PCAOB Rulemaking Docket Matter No. 017

Re: PCAOB Release 2004-015

Comments of Donald H. Chapin

Summary Statement

Except for allowing tax services for Audit Committee members, the proposed ethics rules are appropriate, as far as they go. But the Board should do more towards satisfying the stated SEC's public policy goals of:

- Promoting investor confidence, and
- Minimizing the possibility that external factors will influence auditors' judgment.

There are needed changes in auditing standards that would further these goals. I believe the Board should:

- Adopt the responsibility concepts enunciated in United States vs. Arthur Young & Co. This expansion of auditor responsibilities will increase auditor attention to both the concept of independence and the principles and rules of independence. The recognition of these responsibilities in the standards will increase investor confidence in the markets.

- To the fullest extent possible, deal with bias arising from some permitted non-audit services and from other known factors affecting relationships with management. With appropriate warnings and supportive changes in the standards, auditors will be better able to both overcome their own bias, and deal with management's. These steps will reduce the influence of external factors on auditors' judgment.

Strengthening auditor independence, and its corollary auditor objectivity, is critical. Changes in standards that will do this should not wait until the Board finds the time to make the much needed overhaul of AU 110 and the General Standards of Auditing.

The ethics rules could be a temporary home for my suggested changes. But they, and the essence of certain of the Board's proposed ethics rules, belong in the auditing standards. There, they will receive the full attention they deserve.

United States vs. Arthur Young & Co. – Auditor Responsibility

Auditor responsibility should be expanded by inclusion in the standards of an appropriate version of the concepts enunciated by Chief Justice Burger in the 1984 decision United States vs. Arthur Young & Co. Those were: (a) the auditor owes "ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public" and (b) the auditor has a “public watchdog” function that “demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust”.

Arthur Wyatt articulated these concepts in his 2002 paper on professionism where he stated that the auditor should place “primary emphasis on protection of investors and the furtherance of the public interest”.

Sarbanes-Oxley was enacted to protect potential investors as well as stockholders. By all accounts, trust in the auditing profession by investors continues to be limited. Investors are concerned. Judging from views expressed by the investor representatives on the Board’s Standing Advisory Group, investors believe that auditor responsibilities to the investing public should be clearly and unequivocally stated, as soon as possible.

Bias and its Effects on Auditor Judgment

Fraud is not the same as bias, although it is sometimes hard to draw the between the two. Fraud has been and is being addressed in the auditing standards. But, the causes and cures of auditor bias and the effects of management bias on auditors have not been sufficiently addressed.

The many restatements where no fraud is alleged and the many criticisms by analysts of financial reporting provide evidence that many financial statements are in error or lack representational faithfulness. I believe that bias is a major contributor to this problem and should be addressed in the standards.

If the auditor can overcome his own bias and deal with management’s then, not only will auditor judgments about material error and fraud be improved, but also issues of representational faithfulness are more likely to be raised with the audit committee for discussion and resolution.

<u>Auditor Bias</u>

While much has already been done to eliminate auditor bias, auditors’ judgment will still be affected by:

- Non-audit services such as tax planning and advice, as useful as they clearly are, that will sometimes create significant common interests between the auditor and management and result in pro-management bias. The proposed ethics rule is an important, but perhaps insufficient remedy.
- Other factors affecting relationships with management that are also contributors to bias:
    - Management’s limited, but still continuing influence over auditor compensation, tenure and retention for non-audit services. This results in an economic incentive to accept management positions.

- Close working relationships and related personal associations with management during years of auditor tenure. This makes auditors more receptive to management positions.
- Difficulties in understanding large and complex businesses, auditing fair value accounting and intangibles, and evaluating IT systems. This tends to make auditors management dependent.
- The latitude provided for management estimates and choices of accounting principles, and that resulting from the materiality concept. These provide flexibility to agree with management positions, and avoid the stressful "push back" of disagreement.

My views on the causes of bias are based on experience and observation. They are buttressed by authors of a 2002 Harvard Business School publication "Why Good Accountants Do Bad Audits". The authors relied upon psychological research in making the case that many good auditors have an unconscious bias.

Auditor pro-management bias contributes to borderline opinions and non-comparable financial statements. It inhibits appropriate discussions with the Audit Committee about specific matters as well as the overall quality of the financial statements. It is a serious behavior problem.

The standards should address this problem and the Board's upcoming review of the Quality Control standards should consider it. Unconscious bias, perhaps a bigger problem than conscious bias, will be reduced by warning auditors of the aforementioned dangers to objectivity. Conscious bias may be reduced by the threat of exposure coming from recital of these dangers in the standards and responsive audit committee questioning.

More can be done. The definition of Independence discussed above can be further strengthened by stressing the importance of "character" (John Cary's concept) in living up to the requirements of independence, and by emphasis on the auditor's personal responsibility to act in a truly independent manner. This would be a positive standards' counterpart to the Board's proposed "associated persons" ethics rule.

<u>Undue Respect for Management Bias</u>

The existing independence standard calls for judicial impartiality that recognizes the auditor's obligation for fairness <u>not only to management</u> (emphasis supplied) and the owners of a business, but also to others who may rely on the auditor's report. This sends the wrong signal. Management is an integral part of the audited company, and may often be biased in its financial reporting. The auditor should not, as too often happens, seek ways to support management positions within the latitude provided by accounting standards.

Responsive changes in auditing standards should help auditors deal with management bias.

Legal Jeopardy

Adoption of the concepts of the Arthur Young case and asking auditors to overcome and deal with bias has some legal implications. Potential legal liability costs to auditors can be justified by a cost benefit analysis that considers both the costs to investors and the economy of financial statement error and lack of representational faithfulness, and by the economic benefits to auditors provided by the Board's expansion and strengthening of the auditing function.

Tax Services to Audit Committee Members

I question the advisability of permitting this, but not only because of possible perception of impairment of the auditor's independence. I believe that the resulting favorable bias of audit committee members toward the auditor may inhibit the Committee's objectivity in discharging its own obligations, a view I believe that was held by many of the members of the Blue Ribbon Committee.

Conclusion

I hope that the Board will consider these issues. If the Board has already done so, and the decision has been taken that these issues are not critical to the SEC's public policy goals, or that these issues should be left to the SEC for resolution, then I hope that the Board will discuss the issues and their resolution in the final PCAOB rule.

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