement are increased investor protection arising from greater partner accountability and audit transparency, which are expected to lead to enhanced audit quality (PCAOB, 2009, 2011). Given these potential benefits, financial statement user groups generally support either a signature or disclosure requirement. However, as discussed below, the CPAs and CPA related groups that have responded to the PCAOB’s releases appear to generally oppose such a requirement.

Given this background, the goal of this paper is to briefly review the proposal, discuss supporters’ rationales and opponents’ concerns, and summarize some relevant recent research. Accordingly, the following sections provide a brief summary of the rationales provided and concerns raised, discuss commenters’ responses on the 2009 release and the 2011 proposal, and provide an update on recent academic research that may be relevant to the issues raised.

## **RATIONALES AND CONCERNS<sup>4</sup>**

The first rationale provided for a signature or disclosure requirement in the PCAOB’s 2009 concept release is that it will increase the engagement partner’s sense of responsibility or accountability. Several users or user groups have expressed the belief that the signature requirement would promote an increased sense of accountability by the engagement partner, which should lead to increased audit quality (PCAOB, 2009).<sup>5</sup> In this regard, both releases discuss an analogy to the CEO/CFO certifications mandated by the Sarbanes-Oxley Act (“SOX”)<sup>6</sup> that some believe have increased the sense of responsibility of the certification signers (PCAOB, 2009, 2011).<sup>7</sup> Further emphasizing the expected benefit of increased accountability, the PCAOB’s 2011 proposing release suggests adding the following language to the audit report: “The engagement partner responsible for the audit resulting in this report was [name]” (PCAOB, 2011, p. 11).

The second rationale given in support of a signature or disclosure requirement is providing increased transparency about the audit, which should enable users to better assess the quality of the audit (PCAOB, 2009, 2011). In fact the title of the 2011 proposing release is “Improving the Transparency of Audits” (PCAOB, 2011, p. 1). The PCAOB indicates that the identity of the engagement partner is generally not known to investors and that making such information readily available may help financial statement users, audit committees, and others in evaluating “the extent of the partner’s experience on a particular type of audit and his track record” (PCAOB, 2009, p. 9). Thus, the information may be helpful in auditor retention decisions and in making investment decisions. Further, the PCAOB suggests that the added information may cause CPA firms to improve the skills and experience of engagement partners and increase the competition for higher quality partners, which may lead to improvements in audit quality (PCAOB, 2009).

Another important issue regarding either the signature or disclosure requirement is possible unintended consequences. Both releases seek comments on the potential for increased private liability of the engagement partner and solicit suggestions for mitigating that liability (PCAOB, 2009, 2011). In this regard, although the European Union adopted a signature requirement in 2006, the U. S. is considered to have a more litigious litigation environment than the EU countries (PCAOB, 2011).

In the concept release, the PCAOB (2009) expresses concern about potential increases in audit partner liability, states that it is not the Board’s intent to increase that liability, and briefly discusses various sources of private liability in federal and state courts. The PCAOB identifies the antifraud provisions of the securities laws as a potential source of additional engagement partner liability, particularly Section

10(b) of the Securities Exchange Act of 1934, which is the basis for much private litigation. The Board acknowledges that an audit report signed by an audit firm or partner could be considered “a statement” that might allow attribution of Section 10(b) liability to such a firm or partner in some federal court circuits. In those circuits, the addition of a partner’s signature could result in the partner’s loss of a defense against personal liability (PCAOB, 2009).

In the 2011 proposing release, the PCAOB (2011) discusses the 2009 commenters’ concerns about increased engagement partner liability associated with the partner signature requirement and repeats its prior observation about having no intention of increasing partner liability. The Board also discusses a recent U. S. Supreme Court ruling in *Janus Capital Group, Inc. v. First Derivative Traders* (U.S. Supreme Court, 2011). In the Janus case, the Supreme Court provides an interpretation under Section 10(b) of the 1934 Act of who is the “maker” of a statement in the context of the securities law violation of “mak[ing] an untrue statement of material fact” (PCAOB, 2011, p. 15). The PCAOB observes that the auditor litigation implications of the Janus case remain unclear.

The 2011 proposing release also discusses concerns raised in the 2009 comment letters on whether adopting a disclosure or signature requirement would also result in a partner’s consent being required in filings with the U. S. Securities and Exchange Commission (“SEC”), subjecting the partner to liability under Section 11 of the Securities Act of 1933 or other federal or state securities laws.

## COMMENTERS’ RESPONSES

The PCAOB received twenty-three responses on the 2009 concept release and forty-four on the 2011 proposed amendment. For both, the respondents were predominantly CPA firms or CPA groups (approximately 80% for the concept release and 55% for the proposed amendment), with smaller percentages from users or user-groups, academics, and others. Regarding the 2011 proposed amendment, some responses (including those from a small number of corporations and miscellaneous individuals or groups) are not clearly identifiable with the previously mentioned commenter categories. These responses have been categorized as “other” for discussion purposes. Not unexpectedly, the partner’s signature requirement is generally supported by users and user groups and by some academic groups but not by CPAs, CPA firms, or associated groups. The miscellaneous other commenters on the 2011 proposed amendment predominantly support disclosure of the engagement partner.

While the IAASB’s proposed amendments to the international audit reporting standards are not directly the subject of this paper, the IAASB’s 2013 exposure draft was preceded by a 2012 *Invitation to Comment* (“ITC”) that included a question (Question 12) on whether the engagement partner’s name should be disclosed in the audit report (IAASB, 2012).<sup>8</sup> The ITC received one hundred and sixty-five responses, of which one-hundred and twenty respondents stated a position on the partner disclosure question and seventy percent (70%) of those supported the disclosure (IAASB, 2013a).<sup>9</sup> Although not providing a numerical analysis by respondent type, the IAASB indicates that while there were divergent views on the issue from respondents, “[t]here was generally more support from those jurisdictions where disclosure of the name of the engagement partner is already required by law or regulation...” (IAASB, 2013b, p. 35).

For consistency with the general organization of the PCAOB releases, the following discussion of the responses to the PCAOB’s 2009 concept release and 2011 proposed amendment focuses on commenter views relative to the rationales of accountability and transparency and on concerns regarding unintended consequences. As a matter of note, the IAASB in its 2013 exposure draft cites these same rationales in support of the proposed partner disclosure requirement and similarly mentions litigation as a concern (IAASB, 2013b).

### Users

#### *Accountability*

Only two user groups responded to the PCAOB’s 2009 concept release and four users or user groups responded to the 2011 proposed amendment. The 2009 user commenters generally express the view that a

signature requirement would increase auditor accountability and the 2011 commenters express similar views for the disclosure requirement.<sup>10</sup> The Council of Institutional Investors (“CII”) (2009) states that “... the engagement partner plays a unique role in ensuring the overall quality of an audit. That role includes responsibility for planning the audit, supervising engagement team members, and determining whether the financial statements taken as a whole are fairly stated” (p. 2). In an update to their response letter on the 2011 release, CII (2013) mentions a study that provides evidence that the signature requirement is associated with increased audit quality in the United Kingdom (Carcello and Li, 2013). CalPERS (2009) indicates that “...requiring the engagement partner to sign the audit report will enhance audit quality by increasing the engagement partner’s sense of accountability to financial statement users (providers of capital)...” (p. 2). The users that responded to the PCAOB’s 2011 proposed amendment generally do appear to prefer the partner signature to partner identification requirement, but do not object to the latter. One of the commenters who prefers the signature requirement believes that the proposal will “put the engagement partners’ credibility on the line” providing them with “the leverage to push back against institutional pressures...” (Block, 2011, p. 1).

### *Transparency*

Users and user groups generally believe that the partner signature or disclosure requirement would increase audit transparency. Regarding transparency, CalPERS indicates that identifying the engagement partner through the signature requirement will enhance the activism of investors, company boards and even the audit firms, causing them to evaluate:

- the extent of an engagement partner’s experience and the firms’ policy on developing and enhancing engagement partner’s expertise as well as oversight of engagement partners;
- the quality, expertise and better supervision of the audit team and the entire audit process;
- whether auditors’ biases in information processing is reduced; and
- whether there is enhanced auditors’ consensus and effort (CalPERS, 2009, p. 2-3).

The Council of Institutional Investors indicates that a signature requirement will facilitate enhanced investor oversight of selection and evaluation of the auditors and that “[a]rmed with valuable information provided by the lead auditor’s signature, investors and boards will demand skilled engagement partners, which will lead to improvements in audit quality” (CII, 2009, p. 2). As these benefits appear to be primarily related to the additional information on the engagement partner’s identity, the transparency benefit should be obtained equally by signature or disclosure (PCAOB, 2011).

### *Litigation and Unintended Consequences*

User commenters generally did not address concerns regarding increased litigation.

### **Academics**

Only a small number of academics or academic groups responded to the PCAOB’s 2009 concept release or the 2011 proposed amendment. There were three academic respondents to the 2009 release including representatives of the Auditing Standards Committee of the Auditing Section of the American Accounting Association (Bierstaker et al. (2009) hereafter ASC-AAA (2009)) and certain members of the Auditing Section of the American Accounting Association (Gramling, Carcello, DeZoort, & Hermanson, 2009) as well as one individual professor (Zeff, 2009). Members of Auditing Standards Committee also responded to the 2011 proposed amendment, as did another group of professors and an individual academic.<sup>11</sup>

### *Accountability*

Two academics or academic groups that responded to the 2009 concept release were supportive of the requirement and a third appeared supportive with reservations. Several of the academic responses observe

that as there was no existing research directly on point at the time of the 2009 concept release, it remained unclear whether a signature requirement would lead to higher audit quality. The ASC-AAA (2009) and the Gramling et al. (2009) comment letters cite studies providing evidence that accountability reduces auditors' information biases (Kennedy, 1993), enhances consensus (Johnson & Kaplan, 1991) and effort (DeZoort, Harrison, and Taylor, 2006), and improves workpaper effectiveness and auditor motivation (Brazel, Agoglia, and Hatfield, 2004). Gramling et al. (2009) also identify a study from the psychology literature that provides evidence that a sense of responsibility arises from accountability (Schlenker, Britt, Pennington, Murphy & Doherty, 1994). On the other hand, ASC-AAA (2009) also states that the logic behind adding a partner signature requirement suggests that currently the engagement partner's sense of responsibility is insufficient and cautions that an unintended consequence of such a requirement might be to decrease firm responsibility in the process of increasing partner responsibility. Regarding disclosure versus signature, the ASC-AAA (2009) comment letter suggests that disclosure of the partner's name alone would not have the same effect on accountability as the signature, although it would increase transparency.

Relevant to the CEO/CFO certification analogy, the ASC-AAA (2009) letter cites the Lobo and Zhou (2006) study documenting an increase in conservatism in financial reporting after the SOX requirement for CEO/CFO certification went into effect. ASC-AAA (2009) indicates that "[t]his, at least on the face, provides empirical, archival support for the notion that – even in a high litigation securities market – signing requirements may increase accountability amongst signing parties" (ASC-AAA (2009), p. 3). Regarding the PCAOB's 2011 proposed amendments, while Jones et al. (2012) (hereafter ASC-AAA (2012a)) do support the disclosure requirement, the two other academic letters either do not support the requirement (Fuehrmeyer, 2011) or are unsure whether the accountability and transparency benefits offset what may be a potential decrease in independence caused by the requirement (Lambert, Luippold, and Stefaniak, 2012a). In the ASC-AAA (2012a) letter, the academics discuss the importance of the reputation effect to constrain CEO behavior and they expect a similar effect for partners that have been identified in the audit report. The letter cites several research studies relevant to the disciplining effect on CEOs of the loss of reputation, including higher job turnover and difficulty obtaining subsequent jobs (Desai, Hogan & Wilkins, 2006). CEO turnover is found to be higher subsequent to accounting restatements for irregularities as distinguished from errors (Hennes, Leone & Miller, 2008).

### *Transparency*

The academic commenters on the 2009 release and 2011 proposed amendment generally support the view that the signature requirement may lead to increased transparency of the audit process for investors (ASC-AAA (2009); ASC-AAA (2012a)). While there was no research directly on point at the time of the 2009 release, ASC-AAA (2009) references several studies (Eichenseher, Hagigi, & Shields, 1989; Menon & Williams, 1994; Teoh & Wong, 1993) that find that industry and audit firm size are used by market participants to evaluate quality. The letter suggests that a plausible inference from such research is that audit partner identify may be used to signal audit quality. Another study cited is that of Chi, Myers, Omer, and Xie (2013), which provides evidence that a partner's prior experience auditing other clients can be used to assess audit quality for the current client. ASC-AAA (2009) also observes that because any individual partner audits only a few companies, incorrect inferences could be drawn about audit quality. In response to the PCAOB's 2011 proposed amendment, ASC-AAA (2012a) reiterates that engagement partner characteristics matter to users and could be used to evaluate audit quality. ASC-AAA (2012a) also references the findings of Knechel, Niemi, and Zerni (2011) on the relationship between audit partner compensation (a partner characteristic) and audit quality.

In response to the IAASB's 2012 *Invitation to Comment*, the comment letter from members of the Auditing Standards Committee of the American Accounting Association (Pevzner, Chen, Jones, Lisic, Michas, and Pawlewitz (2012), hereafter ASC-AAA (2012b)), discusses several additional studies that are relevant to audit transparency that focus on the association between audit partner characteristics and audit quality. These studies, as well as more recent research, are discussed below under recent relevant research.

### *Litigation and Unintended Consequences*

While disclaiming expertise in securities litigation, ASC-AAA (2009) and ASC-AAA (2012a) suggest that it is likely that audit partners could be named in civil litigation with attendant negative consequences. ASC-AAA (2009) states that another possible consequence of increased partner liability might be to discourage new entrants into and drive top professionals out of the profession and to cause auditors to engage in defensive auditing, which would drive up audit costs. As already mentioned above under accountability, ASC-AAA (2009) also identifies one unintended consequence of a partner signature requirement as potentially decreasing audit quality by reducing firm accountability in a manner that is not offset by the increase in partner accountability from the requirement. ASC-AAA (2012a) also indicates that partners may be subject to more litigation, privacy, and security issues as a result of the disclosures.

### **CPAs and CPA Groups**

As mentioned above, the majority of the responses on the PCAOB's 2009 concept release and the 2011 proposed amendment are from CPAs, CPA firms or CPA related groups, including the Big-4, the mid-sized firms, and several CPA-related entities (e.g., the Center for Audit Quality and Institute of Management Accountants). The responses from CPAs or CPA-related groups are overwhelmingly negative, with few supporting the disclosure or signature requirement. Several of the CPA firm letters on the 2011 proposal are more receptive to the inclusion of the engagement partner's name on PCAOB's Form 2 as an alternative to disclosure in the audit report.<sup>12</sup>

### *Accountability*

The CPA comment letters on the 2009 concept release provide the following major comments on accountability in order of frequency. Some related comments have been combined.

- Given the existing economic and regulatory sanctions that engagement partners face if there is an audit failure at a public company client, engagement partners are already highly motivated to conduct quality audits.
- The engagement partner is already individually accountable to numerous parties including to the firm, other firm partners, the PCAOB, the SEC, and state boards, which act to ensure a high level of accountability.
- The benefits of the signature requirement are uncertain or there is little or no evidence that the signature requirement will increase the quality of audits.
- Audits and audit reports are the result of a team effort and are conducted in accordance with a firm's quality control system. Having the engagement partner sign the report with his or her name may give the misleading impression that one person is responsible for the audit and may lessen the perceived role of the firm.
- The analogy to Sarbanes-Oxley mandated CEO/CFO certification is not appropriate. The certification requires CEOs/CFOs to acknowledge responsibility for information filed in periodic reports. However, unlike CEOs/CFOs before Sarbanes-Oxley, engagement partners are already fully aware of their responsibilities related to the quality of the audited financial statements.

The tenor of the CPA firm responses to the 2011 proposed amendment are generally similar although less detailed than those summarized above, with the major point being that no change in the audit report is warranted because engagement partners already have a sufficiently high level of accountability.

The Institute of Chartered Accountants in England and Wales ("ICAEW") (2009) in their letter on the 2009 concept release stated that since the European Union's requirement had been in place for such a short time (less than one audit cycle at the time of that comment letter), it was too early to determine whether the requirement was having any effect on audit quality. At that time, most of the issues that had arisen to date were characterized as logistical, that is, from "the death, incapacity or unavailability of engagement partners to sign the audit report" (p. 1). In their letter on the PCAOB's proposed amendment, the ICAEW (2011) indicates that the group's initial skepticism about the benefits of the signature

requirement appears to have been justified because group members noticed little to no behavior changes by auditors. Subsequently, in the ICAEW letter on the IAASB's 2012 *Invitation to Comment*, the group does support an audit partner disclosure requirement since such information is already provided in the United Kingdom, but suggests that an exception be made for situations in which the personal safety of the partner may be threatened (ICAEW, 2012).

### *Transparency*

The CPA comment letters on the 2009 concept release provide a number of comments relative to transparency. The major comments are summarized below in order of frequency and some related comments have been combined.

- The signature requirement emphasizes the role of the engagement partner compared to the firm and could result in misleading inferences about audit quality since the audit is the result of a team effort.
- The identity of the engagement partner is often already available to shareholders, since the lead engagement partner usually attends the client company's annual meeting and is available to answer questions in that context.
- Providing the name of the engagement partner alone through his or her signature without other information about the individual's background is not likely to be useful to users.
- Client confidentiality rules and regulation FD would limit engagement partners from directly responding to investor questions.
- A rating system or competition might develop for engagement partners, which may be uncorrelated with audit quality.
- The audit committee is responsible for selecting the auditor and information about the engagement partner is already available to that committee.

The responses of the CPA commenters to the 2011 release, although briefer, have the same tenor as the comments shown above and generally indicate that providing the additional information regarding the partner's identity would not enhance investor protection or increase audit quality (PCAOB, 2011).

### *Litigation and Unintended Consequences*

The CPA comment letters on the 2009 concept release and 2011 proposed amendment provide numerous comments on litigation and unintended consequences. For the 2009 release, fifteen of the sixteen CPA commenters that address litigation indicate their belief that the partner signature requirement would result in increased liability for the engagement partner and the remaining CPA-related group maintained it possessed insufficient knowledge of U. S. law to comment (ICAEW, 2009). The most frequent comments on litigation and unintended consequences on the 2009 release are summarized below in order of frequency. Some related comments have been combined.

- The partner signature requirement would result in increased liability for the engagement partner and increased defense costs.
- Increased litigation risk for individual partners could have a chilling effect on the profession, causing candidates not to enter the profession and more firms to choose not to audit public companies.
- Some form of mitigation of liability, such as a safe harbor, needs to be provided if the partner signature requirement is adopted.
- Inclusion of the engagement partner's name could lead to harassment of that party.
- Increases in accountability and concerns about litigation may lead to defensive auditing adding to the cost of the audit.
- The requirement might lead to decreased competition among audit firms as those whose partners do not wish to be subject to the increased liability no longer audit public companies.

- Partner’s reputations could be impacted by “guilt by association” with failed or problematic clients. Audit partners may refuse to be associated with companies with financial difficulties.

The CPA firm comments on the 2011 proposed amendment were similar in nature to those above with most raising concerns regarding additional partner liability. Several of the commenters on the proposal also mentioned the Janus case (see discussion above) as increasing uncertainty of litigation consequences.

While citing an expected increase in liability, many of CPA firm responses to the 2009 concept release do not elaborate on the expected cause of this increase. However, a reasonably detailed response on the issue of increased liability exposure is provided by Ernst & Young LLP (“E&Y”) (2009). E&Y acknowledges the legal issue described in the concept release (PCAOB, 2009) that arises in some federal jurisdictions, where liability may attach only to those making a statement (such as in an audit report). However, E&Y indicates that it does not believe that this would be the primary reason that individual partners might be named more frequently in lawsuits if their signature is required on the report. E&Y (2009) states:

... we think it possible that some law firms that routinely practice in this area might simply conclude that, with a partner's signature on the auditor's report, it would be difficult to explain to a jury why the partner is not named as a defendant – the reasoning might go that since he or she signed the opinion then of course he or she should be sued together with the accounting firm. Indeed, the Concept Release analogizes the signature requirement to the CEO/CFO certification requirement imposed by Section 302 of the Sarbanes-Oxley Act; at least in part as a result of that requirement, CEOs and CFOs are almost always named as defendants together with their corporate employer (pp. 4-5).

With regard to the 2011 Janus decision on who is a “maker” of a statement, E&Y suggests that the addition of the partner’s name to the report with a statement that he or she is responsible for the audit could be construed to provide a sufficient degree of “ultimate authority” for the audit that the inclusion of the individual partner in the lawsuit “might survive a motion to dismiss under Janus (E&Y, 2012, p. 10).” The CPA firm believes that naming individual partners in lawsuits could force audit firms to settle more lawsuits rather than to prolong a lawsuit with its negative consequences to the individual partner. These negative consequences “...would be significant – merely being sued for fraud or negligence could lead to the loss of clients for the individual partner, emotional and personal financial difficulties, and so on” (E&Y, 2009, p. 5). In the letter on the 2011 proposing release, E&Y provides several specific examples of cases that had significant personal ramifications for individual partners that were named in lawsuits (E&Y, 2012).

Several of the CPA firms, raise the issue of whether the signature requirement would result in an individual being deemed an expert from whom a consent would be required by the SEC. PriceWaterhouseCoopers LLP (2009) observes that being a named expert would subject the audit partner to Section 11 liability for any “materially false or misleading statements in the audit report... subject only to a due diligence defense” (p. 9).

## **RECENT RELEVANT RESEARCH**

This section of the paper addresses certain research findings that have become available primarily since the issuance of the 2009 or 2011 PCAOB releases and that are relevant to the partner’s signature or disclosure requirement. Earlier research, including that which is cited above in conjunction with the academic comment letters, is not summarized in this section except to the extent necessary to provide context for more recent research.<sup>13</sup> Because of the complexity of the issues, this research update is limited to the main research streams previously highlighted.



## Accountability

As described above in the summary of the ASC-AAA (2009) response to the PCAOB's 2009 concept release, research on individual accountability and audit quality at that time had been primarily behavioral. The studies cited in the summary describe the accountability benefits as including decreased bias, increased auditor consensus, and increased auditor effort, with some evidence that increased effort may not increase audit effectiveness (ASC-AAA (2009)). Several recent experimental studies provide support for the benefits of a personal certification requirement suggesting that certification may improve performance or reduce self-serving behavior in certain circumstances. A recent study by Davidson and Stevens (2013) examines the ability of a code of ethics to improve managers' behavior and increase investor confidence using an investment game. The study finds that when managers can choose to publicly certify the code of ethics, more of the investment is returned to the investor and investor confidence increases. Blay, Gooden, Mellon, and Stevens (2012) find that misreporting is negatively associated with two measures of moral reasoning – traditional values and responsibility – and that misreporting is lower when a sign-off requirement is present, but only if the investor is a study participant, not when the investor is an abstract entity. On the other hand, Bagley (2010) finds that while being accountable to one person can have a positive effect on performance, multiple accountabilities can negatively affect the auditor's emotional state and can hinder low-complexity audit task performance. This suggests that increasing accountability may not increase performance quality in all circumstances.

As discussed above, CPA firms and CPA group respondents do not agree that a signature or disclosure requirement will improve partner accountability. They suggest that given the high level of sanctions faced by audit partners and the multiple sources of accountability, such partners are already highly motivated to conduct quality audits. Experimental research that appears to support the hypothesis that a signature or disclosure requirement may increase partner accountability is criticized as unrealistic. For example, the Center for Audit Quality ("CAQ") of the American Institute of Certified Public Accountants (2009) argues that such behavioral research does not faithfully reflect the audit decision-making process or the levels of accountability that auditors face in practice. This criticism of behavioral accounting research is not new and similar limitations are often acknowledged in the experimental studies.<sup>14</sup> Also, in contrast to the views of the CPA firms, it could be argued that the lack of realism may result in the studies not reflecting factors that have been found to have negative effects on audit quality in actual audit scenarios, such as time pressures (Lopez & Peters, 2013) and fee pressures (Asthana & Boone, 2012).

Regarding the expected benefits of a partner signature or disclosure requirement on accountability, some research suggests that the benefits may depend on the partner. One experimental study (Carpenter & Reimers, 2011) provides evidence that audit risk assessments are higher with an audit partner that emphasizes professional skepticism. Another study (Quadackers, Groot, & Wright, 2009) finds an association between an auditor's skeptical characteristics and his or her judgments and decisions, but finds that the relationship depends on the strength of the control environment. This finding is consistent with the view that the tone at the top of individual CPA firms could impact the effectiveness of the engagement partner signature requirement, a view that is expressed in several of the 2009 comment letters. For example, Frank Gorrell (2009) asks, "Simply put, would the signature of the engagement partner under Arthur Andersen's logo have prevented Enron from issuing bogus statements?" (p. 2).

Concerning relevant research available at the time of the PCAOB's 2009 and 2011 releases, apparently there were no archival studies that both directly examined the effect of a partner signature or disclosure requirement on audit quality and were far enough advanced to be discussed in the PCAOB's releases or the respondents' comment letters. The absence of such research can be partially attributed to the absence of a signature requirement in many major jurisdictions until recently.<sup>15</sup> While several recent archival studies remedy the lack of direct evidence on the effect of the partner signature on audit quality or perceptions of audit quality, the evidence from these studies is conflicting suggesting additional research opportunities.

One study, (Blay, Notbohm, Schelleman & Valencia, 2012), examines the effect of the signature requirement in the Netherlands, a jurisdiction that adopted the EU mandate in 2006, but in which virtually

all companies voluntarily complied with the requirement for fiscal years ending on or after December 31, 2005. Comparing audit quality in the Netherlands before and after the signature requirement and comparing Netherlands audit quality to that in the United Kingdom without such a requirement at that time, the study finds no evidence of an increase in audit quality from the signature requirement. The study uses several measures of audit/earnings quality including abnormal accruals, magnitude of accruals relative to cash flows, and earnings benchmarks.

Another recent study (Carcello & Li, 2013) examines the effects of adopting the signature requirement and finds that the signature requirement is associated with higher audit quality but also with higher audit fees. The study finds an improvement in audit quality for United Kingdom (UK) companies in the year of implementation (2009) of the signature requirement as compared to the prior year with audit quality being measured using abnormal accruals (the absolute value), the propensity to meet an earnings threshold, the earnings response coefficient (a measure of earnings informativeness) and the propensity to issue qualified audit opinions. To address concerns regarding correlated omitted variables – particularly the economic conditions of 2008 and 2009 – the authors compare the UK companies on a before and after basis with matched samples of U. S. companies and four other EU countries during the same two years and the results are generally the same.

### **Transparency**

As discussed above, the signature or disclosure requirement is expected to increase transparency by providing more information to investors about audit partners (PCAOB, 2009, 2011). It is anticipated that increased transparency will enhance users' ability to assess audit quality, leading either to higher audit quality or more accurate audit pricing by investors, although the latter benefit is not explicitly discussed. CalPERS (2009) suggests that the improvement in quality would arise because audit partner signature or disclosure would cause audit committees to do a more thorough assessment of the auditor's qualifications and performance, including those of the lead engagement partner, and would improve the audit firm's internal evaluations of the partner's qualifications and its professional development policies generally. Another attendant benefit cited by both CalPERS (2009) and the Council of Institutional Investors (2009) is increased shareholder involvement in the auditor selection process.

In commenting on the transparency benefits, ASC-AAA (2009) highlight research findings that investors do use existing publicly available information about the CPA firm to make audit quality assessments, e.g., industry expertise or office size or other characteristics. Investors can and apparently do make assessments of quality based on the size of the audit firm (e.g., Eichenseher, Hagigi, & Shields (1989); Boone, Khurana & Raman (2010)) and industry specialization (e.g., Li, Xie & Zhou (2010)) among other characteristics. A similar usefulness is suggested for the engagement partner information (ASC-AAA (2009), ASC-AAA (2012a), ASC-AAA (2012b)). As mentioned above, the Chi, Myers, Omer, and Xie study (2013) finds that a partner's prior experience auditing other clients or the same client can be used to assess audit quality.

As the engagement partner's identity has become available in more jurisdictions, additional studies have focused more directly on audit partner characteristics and how these are associated with audit quality. Other studies also focus on partner characteristics including that of Chi and Chin (2011) that provides evidence that audit quality as measured by discretionary accruals is driven by the engagement partner and concurring partner individually having industry specialization and the combination of both having such expertise. Chang and Choy (2010) examine whether the characteristics of audit partners affect audit opinions and find that the partner's industry specialization and prior experience with bankrupt clients is positively associated with the issuance of going concern opinions.

Other studies focusing on partner characteristics and audit quality include Gul and Ma (2012) which finds that the auditing of multiple Chinese public companies by audit partners of short tenure is negatively associated with audit quality as measured by the propensity to issue going concern opinions, an earnings manipulation measure, and an earnings benchmark. Another study of Chinese companies (Gul, Wu, and Yang, 2013) provides evidence that there are significant differences in audit quality between audit partners measured using abnormal accruals and other proxies and that those differences are

associated with the partner's personal characteristics, such as education, audit firm experience (Big-N), position in the firm, and political affiliation. An association is also found between auditor-in-charge characteristics and audit quality in audits of U.S. nonprofit entities (Feng, Kitching, & Myers, 2013). For a sample of Taiwanese audit partners, lower actual and perceived audit quality is associated with partners with prior restatements (Chi, Lisic, Myers, & Pevzner, 2013). In a recent experimental study, Lambert et al. (2012b) find evidence that providing information on an engagement partner's association with prior year restatements of another audit client reduces the likelihood that more inexperienced investors will invest in a company also audited by that engagement partner. Thus, there appears to be evidence that audit quality is associated with an audit partner's personal and professional characteristics and that investors use such information to evaluate audit quality.

### **Litigation and Unintended Consequences**

While the PCAOB (2009) states: “[t]he Board's intent with any signature requirement would not be to increase the liability of engagement partners” (p. 11), much of the CPA firms' concerns about the requirement appear to focus on potential additional litigation exposure. However, even without increased litigation there could be reputational effects with significant economic consequences for individual partners.

Some prior accounting research suggests that increased litigation risk affects auditor behavior in a manner that increases audit quality as measured by modified audit opinions or reduced abnormal accruals. Francis and Krishnan (2002), for example, find that the likelihood of an auditor issuing a going-concern opinion is positively associated with the likelihood of auditor litigation for non-Big-N auditors. The study also finds evidence of riskier client bases and less conservative audit opinions for both Big-N and non-Big-N auditors after the Private Securities Litigation Reform Act of 1995 (“PSLRA”) reduced the consequences of litigation for auditors. Boone, Khurana, and Raman (2011) find that the risk of client-specific auditor litigation reduces the level of abnormal accruals for Big-N auditors implying that Big-N auditors are more conservative in these circumstances. The paper also finds that larger abnormal accruals are associated with higher litigation risk and that the PSLRA, by reducing litigation consequences, increased the likelihood of larger abnormal accruals. Given this relationship, any attempts to minimize the litigation consequences may be at cross purposes with the rationale of increasing audit quality. Increased litigation risk may be needed for the signature or disclosure requirement to be effective in achieving one of the stated goals.<sup>16</sup>

Bailey, Dickins, and Reisch (2010) point out that the concerns about increased liability arising from the partner signature requirement were also raised when the financial expert identification requirement was being considered for inclusion in SOX. That paper reviews private litigation in federal and state courts from 2002 to 2009 – years after the financial expert requirement went into effect – and finds only three cases brought in state court in which audit committee members designated as financial experts are named in a lawsuit.<sup>17</sup> Since no damages are awarded against the financial expert in any of these suits, the authors suggest that concerns about heightened legal liability are unsupported by subsequent events.<sup>18</sup>

However, auditors' actions can be affected by a perceived risk of litigation that is higher than the litigation that subsequently develops. A KPMG LLP (2006) survey of audit committee members of companies in a number of countries indicates that such members believe they are subject to a higher level of litigation and prosecution risk than other board members and this concern is highest for audit committee members in North America. These concerns could make audit committee members more conservative than their counterparts elsewhere and have a similar effect for auditors. Whether driven by concerns about litigation or other factors, Krishnan and Visvanathan (2008), find that the audit committee's overall financial expertise in the post-SOX years is positively associated with conservatism measured using several accrual and other measures, when financial expertise is limited to accounting experts (i.e., excluding nonaccounting financial experts).

Some CPA firms are concerned about possible new litigation strategies that may result in higher payouts by the audit firm driven by having the partner's signature or name on the audit report (E&Y, 2009). E&Y (2012) indicates that in the EU countries that have a partner signature requirement, five

lawsuits have been brought against the audit firm's affiliates since the requirement was adopted in 2008, with the engagement partner being named as a defendant in three of the lawsuits. Apparently naming the partner was not very common before 2008. Thus, while it may be difficult to predict what effect a signature or disclosure requirement may have on legal strategies, an analogy to the effect of the certifications on litigation against company CEOs and CFOs, who have increasingly been named individually in lawsuits (E&Y, 2009), appears at least reasonable for the signature or disclosure requirement.<sup>19</sup>

Another concern raised by CPA firm commenters is that increases in accountability and concerns about litigation may lead to defensive auditing adding to the cost of the audit. Auditing is a form of monitoring used by companies to reduce agency costs of debt and equity (Jensen & Meckling, 1976; Watts & Zimmerman, 1983). From a societal perspective, presumably there is a Pareto-optimal level of auditing and audit quality (Wu, 2011). However, as used in the context of the proposed PCAOB amendment, the reference to "defensive auditing" suggests more auditing effort than is optimal or at least than can be justified on a cost/benefit basis and often seems to imply increased costs with *no* added benefits.

As mentioned above, Carcello and Li (2013) find that the adoption of the signature requirement in the UK is associated with higher audit fees but the signature requirement is also associated with higher audit quality. While this finding does not address the question of whether an increase in auditing effort is optimal, it does suggest that there is at least a benefit to investors from the requirement. In the context of the partner signature or disclosure requirement, King, Davis, and Mintchik (2012) suggest that based on the view that audit services have attributes of credence goods, economic theory suggests that more audit effort may not result in higher audit quality and that users' perceptions may not accurately measure such quality. They cite research evidence from Bedard and Johnstone (2005) that in the circumstances surrounding SOX, audit fees rose but audit risk declined, suggesting that auditors may have been behaving strategically with respect to fees. Another study provides evidence that auditors of U. S. cross-listed United Kingdom companies charge higher fees that cannot be fully explained by the additional disclosure requirements in the U. S. (Seetharaman, Gul & Lynn, 2002). This seemingly litigation-induced fee increase may be associated with "defensive auditing" or may be associated with the "insurance value" of the audit (Menon & Williams, 1994) rather than a "monitoring" benefit. Given continuing concerns regarding litigation and increased audit fees, there appears to be much opportunity for additional research in this area.

The CPA firm comments cited above also suggest that one unintended consequence for an individual partner of either the disclosure or signature requirement may be "guilt by association" with failed or problematic clients. A recent study (Gao, Jamal, Liu, & Luo, 2011) finds negative reputational effects at the audit firm level that extend beyond litigation concerns. The study finds negative abnormal returns for clients of a Big-4 firm (Deloitte) with spill-over effects to clients of other Big-4 firms in a low litigation environment (China), in which the audit firm failed to detect a fraud involving a public company. Skinner and Srinivasan (2012) find significant numbers of large client defections from a large auditing firm in Japan, also considered to have low litigation risk, after a well-publicized audit failure at a Japanese company. These studies imply that audit quality decisions at the audit firm level may be affected by concerns about damage to the audit firm's "franchise" value apart from litigation concerns.

The reputational effects of an audit failure on other clients of an audit firm or loss of clients from the audit firm suggest that an individual audit partner may also suffer a "guilt by association" penalty, i.e., a decline in personal reputation due to an association with a failed or problematic client. Given recent research evidence that indicates that audit partner personal and professional characteristics are associated with actual and perceived audit quality (see discussion under "Transparency" above), it is reasonable to expect market disciplining effects for audit partners with certain characteristics. As noted above, there is evidence of market disciplining effects on CEOs associated with companies having restatements, including job loss and job market difficulty (Desai et al., 2006; Hennes et al. 2008).

Another concern raised by CPA firms is a chilling effect on the auditing profession generally as individual partners become more concerned about being named in lawsuits. While not based on recent

evidence, Dalton, Hill, and Ramsey (1997) find that former partners and managers that left CPA firms from 1990 – 1992 (before the Litigation Reform Act of 1995) cited both the effect of experience with litigation related payments and the fear of having to make such payments as being associated with turnover decisions. Concerns regarding being individually named in lawsuits could motivate similar decisions by partners or managers if partners are identified in audit reports.

## SUMMARY AND CONCLUSION

The PCAOB's 2009 concept release raised significant issues regarding accountability, transparency, and litigation effects and other unintended consequences of the partner signature requirement. While the 2011 proposed amendment that would require audit partner disclosure rather signature may reduce some concerns, many of the issues raised with respect to the signature requirement are equally applicable to the disclosure requirement. This paper discusses the PCAOB's rationales for the signature and disclosure requirements and unintended consequences that may arise, summarizes the major concerns raised by commenters, and finally discusses some recent research relevant to the issues raised in the proposed amendment, which suggests opportunities for additional research.

## ENDNOTES

1. This paper addresses only the proposed amendment on partner identification in the audit report. The 2011 PCAOB proposal included other amendments. These include a requirement to disclose the firms and persons that participated in the audit in the audit report, amend the Board's annual report form (Form 2) to require disclosure of the engagement partner for each audit report already detailed on the form, and require an explanation of a change in the audit partner (PCAOB, 2011).
2. This observation is based on discussions at a 2013 meeting of the PCAOB's Standing Advisory Group (SAG) (PCAOB, 2013b) and a letter from the Council of Institutional Investors (CII, 2013).
3. While the European Union's directive mandating a partner signature requirement was issued in 2006, the requirement was to be implemented by member countries by June 29, 2008, and effective for reports for fiscal periods beginning on or after that date (Financial Services Authority, 2007).
4. The summary in this section is based primarily on the discussion in the PCAOB's 2009 concept release and the 2011 proposed amendment (PCAOB, 2009, 2011).
5. These users included members of the PCAOB's Standing Advisory Group with investor backgrounds (PCAOB, 2009) and the U. S. Treasury's Advisory Committee on the Auditing Profession ("ACAP") (2008). ACAP also recommended the disclosure of the name(s) of the lead engagement partner(s) in the proxy statement in conjunction with shareholder approval of auditor selection.
6. CEOs and CFOs of exchange-listed firms are required to certify to the "material accuracy and completeness of the financial statements" SOX (U. S. Congress, 2002). SOX added criminal penalties for knowingly certifying financial statements that are not materially accurate and complete and provided for sizable fines and penalties (up to \$5,000,000) for issuing false statements or failing to certify a financial report.
7. One study cited in the PCAOB concept release is Cohen, Krishnamoorthy, and Wright (2010) that finds in a survey of auditors that 68% were of the view that the CEO/CFO certification requirement has improved the integrity of financial reports (PCAOB, 2009).
8. The *Invitation to Comment* covered a broader array of changes to the audit report than just the audit partner disclosure requirement (IAASB, 2012).
9. The commenters that stated a position were ones that addressed the question and did not remain neutral (IAASB, 2013a).
10. Few commenters on the 2009 release addressed the PCAOB's question on whether disclosure would have the same effect as the signature requirement.
11. For the purposes of this paper, any student respondents to the 2011 proposed amendment were classified in the "other" category.
12. This suggestion is made in Question 13 of the 2011 proposing release. The text of question 13 is: "If the Board does not adopt the proposed requirement that audit reports disclose the name of the engagement partner, should the Board nonetheless require firms to identify the engagement partner with

respect to each engagement that the firms are otherwise required to disclose in Form 2?" (PCAOB, 2011, p. 17).

13. This paper focuses primarily on research issued since the 2009 concept release and the 2011 proposed amendment, but does discuss earlier research to provide context. The decision to focus on more recent research considers the fact that the earlier research would have been available to the Auditing Standards Committee of the American Accounting Association prior to the issuance of comment letters on the 2009 and 2011 releases and hence presumably was considered in the letters, which are publicly available.
14. The CAQ (2009) also criticizes certain studies as not being generalizable to the actual audit scenario because their subjects are commonly students or auditors with limited experience.
15. Certain other countries besides those in the EU have partner signature requirements in place including Australia, China, and Taiwan. These latter jurisdictions had signature requirements prior to the European Union's 2006 Eighth Company Law Directive. Certain of the EU countries, including The Netherlands and Germany, required a partner signature before the EU implementation date (Blay, Notbohm, Schelleman, and Valencia, 2012). For UK companies, the audit partner signature added by the Companies Act 2006 was required for years beginning on or after April 6, 2008. (United Kingdom, Secretary of State, 2007).
16. Bailey et al. (2010) also point out the potential incongruence of attempting to increase accountability without increasing partner liability.
17. While SOX provided a safe harbor for the financial expert under federal securities law, the fiduciary duties of a member of the board of directors under state law can still result in liability.
18. However, one reason for the lack of litigation, at least in federal courts, may be the safe harbor the SEC provided for the audit committee's designated financial expert (SEC, 2003).
19. As discussed in the ACAP report (2008), even after the Private Securities Litigation Reform Act of 1995, for the lawsuits involving large cap companies that have market values in excess of the capital of the audit firm, audit firms already feel "pressured to settle such cases, even when they believe they have meritorious defenses, because taking such cases to judgment carries an unpredictable risk of loss in an amount that could threaten survival of the auditing firm" (p. II:7).

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