Statement Submitted to

The Advisory Committee on the Auditing Profession
U.S. Department of Treasury

By

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December 3, 2007

My name is James D. Cox. I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to joining the Duke faculty in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I have in the recent past been a member of the New York Stock Exchange Legal Advisory Committee and the National Association of Securities Dealers Legal Advisory Board. Among my publications are Securities Regulations: Cases and Materials (5^{th} ed. Aspen 2006)(with Langevoort and Hillman) and Financial Information, Accounting and The Law (Aspen 1980). In 1966 I passed the AICPA Uniform CPA Exam and thereafter partially supported myself in law school by working as an auditor for a Big 8 accounting firm.

In response to the Committee's request, my comments are directed to issues bearing on the "sustainability" of the accounting profession. As I understand the Committee's focus on sustainability, it addresses multiple concerns that flow from the accounting industry's concentration and the related vulnerabilities for public companies due to the Big Four accounting firms auditing the vast proportion of the assets and revenues of publicly traded firms. This is indeed a multi-headed problem: first, there is concern, growing out of the demise of Arthur Andersen, that the Big Four might slip to some smaller number; second, there is concern that liability and other considerations might prevent so-called second-tier firms from achieving a stature so that they might compete for a larger portion of the audits of Fortune 500 firms; third, there is a concern that due to the concentration enjoyed by the Big Four accounting firms that they might misbehave as an oligopoly; and, fourth, there is concern that liability and other considerations might prevent the ranks of second-tier firms increasing as a result of the growth and possible mergers of even smaller niche accounting firms. While others appearing before the Committee focus broadly on the questions bearing upon concentration within the accounting industry, my focus is upon the connection between sustainability issues with an emphasis on auditor liability.

I. The Liability-Sustainability Connection

Intuition suggests a strong link between concerns respecting industry concentration and liability. Although it was not crushing civil liability that caused the demise of then Big Five accounting firm Arthur Andersen, it is imaginable that Arthur Andersen might have also ceased to exist due to the twin forces of losing its reputation and being beset by multiple viable class actions arising from several of its audit engagements. Similarly, it is not unthinkable that one or more Big Four accounting firms could suffer fatal liability blows in yet to surface financial frauds of their audit clients. And, if this seems far fetched, the scenario becomes less so with respect to exposure of a second-tier firm to liability; while liability might not cause the disappearance of a second-tier firm it could nonetheless break its stride toward achieving the capital to support audits of larger clients. Furthermore, liability is always a consideration in carrying out acquisitions. Thus, uncertainty regarding the existence and magnitude of contingent or non-contingent claims against the accounting firm can be expected to retard combinations that could produce a vibrant second-tier challenger to the Big Four. Thus, liability concerns transcend sustainability and could well impact the profession's competitive structure.

However, the preceding is at best supposition. Responsible policymaking requires that we move beyond conjecture and base decisions on reliable data. The balance of this statement sets forth how this discussion can better occur and makes suggestions for approaches that might be pursued to moderate the impact of liability on the sustainability of the accounting profession.

By way of background, we must have some appreciation for the sources and purposes of accountants' liability. Liability has both deterrent and compensation functions. Government, most notably the Securities and Exchange Commission, has the authority to impose substantial fines upon public accounting firms. Government enforcement, even with the passage of the Fair Funds provisions in The Sarbanes-Oxley Act of 2002, is aimed largely at deterrence. However, our empirical work shows that government remedies rarely yield recoveries that rival those in private suits. *See* James D. Cox & Randall S. Thomas (with the assistance of Dana Kiku), SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke L. J. 737 (2004)(finding that compared to private suits without a parallel SEC action the SEC suits are against smaller issuers, with lower provable losses and the issuers are experiencing financial distress). In stark contrast to government enforcement actions, the courts consistently assign to private suits, particularly class actions, purely a compensatory purpose. I have written extensively on this topic and consistently point out that class actions are hardly compensatory - although they frequently produce recoveries in eight and sometimes nine figures - settlements consistently yield small recoveries compared to the losses suffered by investors. *See e.g.,* James D. Cox & Randall S. Thomas (with the assistance of Dana Kiku), Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs In Securities Class Actions, 106 Colum. L. Rev. 1587 (2006). Nonetheless, the looming presence of the securities class action is a sober reminder that financial frauds will be aggressively pursued by well-armed and resourceful private attorney generals. Because courts have somewhat clumsily and myopically focused on private suits serving only a compensatory purpose, they have repeatedly missed opportunities to think instrumentally about how better compliance can be achieved by discrete tinkering with liability standards. The Committee has a chance to overcome this oversight. But in doing so, the Committee must have some hard evidence before it.

Among the facts that need to be gathered is a crisp assessment of the risk faced by Big Four, second-tier, and other accounting firms. The risk referred to here is their respective abilities to withstand liability, and most particularly, just what level of liability can they sustain. Among the questions that come to mind are: relative free cash flow, net worth, and profitability of the accounting firm (historically comparing such inputs with time-matched litigation and settlement expenditures would further sharpen the analysis for going forward). It is also important to have a better understanding of the availability and related limitations on reinsurance for the liability accounting firms face and currently self-insure. It is my understanding that this information is not available in the U.S. *See e.g.,* D. L. Green, Litigation Risk for Auditors and Society, 10 Critical Perspectives on Accounting 339 (1999)(lamenting the absence of data about accounting firms prevents an evaluation of the seriousness of the risk accounting firms face). The most recent study using the limited data (accompanied by a good deal of estimation) concludes that the case for believing accounting firms face catastrophic liability is not great. *See* Erik L. Talley, Cataclysmic Liability Risk Among Big Four Auditors, 106 Colum. L. Rev. 1641 (2006). Similarly, a study of U.K. based accounting firms examined the limited financial information public accounting firms are required to disclose and concluded that the case for limiting their liability was not supported by the data at hand. *See* D. R. Gwilliam, Changes In The Legal Environment in Current Issues in Auditing (M. Sherer & S. Turley eds., 3d Ed. 2004). The conclusion of these studies need not be the conclusion of the Committee. But to the extent that any consideration is to be given to imposing a ceiling on accountants' liability (whether expressed in absolute amount or determinable via an algorithm), or for that matter any other approach to insulating accounting firms from the liability shocks, data bearing on their financial position and performance is absolutely essential.

To be sure, another factor to consider is the relative risk of suit against the accounting firm. The data on this point does not now appear to support any change to the status quo. This conclusion is suggested by the extremely small number of suits and settlements against accounting firms in recent years. *See* Cornerstone Research, Securities Class Action Filings: 2005 A year in Review 2006 (auditors were named as defendants in 3 cases in 2004 and 5 cases in 2005) *compared with* Z. Palmrose, Empirical Research in Auditor Litigation: Considerations and Data, 2000 Studies in Accounting Research, Journal Accounting Research 33 (during 1960-1995 average of 28 cases per year against auditors) On the other hand, these numbers go to the probability portion of the exposure equation. Those engaged in risky activity assess their overall exposure by the jointness of the probability of an adverse outcome <u>and</u> the magnitude of that outcome. It is the latter factor, the magnitude of the an adverse outcome, that assumes significance in the current debate.   Even with a low probability of a cataclysmic liability event occurring, the event nonetheless achieves significance due to its size relative to net worth (or presumably so, since we do not have data on this we can only surmise this is the case). Hence, the fear is that failure to detect accounting fraud of a large capitalization audit client exposes the auditing firm to the prospect of crushing liability since we can expect losses suffered by investors to increase as the relative market capitalization of the audit client increases.   It is the magnitude, and not solely the probability, component of the risk-exposure-calculation that no doubt drives the accounting profession's quest for meaningful limitations on their exposure.

II. Mechanisms for Moderating Catastrophic Auditor Liability

We must also understand that the proportionate liability provision that was enacted by the Private Securities Litigation Reform Act, Securities Exchange Act section 21D(f), 15 U.S.C. §77u-4, does not fully address the accountants' concerns. Accountants enjoy proportionate, as contrasted with joint and several, liability under the PSLRA only if their auditor acted without knowledge of the fraud.   The proportionate liability provision of the PSLRA thus poses two problems for the auditor that can seriously qualify the intended purpose of the PSLRA to relieve defendants of crushing liability in cases not involving guilty knowledge. First, there is the possibility, even under demanding pleading standards introduced by the PSLRA, that skillful plaintiff's counsel can allege knowledge by the auditor with sufficient particularity so that the complaint survives the defendant's motion to dismiss. When this occurs, the auditor's exposure, post the resolution of pre-trial motions and through settlement negotiations, is not moderated by proportionate liability. Second, and more significantly, proportionate liability can still yield substantial litigation exposure in cases involving a very large capitalization firm. Thus, an auditor whose proportionate sharing of the fault is low, for example ten percent, still faces the possibility of crushing liability if the defalcation amounted to large investor losses, for example $50 billion. In this hypothetical, the audit firm faces an liability exposure of $5 billion. The example reflects the impact of big numbers: a small percentage of a big number is itself a big number. It is on this very point that my defense attorney friends repeatedly inform me that they are frequently compelled to settle their cases when their motions to dismiss have failed to rid their clients of the suit.

There are at least three distinct approaches to addressing concerns for accountants liability: client-auditor indemnification agreements, capping liability, and increasing the net worth of auditing firms through their public ownership. Each of these are addressed below.

A. Indemnification Agreements

The SEC's position is that indemnification agreements compromise the independence of the auditor. *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions, Other Matters, Question 4 (Dec. 13, 2004). The correctness of this position is beyond dispute: a contractual provision that permits the auditor to "put" its liability to its client most certainly creates a contingent financial interest in not simply the audit client and, more importantly, the auditor has an on-going interest in its client's financial success. With respect to the propriety of indemnification clauses in situations that are beyond regulatory jurisdiction of the SEC, a clause that shifts or otherwise limits liability on the part of the audit firm for its member's active participation, knowledge or even recklessness in failing to detect fraudulent reporting stands the audit function on its head. The very purpose of the audit engagement is to detect reporting abuses; it is a perversion of that arrangement were auditors permitted through their engagement contract to extract a "pass" for their knowing or reckless failure to fulfill this undertaking. I am somewhat agnostic with respect to indemnity arrangements with respect to failures attributable to "ordinary" negligence, i.e., the failure to conduct the audit with the skill and care of the objectively qualified auditor in similar circumstances. It seems unlikely that even this style of the indemnity arrangement can be supported out of fears of crushing liability since the contours of liability for negligent representation under prevailing state law seriously limits the class of plaintiffs who can recover for negligent misrepresentation.

Furthermore, an overriding concern in all types of indemnity arrangements is the extent that they reflect the ill-effects of the oligopolystic behavior of the Big Four firms. Even to the extent indemnity agreements were to flourish among second-tier firms we might wonder whether smaller auditor firms would have the power to foist indemnification clauses upon their audit clients if such practices were not also occurring among the dominant Big Four firms. So understood, we can see the prevalence of indemnification clauses flows from the ill-effects of the industry's poor competitive structure.

B. Liability Caps

Any ceiling on liability involves a highly textured inquiry. The inquiry is guided by at least two principles. First, at what level does liability for the individual auditing firm become catastrophic. Second, at what level does concerns of liability become so trivial as not to have an important incentive for the auditing firm to adhere to procedures to maintain high quality among its auditors. Imposing a ceiling on liability, as discussed earlier, requires a good deal of information we presently do not have regarding the financial performance and position of the accounting firms. That is, the strongest case for a ceiling on accountants' liability is based on the fear of crushing liability. This requires some insight into just how big a shock an accounting firm can take as well as assessing how big a shock is still necessary to provide appropriate incentives for auditing firms to take liability seriously.

While I do not propose any particular level of cap or an algorithm for right-sizing the cap for the individual audit firm and audit engagement, I do provide some foundational considerations. First, any ceilings on auditor liability should be used as a carrot for improving audit quality. That is, liability should be seen as serving an important deterrent function. This deterrence occurs not because of liability itself, but by earning a ceiling on liability by taking steps regulators believe will, overall, improve the quality of audits. That is, auditors should not be awarded a carte blanche ceiling on liability by regulators. The regulators should set forth conditions the auditing firm must satisfy to be certified, most likely by the Public Company Accounting Oversight Board, with a audit liability ceiling algorithm (ALCA). I defer to the PCAOB, in conjunction with a dialogue with others, including Treasury, SEC and AICPA, to develop internal procedures audit firms should maintain to assure ever-improving quality of their audits that will allow the audit firm to earn an ALCA. Part of the periodic review carried out by the PCAOB of audit firms could this be an assessment of compliance with this standard. Thus, a mechanism would exist by which auditing standards could be pressed ever upward. Second, the ALCA will be conferred for a pre-determined number of years, for example five. At the end of that period, the PCAOB can review and augment its baseline criteria for audit firms to qualify for a future ALCA. Part of this assessment will include an assessment of the individual audit firms record for quality audits. Third, any ceiling on liability should either not apply, or alternatively the ceiling must be substantially greater, if the audit firm certified client's financial reports that its member knew was false. This qualification merely reflects the good sense that ceilings can more easily be justified when allegations support claims that the auditors were reckless in providing a certification function. That is, the appeal for ceilings on liability is much less when the individual auditor acts with complicity with management; this is particularly so today when the auditor has access to an independent audit committee. Fourth, ceilings on liability will have no impact on SEC enforcement efforts or its ability to obtain substantial sums from responsible parties through fines and disgorgement which become available to investors through the Fair Fund provision. Correlatively, the amount recovered by the SEC against the violator could, with the court's approval, reduce the ultimate liability in the private action. It is my opinion that any such reduction should depend on the facts of the individual case which the presiding court can better address than can an inflexible requirement that operates across all possible fact patterns.

C. Public Ownership of Auditing Firms

A final mechanism for addressing liability concerns is permitting auditing firms to become publicly held. This suggestion poses the most serious change in the history of public accounting. For this reason, it is the solution that requires the greatest reserve on the part of policymakers. At the outset, public ownership poses a host of conflict of interest problems to the auditing firm. There is the conflict in the boldest sense if the auditor audits entities that have a substantial ownership interest in the audit firm or audits an entity in which its substantial holder has a substantial financial interest. There is also a risk that the auditing firm devotion to professionalism will be compromised by owners who do not share this lofty other-directed value. It is this latter point that is most disturbing. For example, public owners might pressure the audit firm to increase margins by paring the staff assigned to conduct audits or increase its market share by lowering the quality and cost of audits. To proceed down the road of public ownership of accounting firms we should recall the wise counsel of Dean Roscoe Pound that an organized profession is not "the same sort of thing as a retail grocers' association." R. Pound, The Lawyer from Antiquity to Modern Times 7 (1953). Being a professional, simply put, means that in the discharge of the professional's livelihood the professional has obligations that transcend the client. The professional has obligations to the public. Auditors are members of a profession. Indeed no other profession rivals it in terms of the express and implied responsibilities to the public. It is not imaginable to me that auditors can be a professional and publicly traded at the same time.

I very much appreciate the opportunity the Committee has provided me to share my insights with you. Needless to say I stand ready to provide any further assistance to your work that I might be to the Committee and its staff.