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PRACTITIONER SUMMARY

Should PCAOB Disciplinary Proceedings Be Made Public? Evidence from Sanctions against a Big 4 Auditor

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SUMMARY: In our paper "Client Stock Market Reaction to PCAOB Sanctions against a Big 4 Auditor" (Dee et al. 2011), we examine stock price effects for clients of a Big 4 audit firm when news of sanctions imposed by the PCAOB against the audit firm was made public. These PCAOB penalties were the first against a Big 4 auditor, and they revealed information about quality-control problems at the audit firm that were not publicly known until the sanctions were announced. Our analysis of stock prices suggests that investors in clients of the penalized Big 4 firm reevaluated their perceptions of the quality of the firm's audit work after learning of the sanctions. The negative stock price effects for the firm's clients were consistent with investors inferring that the financial statements were of lower quality. In the paper, we conclude that investors find information about PCAOB sanctions against audit firms to be relevant in assessing audit quality and use that information in setting stock prices for audit firms' clients. This finding has relevance for the debate on the proposed legislation in Congress (H.R. 3503), which would allow the PCAOB to disclose proceedings against auditors before the investigations are concluded. Our results suggest that, although investors may find early disclosure of this information useful, public disclosure of Board disciplinary proceedings before they are completed could unfairly harm an audit firm's reputation if the firm is ultimately vindicated of wrongdoing.

Keywords: Big 4 Auditor; enforcement; PCAOB; quality control

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INTRODUCTION

In our paper "Client Stock Market Reaction to PCAOB Sanctions against a Big 4 Auditor" (Dee et al. 2011), we examine stock price effects for clients of a Big 4 audit firm when news of sanctions imposed by the Public Company Accounting Oversight Board (PCAOB or Board) against the audit firm was made public. The PCAOB sanctions we study are the first against a Big 4 auditor, and reveal information about quality-control problems at the audit firm that were not known publicly until the Board announced its penalties against the firm. This lack of transparency is required by the Sarbanes-Oxley Act of 2002 (SOX, U.S. House of Representatives 2002), which prohibits the

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PCAOB from making disciplinary proceedings against audit firms public before proceedings are completed, unless the PCAOB and all other parties agree to early disclosure (U.S. House of Representatives 2002, SOX §105 (c)(2)). However, legislation introduced in the U.S. House of Representatives (U.S. House of Representatives 2011, H.R. 3503) would modify SOX to make PCAOB disciplinary proceedings public earlier in the process—that is, before their ultimate resolution.[1]

In this article, we summarize our 2011 study's methods, results, and implications as they relate to the current issue before Congress. Our analysis of client stock prices around the date that the Board's sanctions were announced suggests that investors in clients of the Big 4 audit firm reevaluated their perceptions of the quality of the firm's audit work after learning of the sanctions, apparently inferring that the financial statements they audited were of lower quality, leading to negative stock price effects for the firm's clients. We conclude that investors find information about PCAOB sanctions against an audit firm to be relevant in assessing audit quality and use that information in setting stock prices for the audit firm's clients. This finding has relevance for the debate on the proposed legislation in Congress (H.R. 3503) that would allow the PCAOB to disclose proceedings against auditors before the investigations are concluded. Our results suggest that, although investors may find early disclosure of this information useful, public disclosure of Board disciplinary proceedings before they are completed could unfairly harm an audit firm's reputation if the firm is ultimately vindicated of wrongdoing or the wrongdoing is specific to an audit and not systemic.

The following section describes the first PCAOB enforcement action against a Big 4 audit firm, which resulted in sanctions disclosed to the public in December 2007. We then discuss our 2011 paper's methods and results. In the final section, we consider the implications of our study for practice and regulation, in particular as they relate to the proposed legislation (H.R. 3503), which would allow early disclosure of Board enforcement actions.

DESCRIPTION OF SANCTIONS

On December 10, 2007, the PCAOB announced sanctions against Deloitte & Touche, LLP (the Firm) for actions related to its 2003 audit of Ligand Pharmaceuticals Incorporated (the Company). The Ligand engagement partner (the Partner) also was sanctioned. The Firm was fined one million dollars and agreed to create a "leadership oversight committee" to better supervise its partners and directors.[2]

The events leading to the sanctions began in 2003 with an internal-practice office review of the Firm's San Diego office, which staffed the Company audit. The internal reviewers were critical of

[1] The bill "To amend the Sarbanes-Oxley Act of 2002 to make Public Company Accounting Oversight Board disciplinary proceedings open to the public" (U. S. House of Representatives 2011) was introduced by Representative Lynn Westmoreland on November 18, 2011 and referred to the House Committee on Financial Services. On January 12, 2012, the bill was referred to the Subcommittee on Capital Markets and Government Sponsored Enterprises. The Subcommittee discussed the bill during a March 2012 hearing on auditing and accounting oversight. As of July 24, 2012, the bill was still in committee and had not been submitted to the House for a vote.

[2] We omit further references to the audit firm sanctioned or its client, as the specifics of the firm and client are not the focus of our analyses. Rather, we use the event described as a natural experiment to examine the importance placed by investors on the information provided by the PCAOB's disciplinary process. While this was the first Big 4 firm to be sanctioned by the Board, it is not the last. In 2011, the PCAOB sanctioned five Indian affiliates of PricewaterhouseCoopers. The Board also sanctioned Ernst & Young LLP, along with four of its partners, in 2012.

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the Partner's work and reported their concerns to the Firm's national office. During 2003 and 2004, upper management at the Firm had many discussions and eventually concluded that the Partner should no longer be in charge of public company audits and should be counseled to resign. However, the Partner remained with the Firm and continued to be in charge of the Company audit until the Firm resigned from the engagement in 2007.

In 2005, the Company announced that it was restating its financial statements for 2003 and other periods. The 2003 restatement involved accounting for revenue when a right of return exists; this restatement reduced the Company's 2003 revenue by over 50 percent. According to the Board's orders that imposed sanctions against the Firm and Partner, shortly after completing the 2003 audit the Firm became aware of large quantities of products that were being returned to the Company under its sales return policies (PCAOB 2007a, 2007b). The PCAOB claims that the Firm failed to evaluate the effect that these sales returns had on the Company's 2003 financial statements, and whether this knowledge would have influenced the Firm's audit opinion if it had been aware of it as of the report date.

In sum, the Firm was sanctioned primarily for its quality-control failure regarding the supervision of the Partner. Even though it was aware of his actions, the Firm did not remove the Partner from audits of publicly traded companies. This information was not made public until the PCAOB sanctioned the Firm in December 2007.

METHOD

The PCAOB's order that imposed sanctions against the Firm contains three pieces of information that investors may consider relevant in evaluating their investments in companies audited by the Firm. First, the Firm did not conduct a quality audit of the Company's 2003 financial statements, as evidenced in part by the 2003 restatement. Second, the Firm had quality-control problems extending beyond the audit failure. Even though upper management at the Firm knew of the Partner's performance, he was allowed to continue auditing publicly traded companies. Third, the quality of the Firm's audit work had potential to improve in the future, because the sanctions required remedial actions to improve supervision of the Firm's partners and directors.

To examine whether investors used this information to reassess their perceptions of the quality of the Firm's audits, we examine the stock price reactions to the PCAOB sanctions for 707 of the Firm's clients (excluding the Company), as well as 2,363 clients of other Big 4 auditors.[3] Examining the stock price reaction for clients of the other Big 4 auditors allows us to investigate whether the news contained in the PCAOB sanctions affected the perceptions of the work of the Big 4 audit firms that were not sanctioned by the Board. We analyze the changes in stock prices (for both the Firm's clients and clients of other Big 4 auditors) around the date that the sanctions were announced, using statistical techniques intended to control for changes in stock prices that are unrelated to the sanctions (e.g., overall market movements caused by unrelated economic events).

[3] We included in the study's sample clients of the Firm and the other Big 4 auditors that had the necessary data available on all three of the following research databases: Audit Analytics, Compustat, and CRSP. The Company was not included in the sample, because as of the date that the PCAOB sanctions were announced, the Company had not used the Firm's services for over three years. To ensure that our findings were related to the PCAOB sanctions and not to other events, we excluded clients that made other value-relevant disclosures close to the event date (such as announcements of earnings, dividends, mergers, acquisitions, repurchases, equity issuances, bankruptcy filings, and tax-related events).

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RESULTS

We find that stock prices for the Firm's clients fell significantly when news of the sanctions was made public. The Firm's clients had average negative abnormal returns of −0.46 percent, −0.53 percent, and −0.83 percent when measured over a one-day, two-day, or three-day period around the event date, respectively; these abnormal returns all were significantly less than zero (i.e., negative).[4] Clients of other Big 4 firms experienced abnormal stock returns of 0.04 percent, −0.17 percent, and −0.38 percent, respectively, over the same periods; however, none of these abnormal returns differed significantly from zero. Further, we find that abnormal returns around the event date for the Firm's clients were significantly more negative than were those for clients of the other Big 4 firms. These results suggest that (1) investors in the Firm's clients perceived the news of the PCAOB sanctions negatively, (2) the price reaction was not caused by factors common to clients of all Big 4 audit firms, and (3) the bad news did not "spill over" to tarnish the reputations of other Big 4 firms.

The negative reaction by investors to the Firm's clients could be attributable to news related specifically to the Company's audit failure and/or to news implying that the audit Firm had systemic quality-control problems. While quality-control problems at the Firm were not publicly revealed until the PCAOB's sanctions against the Firm were announced, news of the Company's audit failure was made public years earlier when the Company announced the restatement of its financial statements for 2002–2004. Therefore, we argue that the negative market reaction we observe is driven primarily by news of the quality-control problems as opposed to new information about the audit failure itself contained in the sanction. We refer interested readers to the paper, in which we report additional analyses that provide empirical support for our argument that news of the Firm's quality-control problems was the primary driver of the negative stock price reactions to the PCAOB's disciplinary proceedings.

IMPLICATIONS

Our findings have implications for the debate on proposed Congressional legislation (U.S. House of Representatives 2011, H.R. 3503) that would amend SOX to make PCAOB disciplinary actions against auditors public knowledge before they are ultimately resolved. Before discussing these implications, we highlight some important differences between the event we study and the nature of the proposed legislation.

First, we examine an actual PCAOB sanction resulting from a *completed* investigation. The proposed legislation would allow the Board to disclose *incomplete* investigations, which may or may not lead to disciplinary actions against audit firms. Investors may react differently or not at all to news of incomplete investigations, absent an objective means of distinguishing between investigations that will lead to sanctions and those that will not. Second, our study is limited to the first PCAOB disciplinary action taken against a Big 4 firm. Whether the market reaction we document to this first sanction will hold for subsequent sanctions issued by the Board to other firms is an empirical question that has not been investigated. As more sanctions are imposed by the Board, investors may perceive sanctions as ordinary events with little or no implications for audit

[4] An abnormal return is the difference between the actual return on a security and its expected return. Expected returns usually are estimated by relating a security's return over several months to a benchmark, such as the S&P 500. Abnormal returns often are used as a measure of the effect that an external event (such as a legal judgment or regulatory action) has on a company's stock price.

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quality. Third, the market reaction we document was driven primarily by the audit firm's quality-control problems that were revealed for the first time when the PCAOB issued its order describing the sanctions. Thus, our results may not generalize to Board investigations related to audit failures that do not involve firm-wide quality-control problems.

With the above limitations in mind, the primary finding of our study is that investors pay attention to completed disciplinary actions announced by the Board. Our results suggest that investors use the information gleaned from PCAOB disciplinary actions to evaluate the quality of a firm's audit work and thus the overall quality of financial statements issued by the firm's clients. This finding has relevance to the debate on the proposed legislation in Congress allowing the PCAOB to disclose proceedings against auditors before the investigations are concluded. In a recent Congressional Subcommittee hearing on accounting and auditing oversight, PCAOB Chairman James Doty testified that lack of public disclosure of Board investigations leaves the audit firm's clients (as well as clients' audit committees and investors) in the dark about PCAOB allegations.[5] Additionally, under current rules, investors would not be aware that a company in which they own stock or debt is audited by a firm being investigated by the Board for possible violations of PCAOB standards. Further, audit firms currently have incentives to litigate cases rather than settle with the Board. Drawn-out legal proceedings postpone disclosure of the Board's actions against the firm, allowing the firm to continue its audit practice while the firm's clients and stakeholders remain unaware of the allegations.

Other testimony presented at the hearing pointed out that disclosure of Board disciplinary proceedings before they are resolved risks unfairly damaging an audit firm's reputation if the firm ultimately prevails and is absolved of wrongdoing. Damage to an audit firm's reputation can impair investors' perceptions of audit quality, leading to negative stock market effects for the audit firm's clients (Rauterkus and Song 2005; Krishnamurthy et al. 2006; Weber et al. 2008). Barry Melancon, President of the American Institute of Certified Public Accountants (AICPA), testified that the Board already has the ability to make disciplinary proceedings against a firm public simply by referring the matter to the SEC for enforcement.[6]

The above arguments—both for and against public disclosure of PCAOB disciplinary proceedings—are predicated on investors drawing conclusions about audit quality (and thus financial statement quality) from news of PCAOB enforcement actions. Those in favor of early disclosure of disciplinary proceedings believe that investors, audit committees, and other stakeholders need to be informed promptly about potential problems at an audit firm. Those against early disclosure are concerned that it could unfairly damage the audit firm's reputation if the firm ultimately is cleared of any offenses. While they disagree about the timing of the disclosure, both groups agree that the information is important to investors.

[5] Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy. Hearings before U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, 112th Cong. Statement of James Doty, Chairman of the PCAOB. (March 28, 2012). Available at: http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-JDoty-20120328.pdf

[6] Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy. Hearings before U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, 112th Cong. Statement of Barry Melancon, President and CEO of the American Institute of Certified Public Accountants. (March 28, 2012). Available at: http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-BMelancon-20120328.pdf

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Our research supports this notion. In the context that we examine, we find evidence to support the idea that investors draw conclusions about audit quality from news of PCAOB *sanctions*, leading to negative stock market effects for the audit firm's clients. This result implies that investors may perceive news of PCAOB disciplinary proceedings *in process* against an audit firm as indicative of deterioration in the firm's ability to produce high-quality audits. However, disciplinary proceedings do not necessarily result in sanctions, as an audit firm may be exonerated after the Board has completed its investigation. Further, sanctions imposed by the Board do not necessarily indicate a firm-wide problem that would negatively affect the firm's ability to conduct quality audits. For example, sanctions may result from a client-specific audit failure that does not reflect on the overall quality of the audit work delivered by the firm. Thus, we conclude that, while investors may value information related to uncompleted PCAOB enforcement actions (as argued by proponents of the proposed legislation), the disclosure of Board investigations against an audit firm before they are resolved could unfairly damage the firm's reputation, if it is ultimately cleared of wrongdoing.

Second, we show that investors value information about quality-control problems at audit firms. Although our study is based on examination of an enforcement action rather than a routine firm inspection, it is possible that investors would use information about quality-control problems identified in PCAOB inspections when valuing a firm's clients. Currently, SOX (U.S. House of Representatives 2002, §104 (g)(2)) prohibits complete disclosure of quality-control problems found by the PCAOB as part of its regular inspection program unless the audit firm fails to remediate them within one year.[7] However, unlike its enforcement program, the primary focus of the Board's inspection program is remedial; that is, its purpose is to identify problems early so that firms can correct them going forward. Thus, the cost of damage to firm reputation by early disclosure of quality-control problems found in inspections reports may exceed any benefit to investors. The current lack of full, immediate disclosure may facilitate a more open dialog between the PCAOB and auditors that could lead to faster identification and remediation of audit and quality-control deficiencies.

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[7] According to Evans et al. (2011), non-public information from PCAOB inspection reports is not widely distributed among Big 4 firm personnel, much less given to clients. In addition, in 2011, the Board disclosed quality-control defects at Deloitte, which may represent a related opportunity for future research. Available at: http://pcaobus.org/Inspections/Reports/Documents/2008_Deloitte.pdf

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