INTRODUCTION
In July 2009, the Public Company Accounting Oversight Board (PCAOB), the entity responsible for the oversight of audits and auditors of US publicly traded companies, issued a Concept Release requiring audit engagement partners of US publicly traded companies to be identified by signing their firm’s audit reports. This article attempts to identify who would benefit from and who would pay for identifying the audit engagement partner. We do this by summarizing the commentary of responders on the Concept Release, comparing the Concept Release to provisions contained in the Sarbanes-Oxley Act of 2002, examining arguments for and against identifying the audit engagement partner, and summarizing the likely impact of adopting the Concept Release. We conclude that, if adopted, it is unlikely that audit partner identification would enhance audit quality. Further, the cost of additional audit and/or quality control procedures associated with implementation will likely be borne by companies and their shareholders.
US publicly traded companies, issued *Concept Release Requiring the Engagement Partner to Sign the Audit Report* (No. 2009-005 – Concept Release). The release solicited public comment on whether the PCAOB should require the partner with final responsibility for the audit to sign the auditor’s report. Currently, auditors' reports are signed only with the name of the auditing firm issuing the report and the city in which the engagement team is located.

Members of the PCAOB’s Standing Advisory Group (SAG), a group of 30 individuals representing auditors, investors, public companies and others who advise on the development of auditing and related professional practice standards, generally believe that a signature requirement could increase the audit engagement partner’s accountability and transparency, and hence will improve audit quality. In October 2008, the US Treasury Department issued a report urging the PCAOB to ‘undertake a standard-setting initiative to consider mandating the engagement partner’s signature on the auditor’s report’ (U.S. Treasury Department Advisory Committee on the Auditing Profession, 2008, p. VII: 20). The accounting firms provide a variety of reasons why identification of audit engagement partners is not necessary including: existing mechanisms are sufficient to ensure accountability and audit quality; identification could result in unreasonable exposure to personal liability for the engagement partner; and the possibility of a decrease in audit efficiency. For example, in commentary on the Concept Release, Ernst & Young (E&Y) argues,

> … at a practical level in terms of audit quality, we do not believe there will be any appreciable benefit in light of the accountability already provided through a firm’s system of quality control, the exposure of the engagement partner to personal sanction and penalty as provided under SEC and PCAOB rules and regulations, potential proceedings by State boards of accountancy and the threat of private litigation.

In its commentary, PricewaterhouseCoopers (PwC) also suggests that the signature of the engagement partner will result in increased liability to partners. As a result, additional audit

**COMMENTS ON THE CONCEPT RELEASE**

As of 17 September 2009, the date the comment period expired, the PCAOB had received 23 letters commenting on the Concept Release. Most comments were from practicing auditors or organizations representing practicing auditors.

**Auditing firms**

Each of the major auditing firms (Deloitte, Ernst & Young, KPMG, Pricewaterhouse-Coopers), among others, generally dispute the Treasury Committee’s assertion that identification of the engagement partner ‘should not impose on any signing partner any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of an auditing firm’ (U.S. Treasury Department Advisory Committee on the Auditing Profession, 2008, p. VII: 19). Several other jurisdictions already require identification of the audit engagement partner (for example, Australia) or are considering adopting similar mandates (for example, European Union).

In this article, we attempt to identify who would benefit from – and who would pay for – identification of audit engagement partners. We do this by summarizing the commentary of responders on the Concept Release, comparing the Concept Release to provisions contained in the Sarbanes-Oxley Act of 2002 (SOX), examining arguments for and against identifying the audit engagement partner, and summarizing the likely impact of adopting the Concept Release. We conclude that, if adopted, it is unlikely that audit partner identification would enhance audit quality. Further, the cost of additional audit and/or quality control procedures associated with implementation will likely be borne by companies and their shareholders.
work will be necessary to mitigate the increased risk of litigation, thereby reducing the efficiency of the audit. Specifically, PwC states,

… the proposed requirement could result in unintended adverse consequences and burdensome complexities that would be counterproductive to the efficiency, timeliness and cost effectiveness of the audit.

**Investors**

Although the auditing firms provide arguments against the Concept Release, investors are generally supportive of the proposal. For example, a representative of the Council of Institutional Investors comments,

Greater transparency regarding the background and experience of the lead auditor will help investors better assess the rigor of the audit process, and by extension, the quality of the financial statements.

Similarly, a representative of CalPERS, an institutional investor with approximately US$250 billion in assets, states,

Although CalPERS agrees that the skill of the audit firm as a whole is represented and stated in the opinion of the audit report, we believe 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), lead to greater care in performing the audit and possibly provide better investor protection.

Not all investors are supportive of the Concept Release. At a meeting of the SAG on 23 October 2009, one person testified against partner identification citing the potential for increased audit fees, the reputation of the engagement partner impacting issuers, and the possibility that early engagement partner rotation might create disclosure issues.²

**ANALOGIES TO PROVISIONS IN SARBANES–OXLEY**

The Concept Release has been viewed by some as being somewhat analogous to existing financial reporting standards, which require specific representations by management of audited companies. In the CalPERS commentary, the representative comments that,

We continue to support the certification requirement of the CEO and CFO of companies under Section 302 of Sarbanes–Oxley and directors’ signatures on public company annual reports and liken this proposed recommendation to these requirements and to the inherent benefits this may produce.

As alluded to by the CalPERS representative, officers and directors of publicly traded companies are required to be identified in companies’ annual reports. For example, under Sections 302 and 906 of SOX, Chief Executive Officers (CEO) and Chief Financial Officers (CFO) must certify, among other things, that the annual report does not ‘contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report’.

The identification and personal acknowledgement of the above statements by CEOs and CFOs is thought to increase transparency and accountability. However, before SOX, the identities of the executives were publicly available and the executives were required to sign their companies’ Form 10-K, thereby acknowledging some level of responsibility for its content, including the financial statements.

A more analogous rule to the Concept Release is the requirement under Section 407 of SOX that companies identify a member of their audit committees a ‘financial expert’. Before SOX, although members of the audit committee were included in SEC filings, there was no identification of a member of the audit committee as being a ‘financial expert’. Expertise
of audit committee members was discoverable in the event of a lawsuit, as is the name of the audit engagement partner, but there was no public disclosure of this information before SOX.

During the drafting of SOX in 2002, managers and board members of publicly traded companies greatly opposed the identification of a financial expert mandate, citing reasons similar to those expressed by the auditing firms in opposition of the Concept Release.³ For example, Douglas H. Philipsen, Chairman of the Board of Independent Bank Corp. stated,

… in addition to the small applicant pool, many of these qualifying individuals may not be willing to accept the increased risk of liability inherent in the position. Although the Commission assures us that the ‘mere designation [of an individual] as a financial expert should not impose a higher degree of individual responsibility or obligation’ on the individual, the reality is that the public perception is that there is indeed a higher degree of risk.

Karen Robards, Audit Committee Chair, writing on behalf of the independent Directors of the Merrill Lynch Mercury Funds and the Merrill Lynch Funds for Institutions Series echoed these views when she wrote,

We strongly oppose the portion of the proposed rules that would require an issuer to identify the financial experts on its audit committee. As the Commission itself noted, the Act does not require disclosure of the experts’ identity, and identifying specific committee members as experts would expose those members to greater scrutiny and risk of being singled out in litigation. As a result, individuals will be unwilling to be designated ‘financial experts,’ even where they would otherwise qualify.

In contrast to the position of management, and contrary to their position on engagement partner identification, the major auditing firms were generally in favor of identification of a financial expert during the formation of SOX. For example, PwC commented,

We believe that all foreign private issuers should be required to disclose if they have an audit committee financial expert and, if applicable, the reasons why they do not have one. There is virtually no cost to providing this information, and it is valuable to a US investor.

KPMG, among others, felt that the definition of ‘financial expert’ needed some revision, but, nevertheless, supported identification as depicted in the following statement:

We concur with the Commission’s statement that ‘disclosure of the names of the company’s financial expert or experts would assist investors in evaluating the company’s annual report and proxy or information statement disclosure that describes the background and business experience of the company’s directors’.

E&Y’s commentary supported the measure believing it would have a positive impact on financial reporting quality, but also expressed concerns. E&Y wrote,

‘… we expect that this disclosure requirement will prompt companies to ensure that at least one audit committee member has relevant, sophisticated financial expertise. We support this objective and believe that financial expertise strengthens the effectiveness of audit committees in discharging their important role in corporate governance.’ Notwithstanding these views, we believe that publicly naming any member of the audit committee as a “financial expert” is likely to have the inevitable effect of increasing the responsibility, and potential liability, of the named audit committee member. As a consequence, companies may find it more difficult to attract and retain the most qualified financial experts to serve on audit committees,
with the unfortunate consequence that the effectiveness of audit committees could be diminished.’

Deloitte also supported requiring that audit committees have at least one financial expert, but felt that identification of the qualifying member was not necessary.

**SUPPORT FOR ARGUMENTS FOR IDENTIFICATION**
The primary argument in favor of identification of the audit engagement partner is that identification increases accountability and leads to increased professional care to protect the individual’s reputation and to minimize any increase in personal liability. Although there appears to be no direct empirical evidence regarding the relationship between having to personally sign and accountability, there is a base of research that focuses on the relationship between accountability and antecedents to audit quality. For example, Schlenker et al. (1994) find that an individual’s sense of responsibility is related to their sense of accountability. DeZoort et al. (2006), Kennedy (1993), and Johnson and Kaplan (1991) find the greater an individual’s sense of accountability, the less likely their audit judgments are to be biased. Collectively, this evidence generally supports the notion that if identification of the audit engagement partner increases the partner’s sense of accountability, audit quality may be enhanced.

The inclusion of a partner’s signature increases the auditor’s transparency to investors, and as the SAG argues, the increase in transparency may improve audit quality; however, transparency alone may not improve audit quality. Audit quality is difficult to define, and evaluating audit quality is subjective; therefore, disclosure of more information does not guarantee behavior will change. Nevertheless, the additional information may provide a benefit to investors, audit committees, regulators and other stakeholders when evaluating audit firms and engagement teams.

**ANALYSIS OF ARGUMENTS AGAINST IDENTIFICATION**
Several arguments can be made against audit engagement partner identification. These include, but are not limited to, (1) increased liability for the engagement partner; (2) the potential for decreases in audit efficiency, which may lead to increases in audit fees (or reduced audit firm profits); (3) the existence of sufficient auditing quality control standards currently in place; (4) the potential adverse effect on companies resulting from the engagement partner’s reputation; and (5) the lack of a need, as the engagement partner’s identity is already known by the audit committee.

**Increased personal liability for the engagement partner**
To determine the impact of the Concept Release on the personal liability of engagement partners, we review case history of the analogous provision, Section 407 of SOX – Identification of a Financial Expert. As discussed above, managers and board members argued during the implementation of SOX that identification of specific financial experts would increase the designated expert’s liability. If enactment of the rule actually did increase the named financial expert’s liability, we would expect to find litigation brought against these individuals since the date of enactment.

We search Federal and state cases during the period July 2002 – December 2009 for matters brought against audit committee members designated as financial experts under Section 407. We find no cases brought in Federal courts. We find three state cases in which reference is made to a board member’s designation as a financial expert. None of these cases makes specific assertions about the designate financial experts having a higher level of authority or expertise, and in no case is the designated financial expert the sole plaintiff. One case was dismissed because of a lack of evidence; the other two were unsuccessful. This lack of case law, to date, suggests that the same arguments managers and board members assert against the
identification of an audit committee financial expert are unsupported, and by extension, suggest auditors’ similar concerns about the identification of the engagement partner may be unwarranted.

It is important to note Federal law requires the designation of a financial expert. State laws generally mandate that corporate directors owe a duty of obedience, care and loyalty to the corporation to act in its best interest, without profit at the corporation’s expense. Director liability has long been insulated by a presumption of ‘business judgment’, which suggests that absent gross negligence, directors are presumed to act in good faith when honest actions are taken in the corporation’s best interest if done so on an informed basis by financially disinterested directors. Therefore, at a state level, absent gross negligence, these standards in conjunction with reasonable oversight will generally protect directors, including those designated as financial experts, from liability. Further, unlike the current signing partner recommendation, safe harbor language is afforded designated financial experts which states,

The designation or identification of a person as an audit committee financial expert pursuant to this Item 407 does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification.

Having considered the arguments of heightened liability of designated financial experts, we turn to the Federal body of law that presumably would apply to signing partners. Legal actions against accountants can originate from common law assertions of negligence, breach of contract, breach of fiduciary trust and constructive fraud, and relevant securities law. Similar to the designation of a financial expert, any increased responsibility of signing partners would presumably originate at the Federal level.

Although an auditor’s civil liability can arise from failure to meet legal standards for performance in many other areas whether from violation of various securities laws, federal criminal statutes, or regular common law breaches of contract, the issue is whether the mere identification of the signing partner is sufficient to heighten individual liability for negligence. Under the Doctrine of Respondeat Superior, accounting firms retain liability of audit partner-agents’ actions when such actions are deemed to be within the realm of the partner’s apparent authority in a role more comparable to an employee than an independent contractor. Where the partner is not in a separate trade or business, as with most auditing firms, and negligent actions occur in a process that is set and controlled by the policies of the firm and within the scope of the partner’s employment with the firm, dual accountability for such negligence occurs. This distinction can become blurred when unauthorized intentional actions by the partner create this asserted dual liability. Nonetheless, shared liability for successfully proven negligence in an audit is most often not pursued given that the audit firm has greater resources, or ‘deeper pockets’, than the audit partner.

**Potential decreases in audit efficiency**

As identification of the engagement partner does not alter the auditor’s duty to use professional care, or auditing firm’s need for an appropriate system of quality control, the partner’s signature on the auditor’s report theoretically should not alter the conduct of the audit. Practically, however, implementation of the Concept Release will likely have a negative effect on audit efficiency. For example, it is likely that partner identification will result in additional audit or quality control procedures designed to protect partners and their firms from the threat of litigation.

Investor commentary in support of engagement partner identification acknowledges an increase in transparency that will lead the auditor
to develop a more rigorous audit process and improve audit quality. Assuming identification of the engagement partner either creates more work by the auditor or requires a higher fee to offset additional insurance or reputational effects, the auditing firm may either absorb these costs, or pass them along to the client. Unfortunately, the impacts of audit inefficiencies that are absorbed by the auditor, reducing the auditor’s engagement profitability, are unobservable; however, these are likely of less concern than audit inefficiencies passed along to companies in the form of higher audit fees. To assess the likelihood that decreases in audit efficiencies will be passed along to companies, we look at the impact of similar changes.

The most recent regulatory change that may have had impacts similar to those expected of the Concept Release was the adoption of SOX in July 2002. In 2002 and 2003, many of the provisions of SOX were required to be implemented, but, like the Concept Release, none of those provisions would have obviously increased audit work, but several may have impacted the auditor’s insurance or reputational costs. For example, auditors were required to register with the PCAOB and undergo periodic inspections by the PCAOB. Arguably, the only SOX provision that obviously increased audit work was Section 404, which requires auditors to report on the effectiveness of companies’ internal control over financial reporting.

In spite of Section 404 not being effective until 2004, audit fees among publicly traded companies increased at a rate significantly higher than inflation. In 2001, the average audit fees of all publicly traded companies included in the Audit Analytics database was $424,000, compared to $533,000 in 2002 (26 per cent increase over 2001, versus 1.5 per cent inflation in 2002), and $567,000 in 2003 (6 per cent increase over 2002, versus 2 per cent inflation in 2003). In 2004, the year that Section 404 was required for companies with a market capitalization of at least $75 million, the average audit fees for all publicly traded companies further increased to $849,000 (50 per cent increase over 2003, versus 2.5 per cent inflation in 2004).

These data suggest that the cost of insurance and reputational effects of auditors likely increased as a result of SOX, and these increases were passed along to companies. By extension, it is likely that incremental audit or quality control procedures implemented as a result of the Concept Release will at least in part be borne by companies and their shareholders.

Audit firms already conduct high-quality audits
One of the arguments of the SAG is that requiring the engagement partner’s signature will increase audit quality. Auditing firms currently must comply with existing quality control standards that provide reasonable assurance that the audit firm and its personnel comply with professional, regulatory and legal requirements, and that reports issued are appropriate in the circumstances. Accordingly, it does not necessarily follow that engagement partner identification will result in enhanced audit quality.

Others have investigated regulation’s ability to enhance audit quality with mixed results. For example, Abbott et al (2010) found that certain SOX regulations may have diminished audit quality for some registrants, and Lobo and Zhou (2006) report that financial reporting may have become more conservatively biased, not less biased, since SOX. Moreover, audit quality is a latent variable, and therefore proving that audit quality will be enhanced by a partner’s signature on the auditor’s report would be difficult.

Audit partner reputational effects
This issue concerns the potential negative impacts companies may experience if their audit engagement partner has or acquires a negative reputation, such as when the auditor is associated with an audit failure of another company, and financial statement users incorrectly evaluate the quality of the company’s financial reporting as a result. Presumably, if an
Audit partner has a negative reputation at the date of appointment, companies will either not permit that partner to work on the audit, or will require the audit fee to reflect the expected impact of the audit partner’s reputation. On the other hand, if an audit partner acquires a negative reputation during the course of the audit, the company may insist that the audit partner be removed from the audit engagement. If the auditing firm insists that any audit inefficiency be passed along to the company as a result of replacing the partner, the company may, or may not, have the option of replacing the audit firm. The company would likely consider SEC filing deadlines, and the expected impact of the partner’s reputation when deciding whether to replace the audit partner or audit firm.

The results of prior research suggest the auditing firm’s reputation impacts companies’ market values. For example, Weber et al (2008) studied the stock and audit market effects associated with a widely publicized accounting scandal involving KPMG’s German practice. They found significant negative stock price impacts on the audit clients of KPMG in Germany, around the time of the scandal, and conclude that audit clients of KPMG were adversely impacted by the change in KPMG’s reputation. Huang and Li (2009) study the impact of Arthur Andersen’s reputation on the market value of its clients, finding that clients of Andersen’s Houston office, in particular, suffered significant negative stock price effects following news that the office had shredded workpapers. Barton (2005) reports similar findings studying the Arthur Andersen issue and concludes companies more visible in the capital markets tend to be more concerned about engaging highly reputable auditors, as they try to preserve their own reputations for credible financial reporting. Baber et al (1995) also find significant negative stock price reactions of the clients of Laventhol and Horwath in the period surrounding announcement of the auditing firm’s bankruptcy, although they are unable to distinguish whether such impacts were the result of reputational or insurance effects.

Collectively, the results of prior research support companies’ concerns that the reputation of the audit partner could adversely impact them; however, circumstances will likely determine whether companies or auditors will bear individual audit partners’ reputational costs.

**Engagement partner’s identity is already known by the audit committee**

Another argument against the partner’s signature is that shareholders already know, although indirectly, who is the engagement partner on the audit. Communication between the auditor and governing body of the client, usually in the form of an audit committee, is required by auditing standards. Audit committees are composed of independent (non-management) board members who are elected by shareholders, and are charged by shareholders to act in the interest of shareholders. Thus, although individual investors may not know who the engagement partner is, the partner is known by a committee elected to represent the investors.

**SUMMARY**

In this article, we attempt to identify who would benefit from – and who would pay for – identification of audit engagement partners. Although we find that investors may benefit from transparency, audit partner identification is unlikely to directly impact audit quality. Further, the cost of additional audit and/or quality control procedures associated with implementation of the Concept Release will likely be borne by companies and their shareholders. Although auditing firms have been most vocal about the potential negative impacts of adopting the Concept Release, we are unable to identify evidence supporting the notion that personal liability of audit partners will increase, and prior evidence suggests that the cost of decreases in audit efficiency because of insurance or reputational effects will likely be passed along to companies.
This discussion of public identification of US audit engagement partners precipitates several questions for future research. First, does the Concept Release go far enough? Is simply having an engagement partner’s signature enough to satisfy the need for increased auditor transparency? Other disclosures about the audit engagement partner may be necessary to substantively enhance auditor transparency, a key goal of the Concept Release according to SAG. Additional disclosure of an engagement partner’s educational background, competency, industry experience, disciplinary proceedings, pending litigation and legal settlements may more directly enhance transparency. Future research may investigate whether these types of disclosures incrementally enhance transparency or effect investors’ decisions.

Second, at this point, no safe harbor provisions similar to that afforded designated financial experts exist. One way to address audit partners’ and firms’ concerns regarding increases in individual partner liability may be to include safe harbor language similar to that included in Section 407. However, if some type of safe harbor language is adopted, a conundrum may result in the responsibility of audit committee members. When charged by SOX with responsibility for appointing and supervising the independent auditors, one might argue that to discharge their duty of care and sound business judgment obligations, the audit committee should hold the audit engagement partner to the highest level of accountability; but how can choice of auditor be considered sound when accountability of the engagement signing partner is lessened as a result of safe harbor language? At some point, accountability must be present in assessing liability.

Third, it has been posited that auditors may be less concerned with enhancing the credibility of financial statements than they are on minimizing their legal liability (Healy and Palepu, 2001). Therefore, they are likely to lobby for standards that reduce their own risk even if such standards reduce the value of the financial statements to investors. However, to our knowledge, no research has been conducted to directly test this assertion.

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NOTES
5 In order to be afforded safe harbor protections, if adopted, the identification of the audit engagement partner would have to be a federal law, promulgated by the SEC, not a rule of the PCAOB as currently contemplated.

REFERENCES


