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I very much appreciate the invitation to contribute to the important discussion about the Public Company Accounting Oversight Board's (hereafter "the PCAOB" or just "the Board") proposal to expand the current auditor's reporting model.¹

To begin, let me state that I think the Board is to be congratulated for investing significant resources to understand whether the current auditor reporting model—which, as the Board observes, has been in place without significant modification since the 1940s—needs to be modified given the extent to which our capital markets and economy have changed since that time. Further, I think most will agree with the general proposition that expanding the amount of disclosure about the audit process is potentially beneficial to investors.

My comparative advantage in these proceedings is perhaps to inform the Board and other interested parties about the academic literature on disclosure and offer some words of caution about the general thrust of the current proposal that significantly expands the disclosures required by, as well as the role of, auditors.

By way of background, I am a professor of accounting at the University of Chicago, and have served as editor of the Journal of Accounting Research since 2006. Prior to that, I served as editor of the Journal of Accounting & Economics for seven years. JAR and JAE are generally considered, along with The Accounting Review, to be the top academic accounting journals in the world. My research interests span financial accounting, auditing, disclosure, and corporate finance, and I generally take a strong empirically-oriented economics-based approach to problems in these areas. I also have consulting experience in these areas and have in the past provided input to policy deliberations at both the FASB and SEC.

There is a very large literature in economics, finance, and accounting on disclosure, both mandated disclosure (that is, required disclosures such as 10-K filing requirements) and voluntary disclosure (such managers' decisions to provide earnings guidance). I will focus my comments on what economists have to say about mandated disclosure, since that is what we are talking about here.

As a general proposition, I think it is fair to say that economists agree that increasing disclosure has benefits. As the proposal observes, there is much theoretical work that

¹ My comments address the two new auditing standards being proposed by the Board, as described in PCAOB Release No. 2013-005 (August 13, 2013).

shows, generally, that increased disclosure of information—assuming that information is in some sense relevant and informative to investors—has benefits in terms of reducing information asymmetries in capital markets (differences in the information available to different sets of investors) and can result in improvements in market liquidity and improved pricing, including a lower cost of capital.

However, there are also costs of mandating additional disclosure, both direct costs such as proprietary and litigation costs, and indirect costs which we might refer to collectively as “unintended consequences.” In the case of the current proposal, I think these costs—which are inherently hard to observe and quantify—could be very significant. Moreover, I have some skepticism about the potential benefits of these disclosures, which are perhaps even more difficult to quantify. This makes it hard to assess the cost-benefit tradeoff involved in making a decision about the proposals. Let me expand on these points, focusing on the benefits first.

Professor Mock and his co-authors have prepared a very useful and thorough summary of a particular part of the auditing literature in accounting.² Given Professor Mock’s participation here, I will not reiterate the conclusions of that research. However, I will observe that, as the authors of these studies acknowledge, much of the evidence offered on the espoused benefits of the new disclosures is based on survey and experimental data, as opposed to empirical-archival data. There is not much we can do about this—it is exceedingly difficult to design studies using real world data (non-experimental or “archival” data) to assess the costs and benefits of disclosure.³ However, in my view, we should be very careful placing too much weight on survey evidence from investors who say they want more disclosure—given that there is no cost to them, what else would we expect them to say? I am not sure we learn very much about the benefits of disclosure from this type of evidence. The logical extension of this idea—that the world will be better with more disclosure—is sometimes known as the “nirvana fallacy.”⁴

I would also point out that there is perhaps a reason why the audit report in its current form has survived largely unchanged for many decades, not only in the United States but essentially throughout the world. As the economics literature makes clear,⁵ auditing generally, including the traditional “pass/fail” model, plays a central role in validating the information in firms’ general purpose financial statements. This role predates regulations that mandated the disclosure of audited financial statements. Audited financial statements have been used for hundreds of years, dating back to at least medieval times in England.⁶ This implies that the basic attestation role of auditors, which includes the pass-fail model,

² See T. J. Mock, J. Bedard, P. J. Coram, S. M. Davis, R. Espahbodi, and R. C. Warne, “The auditor reporting model: Current research synthesis and implications,” *Auditing: A Journal of Practice & Theory* 32 (2013): 323-351 and the December 10, 2013 comment letter by the same authors.

³ To perhaps over-simplify things, this is because we cannot observe the “counter-factual world” with the proposed disclosure regime.

⁴ For example, see R. Leftwich, “Market failure fallacies and accounting information,” *Journal of Accounting & Economics* 2 (1980): 193-211.

⁵ See, for example, M.C. Jensen and W. H. Meckling, “Theory of the firm: Managerial behavior, agency costs, and ownership structure,” *Journal of Financial Economics* 3 (1976): 305-360.

⁶ For example, see R. L. Watts and J. L. Zimmerman, “Agency problems, auditing, and the theory of the firm,” *Journal of Law & Economics* 26 (1983): 613-633.

serves an important economic function as currently configured. Thus, while surveys may indicate that certain users claim not to use the audit report very much,⁷ we should take care in inferring from this that the report in its current form is not fulfilling an important economic role given the very strong survival value of the current model.⁸ I worry that tampering with a model that has survived for so long will have consequences that we cannot easily predict.

Let me turn to some of the potential costs of these disclosures.

First, it seems to me that the proposed requirement for auditors to report “critical audit matters” (CAM) could expand the set of information disclosed about firms beyond what is currently required under the Securities Laws and related SEC regulations.⁹ This seems like a very significant change in the whole financial reporting model, because it means that the audit report would potentially become *a disclosure mechanism in its own right*—beyond what is currently disclosed by issuers in their financial statements and related disclosures. Thus, an important element of the current model—that management takes responsibility for preparing financial statements and disclosing related information and that auditors then attest to the reliability of that information—would change, because now the auditors potentially would actually be disclosing information about the firm directly.

To the extent that the new auditor reporting model expands firm disclosures, it seems likely that proprietary costs come into play. These are the costs to firms of additional disclosures that provide important competitive information about the firm’s operations and strategies to competitors, suppliers, customers, or other entities with which it conducts business. For example, a bank’s risk management strategies and procedures are likely to be one source of its competitive advantage. To the extent the auditor now provides additional detailed and specific information about the financial instruments a bank uses to implement that strategy, other banks may be able to infer useful information about the bank’s risk management program, reducing its competitive advantage. While firms always use some variant of the proprietary costs argument to lobby against expanded disclosure requirements, it seems to me that the proposed rule is likely to impose such costs.

Auditor litigation costs are also a concern. There is an extensive academic auditing literature that examines the determinants of audit fees. It is clear from both economic arguments and empirical data that expected litigation costs are a big driver of audit fees (for example, a number of empirical papers provide evidence which shows a large increase in the audit fees for non-US firms that cross-list their securities in the US; these studies attribute this result to

⁷ If the “expectations gap” described by Mock et al. (2013, op cit.) is really the problem, it seems that market-wide disclosures about auditors and the audit process could be a useful solution.

⁸ See, for example, R. Ball, S. Jayaraman, and L. Shivakumar, “Audited financial reporting and voluntary disclosures as complements: A test of the confirmation hypothesis,” Journal of Accounting & Economics 53 (2012): 136-166.

⁹ While it is not fully clear to me what comprises a CAM, I think for example about auditors’ role in validating management judgments about the fair value of complex financial instruments, which I think could easily qualify as a CAM. I could well imagine it being the case that the proposed requirements would result in the auditors’ related CAM disclosure providing detailed information about say the entity’s hedging and risk management strategies, and that this disclosure goes beyond what is currently required by the relevant SEC/FASB requirements.

litigation costs¹⁰). By expanding the auditors' role and disclosures in the manner envisioned in these proposals, I think we can confidently predict that the plaintiffs' bar will not have to work very hard to expand both the extent to which auditors are held liable for client firm problems and the magnitude of the associated damages claims. It therefore seems hard to imagine a world in which audit fees will not increase if these proposals go forward.

These are the obvious costs. However, the more pernicious problem engendered by these proposals fall under the general label of what economists call the "real effects" of disclosure.¹¹ The idea here is fairly straightforward—by changing the mandated disclosure regime, the underlying actions of the affected economic agents are not held constant. That is, if agents know *ex ante* that the information they will have to disclose after the fact (*ex post*) has changed, it will change the way they play the game.

The implication here is also straightforward: once auditors and client firm management and personnel know that the auditors will be reporting additional, more detailed information about the audit as CAMs, it will likely change their incentives going into the audit process and may even change how managers make operating and financing decisions. For example, if managers now know that auditors will be reporting detailed information about how they get comfort about certain of the entity's transactions, managers (and personnel) may well be less open and forthcoming in providing information to the auditor about these transactions, and may even change the transactions themselves. This in turn will change how auditors conduct their audits as they then need to find alternative audit approaches. Moreover, even if we assume that the actions of the firm and its personnel are held constant, it seems likely that auditors will expend additional effort to either avoid having to disclose a CAM or to support the required CAM disclosures. Without much doubt, the actions of firms and auditors will change under the new requirements in ways that are hard to predict *ex ante* and that are likely to vary across firms. This is especially the case if there is uncertainty and lack of clarity about the definition of CAMS, which I gather is the case based on what I have read from the comment letters provided by my colleagues on the panel from Deloitte and Cleary Gottlieb.

This leads me to a suggestion, with which I will conclude. As a reasonably sophisticated consumer of financial statements for a variety of purposes, one of the major improvements I have seen in financial reporting over the past decade or so has been the addition to the MD&A of the "critical accounting policies" discussion. In the interests of minimizing the extent to which the new audit model expands disclosure—which as I have argued could have a number of potentially costly effects—I wonder if the CAM proposal could not be modified to require the auditors to comment just on the "critical accounting policies" discussed by management in the MD&A. Presumably, the auditors are focusing attention and additional work on these already (it seems likely that the auditors work helps identify such policies) so that the "real effects" problem, as well as the expanded disclosure problem, I have identified above would be minimized.

¹⁰ For example, see I. Khurana and K. Raman, "Litigation risk and the financial reporting credibility of Big 4 vs. Non-Big 4 audits: Evidence from Anglo American countries." *The Accounting Review* 79 (2004): 473-495.

¹¹ For example, see I. Goldstein and H. Sapra, "Should bank stress tests be disclosed? An analysis of the costs and benefits," unpublished manuscript, December 1, 2013, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2367536.

More generally, I think it would behoove the PCAOB to think carefully about the possible unintended “real effects” of expanding the auditors’ role and disclosures, and so craft the new rules to minimize the associated possible adverse consequences by minimizing the likelihood of changes in economic behavior that might occur as a result of the proposed changes.

Thank you again for the opportunity to participate in this important process.