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Hostages to Fortune: A Change in the Audit Certification Can Reduce Auditors' Risks

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Although the public, the media, and even lawmakers seem to think that financial statements accurately record what happened in the past, financial statements prepared under Generally Accepted Accounting Principles (GAAP) are largely shaped by management estimates and forecasts about an unknowable future. Although the use of apparently unambiguous numbers gives the impression of precision, it is an illusion. This places auditors in an impossible position. They are unequipped to assess the accuracy of management estimates and forecasts, yet their standard opinion concerning financial statements suggests that they have. The Public Company Accounting Oversight Board (PCAOB) has the authority to change the format of the auditor's attestation, and thus to relieve auditors of liabilities they do not deserve and cannot avoid. PCAOB action could go a long way toward reducing the liabilities of the major auditing firms—one of the key dangers to the global financial system recognized in all the recent reports on the regulation of U.S. capital markets.

In three major recent reports on the condition of the U.S. capital markets—by the U.S. Chamber of Commerce, by a group of academics and market professionals called the Committee on Capital Markets Regulation, and by New York City mayor Michael Bloomberg and Senator Charles Schumer (D-N.Y.)—there was universal recognition that any one of the four global accounting and auditing firms headquartered in the United States could be destroyed at any time by a large jury award in a private securities class action.[1] Each of the reports saw this outcome as a catastrophic loss to the global financial system, and thus each offered important and far-reaching recommendations to avert this result. The Chamber of Commerce recommended, among other things, backstop insurance issued by the G8 countries,[2] and the others proposed additional forms of relief, including a cap on auditor liability.[3]

While these proposals have merit, each requires significant political will on the part of lawmakers and governments, and none gets at the underlying reasons for the threat of class action liability. If we look carefully at the reasons for the liability risk of auditors, it becomes apparent that this risk is founded in part on a misunderstanding by investors and the public generally about the nature of financial statements and the audit process. This misunderstanding, as discussed below, perpetuates an illusion of certainty and precision that financial statements do not and cannot achieve—a certainty that leaves auditors vulnerable to legal liability that they can neither mitigate nor avoid.

The problem is encapsulated by the audit certification, or auditors' opinion, a four- or five-paragraph statement by the audit firm that immediately precedes the audited financial report of a company. In this statement, the auditor gives what is in effect an opinion about the quality of the financial statements and an implied representation concerning the effectiveness of the audit. The pertinent certification language states:

> In our opinion, the financial statements present fairly, in all material respects, the

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> financial position of the company at December 31, 2005 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

This formula has not varied significantly since it was recommended by a committee of accountants in 1939,[4] although depending on the audited company's particular circumstances there might be slight adjustments in the language. Any major change in this wording, however—even assuming that it would be permissible under current auditing standards—would raise questions among investors, analysts, and regulators. The quoted language is what is known in the financial market's vernacular as a "clean opinion" and in accountants' jargon as an "unqualified opinion." Anything else could be considered a qualified opinion and might be thought to signal a problem in the financial statements.

The trouble with this formulation is that it is easily misinterpreted by people who are not familiar with the jargon, such as unsophisticated investors, the media, and jurors. In particular, it fails to convey two key elements—the uncertainty associated with virtually every line in a financial statement and the uncertainties associated with the audit itself. What is not well understood is that financial statements are mostly made up of estimates by management—forecasts and even guesses about the future—and thus that the bottom line number is itself only an estimate. In addition, because it is difficult for auditors to assess the estimates and forecasts of management, the auditor's actual opinion is far less solid or categorical than its words suggest.

Earnings Are an Opinion; Cash Is a Fact

The reality about financial statements is succinctly stated in a recent paper by three academic accounting experts:

> Financial statement information, be it balance sheet items such as net property, plant and equipment, goodwill and other intangibles, accounts receivable and inventories, deferred taxes and contingent liabilities, or key income statement figures, such as revenues, pension expense, in-process R&D or soon-to-be-expensed employee stock options is largely based on managerial estimates and projections.[5]

This fact, if better understood by investors and juries, would place an entirely different cast on the significance of the numbers in a financial statement and what can be expected of the auditing process. Even Congress seems unaware of how financial statements are prepared and what they actually mean to investors sophisticated enough to understand their imprecision. The Sarbanes-Oxley Act, for example, assumed that improved auditing would improve the "accuracy" of financial statements, and imposed substantial costs on corporations and the economy to achieve this objective. But financial statements based on estimates and forecasts can never achieve anything approaching certainty, and in this sense the Sarbanes-Oxley Act is built on sand.

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Nor is it possible to do away with management estimates as a fundamental element of GAAP. Estimates and forecasts are essential to accounting under the GAAP system because the purpose of GAAP is to bring both revenues and expenses together into the same reporting period so that the user can evaluate whether the company is operating profitably. This means that events expected in the future must be brought into the current period, even though they have not yet happened.

Accounts receivable are a simple example. Say a company sells its products for $1 million in 2007, and this generates cash of $500,000 and receivables for the balance that cannot be collected in 2007. Because the costs of production are paid in 2007, the percentage of receivables recovered in 2008 (and thereafter) will determine how profitable the company was in 2007. In order to bring the future collection of 2007 receivables into the 2007 financial report, management must estimate how much it will ultimately collect. This is done by including all 2007 receivables in the 2007 financial statements—as though collected in 2007—but setting up a reserve for the receivables that will *not* be collected. Clearly, a small reserve will generate increased profits in 2007, but a large one could potentially increase earnings in 2008 if it turns out that the 2007 reserve was larger than necessary. An estimate of how much will be collected in receivables is fairly simple, as these things go, but it may require an assessment of the success of competing products and the effect of the company's warranties—both of which may result in product returns

and a reduction in receivables—as well as how well the whole economy will fare in 2008. This forecasting problem, compounded many times in the preparation of a financial report, is the source of the venerable Wall Street maxim, "Earnings are an opinion; cash is a fact."

Management's estimate, even in this simple example, can be difficult for the auditor to assess. Auditors are not generally experienced with business decision-making. They are not equipped to judge the strength of a market for a company's products or the financial health of its customers, let alone the condition of the general economy in the following year. The auditor has at hand a history of the company's past receivables collections, but past experience can be a weak guide in a competitive and turbulent market, especially when the movement of the entire economy is a factor. And if an auditor cannot easily assess the accuracy of management's forecast on something as basic as the reserve for receivables, what should he do about far more complex forecasts—such as the estimate of a product's useful life—that can affect the rate at which the investment in that product is amortized?

Obviously, management's opportunity to make estimates is also an opportunity for manipulation, but even twelve bishops of the church, sworn to honesty, would have trouble producing perfectly correct—or even reasonably true—financial statements when the process involves predicting the future. It is little wonder, then, that corporate CEOs and CFOs resent the idea that the Sarbanes-Oxley Act has made them criminally liable for certifying the accuracy of their company's financial statements; they know that these statements are strongly influenced by what are no more than educated guesses about the future that are ultimately their responsibility to make.

But the problem for accountants and auditors is worse than this; because of Congressional and public ignorance about GAAP accounting and auditing, they have become liable for *someone else's* guesses and estimates. As one academic paper put it, "What are desperately needed are intensive public relations efforts to get the public, the Congress and the media to understand the forecast nature of financial reports created under accrual accounting."[6] Eventually, of course, we come to know the truth about the collection of receivables, or any one of the many other estimates that will go into creating a financial statement for 2007—even though most non-accountants would assume that the financial statements of a company at the very least present an accurate historical record of what occurred during a completed financial year. This state of affairs validates mathematician Raymond Smullyan's paradoxical statement that "to know the past, one must first know the future."

This Is One Problem That Has a Solution

Here, then, is the nub of the problem. In practice, most lawyers know that a jury—being unfamiliar with what an audit actually involves or the imprecision of a financial statement—can easily be led to believe that if a company's financial statements are materially wrong the auditors are at least partially at fault. This is especially true in hindsight when, with a few more questions or a few more tests, the error or fraud would have been discovered. Materially incorrect financial statements thus become the responsibility of the auditors, even though estimates and forecasts by the company's management are far more likely to be the cause of materially false or misleading financial statements than audit failure. Of course, there are cases of bad or negligent audits, where egregious and obvious frauds should have been discovered, but these are relatively rare.

One way to address the problem of excessive auditor liability would be to modify the language of the auditor's certification so that it more closely reflects . . . what the financial statements actually represent.

The language of the auditor's certification on a financial statement—that the statement "presents fairly in all material respects" the financial condition and results of operations of the company—contributes importantly to the misperception that the auditors knew, or should have known, that the financial statements were false or misleading.

Accordingly, one way to address the problem of excessive auditor liability would be to modify the language of the auditor's certification so that it more closely reflects the reality of the audit and what the financial statements actually represent. Such a change would in no way alter what auditors do, but it would allow the auditor to attest to the accuracy only of what he or she can actually know as fact, and to furnish a less categorical opinion on other parts of the financial statement.

This idea was developed more fully by a group of over fifty experts on auditing, accounting, and accounting

policy, convened by the American Assembly in fall 2003. Their report, *The Future of the Accounting Profession*, noted the discontinuity between what auditors reported in certifying financial statements and what they could actually know:

> Financial statements, simply because of the way they are presented to the user, appear to claim a degree of exactitude that is, in fact, unrealistic. As a result, a large part of the investing public believes these reports—when properly audited—are precise and accurate. In fact, they are the result of a long series of judgments by managers, accountants and auditors. . . . The truth of the matter is unpalatable to some, but unavoidable: no matter how carefully financial statements may be prepared and no matter how competent the auditors, neither the financial statistics nor the underlying transactions that create those figures are as "hard and fast" as the public has presumed them to be.[7]

The PCAOB would perform a major public service by using its new authority to institute a change in the auditors' financial statement certification.

Accordingly, the group recommended a change in the auditor's certification so that it would correspond more closely to what the auditor can actually know:

> Ideally, auditors would use the current wording [i.e., "present fairly," etc.] to vouch for the most concrete, non-speculative aspects of future financial statements, such as those items for which historical cost is an adequate accounting metric. For information that is subject to individual judgments by managers and auditors, those auditors would give a significantly more limited attestation. . . . In these instances, the audit function could be structured in such a way as to verify that a company has reached these judgments with respect to estimated fair value using a clear and seemingly reasonable process.[8]

This is an important idea that has not received the attention it deserves. Among other things, it would be of substantial assistance in reducing the broad liability of auditing firms for errors or omissions by company managements—deliberate or not—that auditors themselves are largely powerless to detect or prevent. If auditors were understood by the public to be attesting only to the accuracy or fair presentation of those things that they could actually know, the scope of their liability would be substantially reduced without in any way modifying the scope of their actual work. Holding auditors responsible for matters that they cannot know or change not only is unfair, but also casts them in the role of insurers rather than as service-providers.

The Role of the PCAOB

In proposing these major changes in the auditor's certification, the American Assembly's expert group did not discuss implementation in detail. Before the Sarbanes-Oxley Act, a change of this kind would have been difficult to achieve. It would have required a long period of gestation in accounting associations and of course the eventual approval of the Securities and Exchange Commission (SEC) for use in connection with the financial statements of public companies. However, in creating the PCAOB as part of the Sarbanes-Oxley Act, Congress gave it the authority to "amend or otherwise modify or alter, such auditing and related *attestation standards* . . . to be used by registered public accounting firms in the preparation and issuance of audit reports."[9] Thus, a power that existed in no single place before has now been lodged in the hands of a regulatory body established by Congress.

This opens the possibility that the PCAOB could modify the auditors' traditional certification language in order to bring it into conformity what auditors can know and an audit can actually achieve. In light of the jeopardy in which the major auditing firms now find themselves—and the recognition of this jeopardy in the three reports mentioned on page 1—the PCAOB would perform a major public service by using its new authority to institute a change in the auditors' financial statement certification. Indeed, in its report on competitive challenges to the financial preeminence of the United States, the U.S. Chamber of Commerce committee noted that

> Public companies, audit firms, the SEC, PCAOB, and other financial services regulators and policymakers should take affirmative steps toward closing the "expectations gap"—that is, work to establish realistic public expectations about the degree of precision inherent in financial statements and constraints on those auditing these statements.[10]

As the Chamber's report suggests, it would be important to consult with other groups before moving ahead, but clearly the PCAOB has the authority to make the necessary changes.

A more far-reaching reform, of course, would modify the traditional presentation format of financial statements under GAAP. One interesting proposal would separate financial statements into three columns: "realized," "expected," and "total."[11] The "total" column would look much like today's income statements, but because it explicitly breaks out the expectations (estimates and forecasts) that are implicit in today's GAAP format, this new approach would better inform investors and relieve accountants of a liability they rarely deserve to bear.

A far-reaching change in financial statement format is beyond the authority of the PCAOB; it may rest with the Financial Accounting Standards Board and the SEC. But the more modest proposal—a change in the language of the auditors' opinion—would be well within the authority of the PCAOB and would go a long way toward relieving auditors of a liability that unfairly threatens both their profession and the world financial system.

AEI research assistant Daniel Geary and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook.

Notes

1. See Peter J. Wallison, "The Sorcerer, the Apprentice, and the Broom: What to Do About Private Securities Class Actions," *Financial Services Outlook* (March 2007), available at www.aei.org/publication25728/.

2. U.S. Chamber of Commerce, Committee on the Regulation of the U.S. Capital Markets in the 21st Century, *Report and Recommendations*, March 2007, 170–72, available at www.uschamber.com/publications/reports/0703capmarketscomm.htm (accessed April 2, 2007).

3. Committee on Capital Markets Regulation, *Interim Report*, November 30, 2006, 14, available at www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (accessed March 5, 2007); and Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Services Leadership*, January 22, 2007, 102, available at www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (accessed March 5, 2007).

4. Stephen A. Zeff, "The Evolution of U.S. GAAP: The Political Forces behind Professional Standards, Part I," *The CPA Journal* (January 2005), available at www.nysscpa.org/cpajournal/2005/105/infocus/p18.htm (accessed April 2, 2007).

5. Baruch Lev, Siyi Li, and Theodore Sougiannis, "Accounting Estimates: Pervasive, Yet of Questionable Usefulness" (meeting paper, American Association of Accountants, Financial Accounting and Reporting Section, April 2005), available at http://pages.stern.nyu.edu/~blev/docs/Accounting%20Estimates.April%202005.pdf (accessed April 2, 2007).

6. Jonathan C. Glover, Yuji Ijiri, Carolyn B. Levine, and Pierre Jinghong Liang, "The Emerging Needs to Separate Facts and Forecasts: Exploring 'Intertemporal Financial Statements' with Two Time-Phases" (working paper, Graduate School of Industrial Administration, Carnegie Mellon University, Pittsburgh, PA, December 2002), 20, available at https://littlehurt.gsia.cmu.edu/gsiadoc/WP/2004-E27.pdf (accessed April 2, 2007).

7. The 103rd American Assembly, *The Future of the Accounting Profession* (New York: Columbia University, November 2003), 8, available at www.americanassembly.org/programs.dir/prog_display_ind_pg.php?this_filename_prefix=accounting&this_ind_prog_pg_filename=report (accessed April 2, 2007).

8. Ibid., 12–13.

9. *Sarbanes-Oxley Act of 2002,* Public Law 107-204*, U.S. Statutes at Large* 116 (2002): 103 (a)(1) (emphasis added).

10. U.S. Chamber of Commerce, Committee on the Regulation of the U.S. Capital Markets in the 21st Century, *Report and Recommendations*, 171.

11. Jonathan C. Glover et al., "The Emerging Needs to Separate Facts and Forecasts."