Deconstructing the PCAOB: Using organizational economics to assess the state of a regulator*

Francine McKenna
The University of Pennsylvania
mckennafrancine@gmail.com

Mikhail Pevzner
University of Baltimore
mpevzner@ubalt.edu

Amy Sheneman
The Ohio State University
sheneman.2@osu.edu

Tzachi Zach
The Ohio State University
zach.7@osu.edu

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Abstract:
Using the principles of organizational economics in this study we assess the quality of the organizational architecture of the Public Companies Accounting Oversight Board (PCAOB). In particular, we use the Four Pillar Framework developed in Brickley et al. (2000) to understand why—according to the SEC's Chairman Gensler and other stakeholders—the PCAOB may not have entirely realized its mission of investor protection. Our analysis is enabled by the transcripts of the 2019 criminal trial *U.S. vs. Middendorf and Wada* (i.e., PCAOB-KPMG "steal the inspection data" scandal), which for the first time exposed the inner workings of the PCAOB. Our analysis of the transcripts is augmented by other publicly available documents. Our primary conclusion is that the functioning of the PCAOB has been significantly hampered by misalignment of its tasks (in particular in relation to the SEC), sub-optimally designed performance measurement and employee compensation, and weaknesses in the PCAOB's organizational culture. These misalignments created an environment susceptible to PCAOB employee criminal misconduct which enabled to the PCAOB-KPMG "steal the inspection data" scandal and to Board governance and leadership issues, both leading to the scandal and in its aftermath.

Keywords: PCAOB, organizational architecture, incentive alignment

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1. Introduction

On June 4, 2021, Securities and Exchange Commission (SEC) Chair Gary Gensler fired the Public Company Accounting Oversight Board (PCAOB) Chair William Duhnke and announced his intention to replace the entire Board, explaining that a clean sweep of leadership at the audit industry regulator was necessary to give the PCAOB "an opportunity to live up to Congress's vision in the Sarbanes-Oxley Act (SOX)" (SEC 2021). Critics of Chair Gensler's decision expressed concerns that the PCAOB was becoming a politicized agency, one where its Board would be replaced with every change in the White House (Eaglesham and Michaels 2021).[1] Others were not surprised by the announcement because the PCAOB had struggled to regain credibility after the 2017 audit inspection scandal where current and former PCAOB employees illegally provided confidential inspection data to KPMG's audit practice leadership (McKenna et al. 2022a, 2022b).

In this paper, we utilize the Four Pillar Framework (Brickley, Smith, and Zimmerman 2000; Zimmerman 2017; Zimmerman 2021; Zimmerman and Forrester 2021) from organizational economics to examine the mission of the PCAOB and to understand a series of scandals, crises, and challenges that have threatened the audit industry regulator's credibility and its ability to fulfill its statutory mission. According to Section 101 of SOX, the PCAOB was established "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

We examine the PCAOB organizational structure, including the SOX-mandated oversight by the SEC, and the its internal policies and processes intended to fulfil the law's requirements.

[1] SEC Chair Gary Gensler's actions matched the actions of his predecessor, SEC Chair Jay Clayton, who replaced PCAOB Chair Jim Doty and the majority of the PCAOB members in December 2017 (Michaels 2017).

By examining how the PCAOB operates internally and with its oversight agency, the SEC, our goal is to understand how well the PCAOB has accomplished its mission to protect investors since its inception.

A primary source for our analysis is the publicly-available transcripts of the 2019 trial of David Middendorf and Jeffrey Wada (i.e., *U.S. v. Middendorf and Wada*), which took place following the SEC's charges and Department of Justice criminal indictments in 2018 after the revelation of the audit inspection scandal by KPMG in 2017.

Source material related to PCAOB's standard-setting and regulatory activities has in the past been difficult to obtain because, unlike a federal government agency, SOX made the PCAOB one of the least transparent agencies by statute in the U.S. government.[2] The establishment of the PCAOB, an independent regulator, by SOX imposed dramatic changes on the public accounting industry after decades of self-regulation. Academic researchers, journalists, investor protection advocates, and government watchdogs who wish to study these changes by looking at the activities of its regulator, the PCAOB, have been limited to scrutinizing only what the PCAOB is willing to disclose. Such disclosures typically provide researchers minimal insight regarding the PCAOB's internal organizational structure and processes. The PCAOB imposes restriction on using its internal data by academic researchers. For example, the data can only be used on-site and only by approved research fellows (PCAOB 2022b).

Our primary conclusion is that the functioning of the PCAOB has been significantly hampered by misalignment of its tasks, in particular with regard to the SEC's oversight, sub-

[2] The PCAOB is not subject to the common transparency provisions, such as the Sunshine Act (the law that provides for mandatory open meetings in certain circumstances), the Freedom of Information Act (the law that provides a mechanism for obtaining various records from agencies), and the Administrative Procedure Act (the law that mandates notice and comment in the case of certain rulemakings and requires the implementation of a mechanism for petitioning an agency to change its rules) (Brown 2019).

optimally designed performance measurement and employee compensation, and serious weaknesses in organizational culture. These factors created an environment susceptible to PCAOB employee criminal misconduct, and weaknesses in Board governance and leadership, all of which enabled the PCAOB-KPMG audit inspection scandal.

Our study contributes to the research streams in financial regulation, organizational economics and management control systems and to management research that studies organizational failures. More specifically, our paper is the first to provide the comprehensive economic analysis of the PCAOB's organizational effectiveness. Our study addresses the internal causes of the PCAOB's organizational weaknesses and potential failure to achieve its mission to protect investors. This is important because, so far, the extant auditing literature has primarily focused on the consequences of the PCAOB's existence for the audit industry and capital markets. The vast majority of studies in the PCAOB literature evaluate the determinants and consequences of the PCAOB inspection process, and the economic impact of its auditing standards.[3]

The extant literature has dedicated little attention to analyzing the *drivers* of the PCAOB's actions. Some of these organizational issues are discussed in the legal scholarship addressing the PCAOB's (un)constitutionality; however, this literature does not touch on internal economic misalignments within the PCAOB.[4] More recent work addresses some aspects of the PCAOB's organizational activities and their impact (e.g., revolving doors [Hendricks et al. 2022; Knechel and Park 2020]) but do not perform a full organizational analysis of the impact of multiple components of the PCAOB's organizational structure.

[3] For recent papers on PCAOB inspections, see Aobdia (2019), Aobdia (2018), Gipper et al. (2020), and Shroff (2020). For the impact of new PCAOB auditing standards, see Boland et al. (2020), Wang and Zhao (2012), Dee et al. (2015), and Cunningham et al. (2019).
[4] Refer to Nagy (2004), Romano (2004), Rao (2010), King (2010), and Stack (2010).

Most closely related to our study is Palmrose's (2013) commentary on the evolution of the PCAOB during the first decade of its existence; however, this paper focuses primarily on the debates regarding audit regulation, what the PCAOB had accomplished over its first decade given its decisions about how to implement SOX and subsequent legislation that affected its mission, and what the future might bring given ongoing scrutiny of its activities and results. Unlike Palmrose (2013), we analyze the PCAOB's organizational structure and internal contradictions that resulted from weaknesses in its design.[5]

We also contribute to the understanding of the evolution of government regulators and the factors affecting regulators' effectiveness (e.g., Macey 1992; Bregers and Edles 2016; Woods 2016; Donelson and Zaring 2011; Peay 2007). Our paper is the only one we are aware of that applies the Four Pillar Framework to analyze the effectiveness of a federal regulator of accounting or auditing. Finally, we also contribute to the literature on organizational failure (e.g., Probst and Raisch 2005; Peterson et al 1998; McMillan and Overall 2017).

Our paper proceeds as follows. In Section 2 we provide theoretical framing for our analysis. In Section 3 we describe our research method. In section 4 we discuss our findings. In Section 5 we conclude.

2. Theoretical framing

This section begins with a brief discussion of the origins of the PCAOB. We then outline the Four Pillar Framework described in Brickley et al. (2000) and follow with applying this

[5] Carmichael (2014) provides a short overview of the PCAOB's establishment and early activities. Palmrose and Nolder (2018) touches on a single aspect of the PCAOB's functioning, the economic analysis of its standards, which is one of the primary functions of PCAOB's Economic and Risk Analysis (ERA) division.

theoretical framing to the specific challenges that have threatened and continue to threaten the PCAOB's ability to fulfill its statutory mission.

2.1 The origins of the PCAOB

SOX was enacted in July 2002 as a direct response to the Enron bankruptcy, the collapse of Arthur Andersen, and a massive accounting fraud at WorldCom.[6] The new legislation was controversial. The legislation dismantled the public accounting industry's history of self-regulation and established the PCAOB as a new independent regulator of public company auditors and auditing. Opponents raised concerns that SOX was only passed to assuage popular outrage over the recent accounting scandals, lacked theoretical foundations, was passed in haste and would, therefore, result in a structurally weak law (Romano 2004).[7] Advocates argued that the law was sound and rooted in previously attempted, similar legislation (Romanek 2006).

SOX was designed to address the perceptions of what the U.S. financial system needed at the time (Cunningham 2002). However, implementing the law, in particular regarding the activities of the PCAOB, has been contentious, perhaps because the new regulator was not created organically in response to market forces but by legislation designed to address a perceived market failure of the auditing industry's self-regulatory regime. This presumed market failure led to the perception that low-quality audits had been performed and that weakened auditor independence had compromised the integrity of financial information provided to investors. However, in the early years of SOX and the PCAOB, some academics questioned whether the premise of low audit

[6] During the time of the legislation, Senator Sarbanes stated that "[i]t is becoming increasingly clear that something has gone wrong, seriously wrong, with respect to our capital markets. We confront an increasing crisis of confidence that's eroding the public's trust in those markets" (148 Cong. Rec. S6327-S6347, 2002).

[7] Romano (2004) was pessimistic about the prospects of a law that had been "enacted in a flurry of congressional activity in the runup to the midterm congressional election campaigns."

quality used to motivate SOX and to establish the PCAOB was soundly rooted in observed audit quality data (e.g., Francis 2004).

The PCAOB was established as a quasi-governmental, autonomous, non-profit corporation. Although technically not a U.S. federal government agency, the PCAOB is overseen by the SEC, a federal agency whose chair is appointed by the President with Congressional approval (Kalorama Legal Services, hereafter KLS 2021). This hybrid legal structure makes the PCAOB a unique institution because it combines features of private industry Self-Regulatory Organizations (SRO), such as the Financial Industry Regulatory Authority (FINRA), and of government agencies such as the Office of the Comptroller of the Currency (OCC) and the Consumer Financial Protection Bureau (CFPB).[8]

The PCAOB's mandated functions include: (i) creating or adopting of standards on auditing, audit quality control, and ethics related to the audits of public companies; (ii) monitoring of public company audit quality via the audit firm and audit engagement inspection program; and (iii) investigating and disciplining public accounting firms and professionals for violations of auditing standards.[9]

2.2 The Four Pillar Framework

Based on well-established theories in financial economics (e.g., Coase 1937; Jensen and Meckling 1976), the Four Pillar Framework answers the basic question of what makes a particular organization operate effectively (i.e., accomplish organizational objectives at the lowest possible cost). Brickley, Smith, and Zimmerman (2003), Zimmerman (2017), and Zimmerman and Forrester (2021) describe the concept of organizational architecture as a function of four pillars.

[8] Similar to the PCAOB, the OCC is funded through external fees. The CFPB and PCAOB share the feature of long member/director appointments to shield both agencies from political influence. Both agencies have been subject to similar constitutional challenges (Nicodemus 2021).
[9] The PCAOB shares responsibility for disciplining audit firms and individual audit professionals with the SEC.

The Four Pillar Framework is based on the fundamental economic concept of self-interest and provides a cohesive structure for solving the strategy-incentive-alignment problem (i.e., the shirking problem) that plagues all organizations.

According to the Four Pillar Framework, the success of an organization depends on how it integrates its organizational goals and tasks (first pillar), measures its accomplishments (second pillar), rewards its managers and employees (third pillar), and integrates the previous three pillars throughout the organization (fourth pillar). Brickley et al. (2000) note that the fourth pillar, corporate culture, "usually encompasses the ways work and authority are organized, the ways people are rewarded and controlled, as well as organizational features, such as customs, taboos, company slogans, heroes and social rituals." (p.273). In other words, every organization has its own way of implementing the first three pillars; the choice of a particular alignment of the task assignment, performance measurement, and performance evaluation pillars is steered by organizational culture. Ouchi (1980) further elaborates on why task assignment has to be tightly balanced with performance evaluation: "A bureaucratic organization operates fundamentally according to a system *of hierarchical surveillance, evaluation, and direction*. In such a system, each superior must have a set of standards to which he can *compare behavior or output in order to provide control*. These standards only indicate the value of an output approximately, and are subject to idiosyncratic interpretation. People perceive them as equitable only as long as they believe that they contain a reasonable amount of *performance information*. When tasks become highly unique, completely integrated, or ambiguous for other reasons, then even bureaucratic mechanisms fail. Under these conditions, it becomes impossible to evaluate externally the value added by any individual. Any standard which is applied will be by definition arbitrary and therefore inequitable" (pp. 134-135, emphasis added).

As organizations evolve and environments change, the four pillars should be adjusted to respond to changing conditions.[10] In his research presentation, Zimmerman (2021) argues that "the Four Pillars are complements and are self-reinforcing." The Four Pillar Framework can also be viewed as a system of management controls (MCSs). Merchant and Otley (2020), however, note that a system is an "integrated and coordinated set of MCS mechanisms" (p.2). They further point out that "different overall MCSs have differing degrees of internal integration (or coupling)" despite the desire of most system designers and executives to integrate control systems in an organization (p.2). The "contrary tendencies for organizations to keep adding or changing these subsystems and for natural adaptation and evolution leads to decreased integration" (Merchant and Otley 2020, p.2). In other words, what the Four Pillar Framework refers to as "misalignment of the pillars" in the parlance of Management Control Systems literature can also be viewed as "uncoupling" of subsystems in the management control environment.

An advantage of the Four Pillar Framework for strategic analysis is that it provides a coherent method for identifying strategy-incentive misalignments within an organization and applies to any organization, whether a profit-seeking firm or a non-profit organization.

2.3 The Four Pillar Framework and the PCAOB

We apply the Four Pillar Framework described in Brickley et al. (2000) to improve our understanding of the organizational design and implementation choices that may have led to the PCAOB's current crisis of credibility and recent scandals, such as the 2017 audit inspection scandal.[11] Coase (1937) argues that the primary objective of establishing a non-governmental for-

[10] For example, in response to the COVID-19 pandemic, many firms adjusted their pillars to include remote work, which changed employee incentives (Zimmerman 2021).

[11] The framework is also described in Brickley et al. (2003), Zimmerman (2017), and Zimmerman and Forrester (2021). The Four Pillar Framework is sometimes referred to as "Top Level Organizational Architecture" (Brickley and Zimmerman 2010). The framework (based on the first three pillars) is outlined in Brickley et al. (1997) as well.

profit organization is that it is less expensive to accomplish a goal by pooling resources within the firm rather than trying to accomplish it individually through market mechanisms. Such organizations are created because transactions costs of doing business are lower when resources are combined. Zimmerman and Forrester (2021, p.30, emphasis added) describe how the Four Pillars Framework aligns with Coase's ideas:

> "People join organizations because the group can produce goods or services at lower cost than those people acting individually. On the other hand, people in these organizations, being self-interested, have incentives to shirk their duties, or to misappropriate or even steal the organization's assets. To prosper, all lawful and unlawful organizations face a common economic challenge — *how to channel their workers' self-interest to further their goals*? How to solve Strategy-Incentive-Alignment Problem? Enter the Four Pillars. Successful companies have pillars that motivate their people to work hard while controlling their dysfunctional behaviors."

Because of its unique organizational structure and its influence on the public accounting profession, it is important to analyze legislative compromises in SOX as well as subsequent legislation and the subsequent Supreme Court decision on the PCAOB's constitutionality within the context of the Four Pillars Framework. We do so to identify structural weaknesses in the design of the PCAOB that may have led to ex-ante organizational misalignment. Thus, we augment a traditional analysis of organizational design and structure with the crucial role that the legislative process played in shaping but also constraining the PCAOB's organizational structure from its inception.

Macey (1992) provides a bridge between Coase's discussion of for-profit corporations and a discussion of the structure and design of government agencies like the PCAOB. According to Macey (1992), politicians actively dictate the structure and design of the agencies charged with implementing their mandates to mitigate the risk that future political winds will blow legislative intentions off course. The principal-agent problem — a result of the necessity for political actors

to delegate authority to bureaucrats in government agencies to implement legislative mandates — is controlled via the structure and design of those government agencies.

The most fundamental choice in agency design is to decide if an agency is a single-industry or a multi-industry regulatory agency (Macey 1992). As we discuss later, the legislative decision to design the PCAOB to focus on a single industry — public accounting firms — and on a subgroup of the activities of that industry — public company audits — has had a profound impact on the PCAOB's ability to fulfill its mission efficiently and effectively. Unlike for-profit organizations, the PCAOB's ability to quickly and easily adjust its organizational structure to eliminate or mitigate pillar misalignments is limited. The SEC can modify or veto requested changes, in particular if they require an expenditure of the agency's budget which the SEC must approve. More significant changes, such as to the PCAOB's board structure or to modify its legally mandated activities — firm registration and inspection, standard-setting and enforcement — would potentially require Congressional that amends the Sarbanes-Oxley Act. The SEC's task assignments to the agency's Board and its managers are driven by an organizational structure established by SOX, subject to the SEC's oversight, which therefore limits the authority of the PCAOB board and its executive leadership. The PCAOB's ability to address pillar misalignment is, therefore, constrained by the SOX legislation itself and the SEC.

Despite the constraints and potential weaknesses built into SOX, the PCAOB has the discretion to adjust the alignment of its other three pillars (e.g., determining task assignments within the agency, developing performance measurement and compensation policies, defining its own culture) to mitigate or, potentially exacerbate any weaknesses in its inherent organizational structure design.

3. Method

The study's goal is to enhance our understanding of the PCAOB's organizational structure, and how the original legislative design and subsequent implementation may have better anticipated political and economic pressures. To conduct our analysis, we rely upon several types of source material. Our primary source is the trial transcripts for *U.S. v. Middendorf and Wada* from 2019. Publicly available source material on the internal inspection, standard-setting, and enforcement activities of the PCAOB has been nearly nonexistent until the trial transcripts became available. The trial testimony provides information about the PCAOB organizational structure and its inner workings, about the audit firms the PCAOB and SEC regulate, and about the SEC's approach to its required statutory oversight of the PCAOB. Besides the trial transcripts, we use other data sources for our analyses, including the SOX legislation, legal opinions on the SEC and the PCAOB, and related academic research.

Our research method could be characterized as an indirect field study. That is, we base our analysis on evidence of how an organization functions, with the caveat that we did not actually observe the PCAOB's activities directly. Instead, we rely on material that has recently become available in the public domain to study the PCAOB's structure and actions.[12] Our case-base method is similar to that of Gabbioneta et al. (2013) who apply case-based analysis to the longitudinal study of Parmalat's accounting fraud through court transcripts to learn about the actions of the organization and its relevant officers. Our approach also resembles the case-based

[12] Bloomfield et al. (2016) note that "field studies are similar to archival studies in that researchers don't intervene in the setting they are examining: they allow dependent variables, variation in independent variables, and the setting in which behavior occurs to arise in the ordinary course of business. *Unlike archival studies, researchers do not delegate either of the two distillation tasks when they conduct a field study: they record their observations and structure those records themselves in light of the theory they have specified"* (p. 370, emphasis added).

methodology employed in Kraus et al. (2017) who study the role of organizational ideology as an element of MCS in a single non-profit organization.

4. Analysis

In this section, we present our analysis organized by each pillar of the Four Pillars framework. For each pillar, we acknowledge strengths and weaknesses in the PCAOB's organizational structure, including weaknesses originating in the SOX law as well as weaknesses in how the law was implemented by the PCAOB and SEC. We also highlight political and economic pressures that, whether appreciated and addressed when creating the PCAOB, may have affected the PCAOB's ability to fulfill its mission.

4.1 First pillar: Organizational goals and tasks

SOX provides the PCAOB leadership with the responsibility to establish or adopt auditing standards for preparing audit reports with the primary mission of protecting investors and furthering the public interest. SOX uses an ongoing program of inspection of audit firms and audits of issuers to support the promotion of high professional standards and improvement in the quality of audit services offered by registered public accounting firms. The inspection program allows the PCAOB to assess how well each registered public accounting firm complies with SOX, in general, and specifically with professional standards and the rules.

4.1.1 Organizational hierarchy between the SEC and the PCAOB

When SOX established the PCAOB to regulate the audits and auditors of public companies, the law gave the SEC oversight authority over the PCAOB. The SEC has ultimate authority over the content and issuance of PCAOB inspection reports as well as disciplinary and enforcement actions against auditors and audit firms. This allows the SEC to overrule the PCAOB on inspection

report findings and disciplinary actions, which could undermine the PCAOB's authority. The SEC's oversight of the PCAOB also includes the authority to hire and fire Board members, to approve the PCAOB's budget, to approve standards or rules the PCAOB promulgates, and to respond to appeals from audit firms regarding inspection or disciplinary report findings.[13]

As a result of the SEC's oversight role, the PCAOB depends on the SEC, particularly its Office of Chief Accountant (OCA), to complete critical governance and mission tasks. For example, when considering potential PCAOB board candidates, OCA considers the prior PCAOB audit inspection results for that candidate (*U.S. v. Middendorf and Wada* 2019, p.106). This structure has created confusion regarding whether the PCAOB is an extension of the SEC — created as a separate organization only to provide budgetary independence from Congress and heightened confidentiality compared to the SEC — or whether the PCAOB is an independent regulator focused on protecting investors.

The SEC's tripartite mission — investor protection, maintaining fair, orderly, and efficient markets, and facilitating capital formation — seeks to balance investors' interests against interests of the other parties it regulates, such as issuers and market gatekeepers including audit firms. The PCAOB's mission is *exclusively* focused on investor protection.[14] SEC oversight has the potential to constrain the PCAOB's policy and inspection-related choices when their respective missions are in conflict, in particular when conflicts of interest develop between various SEC constituents, such as issuers, investors, and audit firms.[15]

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[13] The PCAOB's funding comes from audit firm and issuer fees, not from Congress, which makes the budgetary approval by the SEC a unique monitoring mechanism.

[14] Section 101 of SOX states that the PCAOB is established "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

[15] The extent to which audit regulation and the PCAOB should protect the audit industry and accommodate its largest firms' needs generates significant debate highlighting differing approaches to regulation (e.g., Palmrose 2013).

The potential for mission misalignment between the two agencies became evident when PCAOB Auditing Standard No. 2 (AS2), the original standard created to address SOX Section 404(b) audits of internal controls over financial reporting, was developed. When the PCAOB finalized AS2, it acknowledged the potential for the additional work and the associated costs:

> "Section 404 and the Board's requirements will entail extra work and, for companies, extra expense, particularly in the first year of implementation. The PCAOB will be vigilant in its inspections of accounting firms and conversations with issuers, particularly small and medium-sized companies, to see that expense isn't increased for its own sake. The Board does not underestimate the demands this auditing standard will impose on auditors and public companies."

The PCAOB believed the additional costs were net beneficial to issuers, allowing the accounting profession to "answer to the higher demand of accuracy, reliability and fairness in the financial statements that provide the basis for trust in our financial markets" (PCAOB 2004a).

Issuers complained directly to the SEC about having to comply with AS2, citing concerns it was excessively rules-based, and that it encouraged issuers and auditors to employ a checklist approach, rather than professional judgment, resulting in significant increases in audit fees (Johnson 2005; Acito, Hogan, and Imdieke 2014). Companies also complained about auditors opining on the adequacy of management's processes for evaluating its internal controls and the high costs of compliance, particularly for smaller firms (Johnson 2007).

The PCAOB believed it had developed a thorough, methodical, verifiable standard (PCAOB 2004b). The PCAOB focuses primarily on protecting investors and its requirement to create consistent auditing standards that can be efficiently applied. However, the standard was criticized almost immediately for not reflecting issuers' views and capital formation goals — the other two parts of the SEC's mission. AS2 was eventually replaced by PCAOB Auditing Standard No. 5 (AS5) which requires audit firms to focus on a "top-down, risk-based approach" for audits of internal controls over financial reporting. AS5 has reduced total audit costs over time but has

also resulted in lowering the effectiveness of internal control audits (Schroeder and Shepardson 2016).

And yet, for issuers and their advocates the process is perceived to still be too burdensome in time and expense (e.g., Johnson 2007). In 2010 the post-financial crisis Dodd-Frank Reform Act added an exemption from auditor attestation on ICFR under SOX Section 404(b) for non-accelerated filers, in a nod to lingering concerns that ICFR audit costs for smaller companies were especially burdensome and were supposedly inhibiting new public listings. In 2012, the JOBS Act, passed on a bipartisan basis, went a step further and incorporated provisions that not only exempt emerging growth companies (EGCs) from SOX Section 404(b) but exempt EGCs from any future PCAOB rules requiring mandatory audit firm rotation or auditor discussion and analysis. Another JOBS Act provision forces cost-benefit analysis on the PCAOB because it exempts EGCs from PCAOB rules adopted after the enactment of JOBS—unless the SEC determines those rules are necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.

Rather than empowering the PCAOB further and reducing the constraints on its authority built into SOX, Palmrose (2013) writes, "[These legislative actions] signal the willingness of Congress to step in and constrain the PCAOB—even early on at the concept release stage during public dialogue and well before, if ever, the PCAOB formalizes any specific proposal." What is left unsaid is that the audit industry had learned a lesson from the AS2 issue. The audit industry needn't fear the PCAOB because it could further constrain its authority by aligning with clients, the issuers, and lobbying Congress for the changes to the SOX Section 404 laws that are more favorable to audit firms' business interests (McKenna 2017).

An important aspect of the relationship between the SEC and the PCAOB is the stated goal of maintaining the PCAOB's independence (Gaetano 2019; McHenry 2021). As a government agency, the SEC is led by political appointees that typically change with each new presidential administration.[16] For example, SEC Chair Harvey Pitt, appointed by President George W. Bush, clashed with his immediate predecessor SEC Chair Arthur Levitt, appointed by President Bill Clinton, throughout the development of the legislative solution to the problems revealed by the Enron, WorldCom, and Andersen failures. While Pitt preferred that the new audit industry regulator would be an extension of the SEC, Levitt lobbied for the creation of an independent audit regulator (Pitt 2002; Levitt 2002). When SOX designated the SEC as the PCAOB's overseer, it exposed the PCAOB to the political winds that blow through the SEC, putting its independence at risk and creating a fundamental challenge to the PCAOB's organizational effectiveness.

4.1.2 Decision-making authority

Decision-making authority is an important component of the first pillar, particularly given the confusion created by the organizational structure between the SEC and the PCAOB. For example, in its evaluation of the PCAOB, KLS (2021) identifies a lack of clarity and direction for Board members regarding roles and responsibilities and legal obligations under SOX, IRS rules, and the Washington D.C. not-for-profit law. While a portion of Board members' confusion may stem from the legal form of the PCAOB, we argue the SEC's handling of certain regulatory initiatives likely contributed to the PCAOB's lack of full decision-making authority, which contributed to undermining its credibility.

To support this view, we analyze two important regulatory changes involving actions by the SEC that undermined the PCAOB: the public identification of audit partners (Form AP,

[16] The U.S. President appoints SEC commissioners with the advice and consent of the Senate. No more than three commissioners may belong to the same political party, which results in frequent changes in SEC leadership.

Auditor Reporting of Certain Audit Participants) and the amendment regarding SEC involvement in the review of PCAOB inspection reports (Rule 140h).

Form AP

In July 2009, the PCAOB issued a concept release proposing audit engagement partners sign the audit report. After significant opposition from public accounting firms (e.g., Deloitte 2009; EY 2009; Grant Thornton 2009; KPMG 2009; PwC 2009), the PCAOB modified its initial proposal in October 2010. The revised proposal was also opposed by the public accounting firms (e.g., Deloitte 2012; EY 2014; McGladrey 2014; PwC 2012) in comment letters to the PCAOB, rejecting the idea of partners signing the audit opinion in their own name or including the partners' names in the audit report. The firms claimed partner names were not useful to investors or the markets because the global audit firms stand behind partners' work.[17] The firms also worried about increasing individual partners' legal liability.

In June 2015, the PCAOB proposed that disclosure of audit partner names by the audit firms be mandated using a new form, Form AP, to be filed with the regulator annually in conjunction with the issuance of the auditor's opinion for each company (McKenna 2015).

On July 1, 2015, the SEC issued a competing proposal for naming partners assigned to public company audits, suggesting audit committees have to disclose audit partner names in the annual proxy statements (SEC 2015). The SEC's competing proposal may have been prompted by comment letters to the PCAOB suggesting the PCAOB did not have authority over issuer disclosures. The SEC's counter-proposal addressed the persistent concerns of the U.S. Chamber of Commerce, which advocated for issuers and the audit firms in this case. The Chamber had

[17] Honigsberg (2019) writes, "By comparison, accounting firms have successfully resisted rules that would produce public disclosure of individual auditor information, allowing audit partners to hide behind their firms' reputations. The resulting incentives have a concerning implication for investors: each individual partner is incentivized to accommodate her clients, even at the expense of audit quality" (p.1883).

pushed the desire of its constituents that the new rules be "sunsetted" after five years unless a post implementation review found they "promote investor protection, capital formation and competition," and expressed concerns about increased individual partner legal liability for securities fraud liability that might result from publicly naming the engagement partner. (SEC 2016).

The PCAOB's proposal, using Form AP, was adopted on December 15, 2015 with an effective date of auditors' reports issued on or after January 31, 2017. Rather than adding the partner name to the proxy — an approach that would have given the SEC authority over the disclosure but which the Chamber and the audit firms objected to on the grounds that it might generate additional liability for individual partners — the Form AP rule was implemented by the PCAOB via a newly developed, non-retroactive process. This new procedure requires audit firms to file the audit partner name with the PCAOB after the audit opinion is issued. Interested parties must visit the PCAOB's site and look up the issuer's audit report rather than learning the partner name via the SEC proxy filing, for example. Even with this new information, Honigsberg (2019) argues that, "As a practical matter, however, the name of the audit partner seems unlikely to provide investors with significant information until those investors know more about that individual through, for example, Auditor Scorecards."[18]

Despite the adoption of the PCAOB proposal rather than the SEC's competing proposal, opponents of the partner-naming initiative had created a final rule that was a compromise and that, per Honigsburg (2019) had potentially reduced the PCAOB's ability to delivering meaningful information to investors on a timely basis. The final rule gives the appearance of new, useful information for investor, but delivers that information in a form that is less convenient to investors

[18] Doxey et al. (2021) find little evidence investors respond to the disclosure of partner identities.

than a proxy filing or a partners own signature on an audit report in a publicly-filed 10-K, that is less timely than the SEC filing, and where there is mixed opinions on whether it is contributing significantly to imporvements in audit quality (Cunningham, et al., 2019 and Burke, et al. 2019).

Rule 140(h) and amendments to SOX section 107

Another case that weakened the PCAOB's regulatory authority over audit firms and undermined its regulatory independence is the adoption of Rule 104(h) in 2010. Rule 104(h) gives the SEC a greater role in PCAOB inspections by granting audit firms an option to request an SEC review of their PCAOB inspection findings. Rule 140(h) states:

> The information provided by the firm, together with any additional information provided by the PCAOB or associated persons, provides a basis for Commission consideration of the review. Rule 140 provides that, based on this information, *the Commission shall consider whether the PCAOB's assessments or determinations are arbitrary and capricious*, or otherwise not consistent with the purposes of the Act." (emphasis added).
>
> Furthermore, OCA is delegated authority to conduct these reviews under Section 104(h) in order to "conserve Commission resources by permitting the Chief Accountant to fulfill the Commission's review requirements in a timely manner (SEC, 2020, p.13).

McKenna (2010) argued that this rule was passed after the 2010 Supreme Court ruling in *Enterprise Fund vs. the PCAOB* to appease audit firms unhappy with the perceived "unfriendly" nature of the PCAOB's inspection process. The PCAOB had been showing its "teeth" as a tough regulator and the audit firms' responses to the PCAOB's criticisms of their audits had been

dismissive prior to the adoption of Section 140(h) Rule.[19] Media reports at the time said the rule caught the PCAOB off guard.[20]

Around the same time Rule 140(h) was implemented, the SEC also amended its rules related to SOX Section 107 to delegate authority to the SEC Chief Accountant (within OCA) for any proposed rule changes of the PCAOB (SEC 2011). Essentially, OCA became the "point person" for the PCAOB at the SEC. As a result of the above changes, the SEC gained confidence to more overtly insert itself into the PCAOB's regulatory activities.[21]

These two regulatory changes allowed OCA to override PCAOB decisions, including inspection findings and disciplinary actions. The OCA override option includes blocking or repealing any PCAOB assessments the OCA finds "arbitrary and capricious," even if the audit firm did not appeal the decision by requesting a review.[22]

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[19] For example, when the PCAOB issued its 2005 inspection report on KPMG, it concluded that KPMG had failed "to identify or appropriately address errors in the issuer's application of GAAP," which likely resulted in material misstatements (PCAOB 2005). In its response to the PCAOB, KPMG claimed judgment plays a part in the auditing process and that reasonable professionals might differ on what specific tests and documentation are needed (PCAOB 2005). In addition, in responding to Part II of the 2008 inspection, Deloitte noted that "professional judgments of reasonable and highly competent people may differ as to the nature and extent of necessary auditing procedures, conclusions reached and required documentation. We believe that reasonable judgments should not be second guessed and therefore disagree with a number of comments as indicated" (PCAOB 2008). The PCAOB perceived negative reactions by the audit firms to its criticisms as evidence of non-compliance and audit firms have stopped using adversarial negative language in their responses to the PCAOB (Ege et al 2020).

[20] Thompson Reuters reported: "'The board was not consulted concerning this rule and was not aware that it would be issued yesterday,' said PCAOB spokesperson Colleen Brennan." The SEC did not issue a press release for this rule. Chairman Shapiro did not mention it in a July 27, 2010, speech that discussed actions the SEC was taking in response to the passage of the financial regulatory reform bill. https://www.sec.gov/news/speech/2010/spch072710mls.htm. It was not an explicit requirement of the Supreme Court decision regarding the PCAOB. https://pcaobus.org/news-events/news-releases/news-release-detail/decision-in-free-enterprise-fund-v-pcaob_292 . See "Auditors Say Jump… New "Appeals" Process Will Impede Timely PCAOB Inspection Reports," Francine McKenna, reTheAuditors.com, August 3, 2010. Available at: https://retheauditors.com/2010/08/03/auditors-say-jump-new-appeals-process-will-impede-timely-pcaob-inspection-reports/

[21] The ability to circumvent the PCAOB after 2010 may also explain why audit firms stopped publicly rejecting the PCAOB's criticisms in their responses to the inspection reports around the same time (Ege et al. 2020).

[22] Palmrose (2013) characterizes the "arbitrary and capricious" standard of SEC review of inspection reports and remediation determinations as a "high threshold" because the Administrative Procedure Act allows for a measure of deference to governmental determinations. The "arbitrary and capricious" standard generally requires only that there be a "rational" foundation for the determination, meaning that the SEC should not be overturning PCAOB decisions as long as there is a rational connection between the facts and the conclusions.

The adoption of Rule 140(h) emboldened the audit firms to use the SEC to circumvent the PCAOB.[23] Deputy Chief Accountant Wes Bricker was personally responsible in 2009 for creating an improved approach for the SEC's review of the PCAOB inspection reports because, he acknowledged, the SEC had missed red flags in PCAOB inspection reports about the Lehman Brothers audit. Bricker testified that "…we [the OCA] look at the reasons and the rationale for the firm seeking a review, we look at the PCAOB's reasons and rationale for having a comment, and then make a judgment about whether to grant it or not" (*U.S. v. Middendorf and Wada* 2019, p. 108). For example, in 2019, the SEC overturned a PCAOB sanction of KPMG partner Cynthia Reinhart because it disagreed with the PCAOB's findings in the case (SEC 2019). In 2018, the SEC vacated a PCAOB disciplinary order based on a ruling by a federal appeals court (SEC 2018).

Although the prior two cases are the only publicly known instances of the SEC directly overturning PCAOB decisions, there have been other ways the SEC has stymied the PCAOB indirectly. For example, in 2015 and 2016 KPMG had ongoing disputes with the PCAOB regarding its audit quality issues and the SEC willingly met with KPMG separately, without PCAOB officials (*U.S. v. Middendorf and Wada* 2019). Deputy Chief Accountant Bricker testified that the goal of the meetings was "to better understand whether there was a problem with SEC rules as a possible explanation, whether there was a problem with the KPMG audit methodology as a second type of explanation, or *whether there was some problem with the [PCAOB] inspection process as a possible third explanation*" (*U.S. v. Middendorf and Wada* 2019, p.177, emphasis

[23] When the PCAOB Chairman Jim Doty joined the PCAOB in 2011, he made it clear that he would regulate, not placate, the firms. Levinson (2015) notes that the audit industry used SEC Chief Accountant James Schnurr to prevent Doty from reining in the firms' pushback on its inspections and disciplinary activities and states that "Doty's efforts have floundered, in large part because Schnurr's office has used its oversight powers to block, weaken and delay them, according to a dozen current and former SEC and PCAOB officials. Schnurr's staff has also campaigned to have Doty removed from office."

added). Such meetings exemplify the audit firms' increased confidence after the adoption of Rule 140(h) that lobbying the SEC directly could eliminate the PCAOB's criticism.

Consistent with the idea that KPMG could appeal to the SEC to solve its problems with the PCAOB, David Middendorf recalls in his testimony that the meeting with the SEC Chair — attended by Middendorf, KPMG audit leader Scott Marcello, KPMG CEO Lynn Doughtie, and KPMG's Vice Chair of Legal Risk and Regulatory Sven Holmes — was precipitated by what he characterized as unfair "attacks" on KPMG by the PCAOB. Specifically, Middendorf testified:

> "So in the beginning of my [Middendorf's] tenure in my role [National Managing Partner – Audit Quality & Professional Practice]"… one of the PCAOB Board Members, Steven Harris, had really I'll say *attacked us* or challenged us regarding the tone at the top within the firm, our level of disagreement with the comments [the PCAOB inspection deficiency findings] historically, or lack of timely response to the PCAOB comments, the lack of timely remediation of… So we were reporting that coming out of that meeting, we had made progress in our relationship with the PCAOB was our view" (*U.S. v. Middendorf and Wada* 2019, p.2827, emphasis added).

Middendorf also testified that he didn't believe the SEC pays attention to the comments the PCAOB makes in its inspection reports (*U.S. v. Middendorf and Wada* 2019, p. 2828-2830). The SEC may have intended to impress upon KPMG executives they should take the PCAOB seriously. However, KPMG walked away from their meetings with the SEC feeling that the SEC agreed that the PCAOB had made unfair attacks against the firm, that the issue was the PCAOB's inspection methodology and not KPMG's audit approach, and that KPMG had the SEC's ear regarding its issues with the PCAOB. (*U.S. v. Middendorf and Wada* 2019, p. 2824-2825).

In summary, these examples illustrate how the SEC has intervened in the decision-making processes of the PCAOB and contributed to undermining PCAOB's authority. In our view, the SEC's actions also thus may have weakened the credibility and effectiveness of the PCAOB inspection regime. Furthermore, the SEC's actions may have negatively affected PCAOB staff

morale, which contributed to the misalignment of the culture pillar, which we discuss in a later section.

The willingness of audit firms to circumvent the PCAOB's authority, and ease in which they could appeal to the SEC to overrule the PCAOB, also potentially contributed to the deteriorating internal culture within PCAOB. Some board members regularly arranged "ex parte" communications with the audit firms seemingly out of loyalty to the firms rather than to the PCAOB's regulatory mission and their colleagues in the inspection and enforcement divisions.[24]

4.2 Second and third pillars: Performance measurement and monitoring, rewards and incentives

In this section, we assess how the PCAOB's approach to performance measurement, monitoring, reward, and incentive mechanisms — the second and third pillars — affected its ability to fulfill its mission. Consistent turnover on the board, open conflict, and "internecine warfare" have led to chronic uncertainty among PCAOB staff regarding strategic direction and future career roles, responsibilities, performance expectations and rewards (KLS 2021, p. 103).

In our analysis, we focus primarily on the inspections division. We view inspections as the most important PCAOB task, intended to fulfill the PCAOB's primary mission of promoting audit quality. The inspections division consistently accounts for approximately 45% of the PCAOB's annual budget (PCAOB 2022a). The PCAOB's Stephanie Rodriguez testified that the cost of planning an inspection for a single GNF firm in a given year was $500,000 or 5,000 labor hours (*U.S. v. Middendorf and Wada* 2019, p.456-458). Extrapolating to 10 GNF firms inspected

[24] Some PCAOB board members undermined the regulator's mission and their own colleagues when they agreed to circumvent the official PCAOB process by meeting with audit firm leaders privately and without alerting fellow Board members. Jay Hanson, a former PCAOB Board member, testified during *U.S. v. Middendorf and Wada* that he met with the firms on his own because he believed the PCAOB inspections teams had a "gotcha" mentality toward their work with the audit firms and went too far in identifying fault. Hanson and Board member Jeanette Franzel met separately with the largest firms' leadership teams, including KPMG's, to coach them for their regular meetings with the full Board.

annually, the PCAOB spends close to $5 million to *plan* the inspection process. This amounts to 2 percent of its annual budget, given the PCAOB's annual budget of roughly $250 million in 2015, or 4 percent of the annual budget of the PCAOB's Division of Registration and Inspections (DRI) in 2015 (PCAOB 2016).

In our discussion of performance measurement, we separately evaluate the performance measurement of the PCAOB's mission and assessing whether it has been achieved in Section 4.2.1. We then turn to performance measurement of PCAOB staff and the rewards and incentives structures used, mainly in the inspection division, in Section 4.2.2.

4.2.1 Performance measurement and monitoring of PCAOB's mission

Section 101 of SOX establishes the PCAOB, "to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports." When describing the duties of the PCAOB, Section 101 specifically mandates that the PCAOB shall adopt auditing standards that include quality control standards for audits that "promote high professional standards" to "improve the quality of audit services" provided by the registered public accounting firms and associated persons the PCAOB will now regulate.

When Arthur Levitt lobbied for the creation of the independent audit regulator before the enactment of SOX, he pushed for it to have a robust audit inspection regime to replace the peer review mechanism managed by the industry's own trade association, the AICPA. SOX Section 104 mandates the new Board to conduct "a continuing program of inspections" of audit firms to ensure compliance with audit quality standards as well as all the new rules of the Board and the rules of the SEC in connection with auditing public companies, issuing audit reports and any other services provided to U.S. listed companies.

However, the full scope and objective of the PCAOB inspection regime or even its underlying "philosophy" was not defined in SOX. One could think of the inspection regime as ensuring that the financial reports of publicly traded companies are subject to a robust audit process that elevates the overall public's trust in financial information available in the capital markets.

How would the PCAOB measure its success in ensuring that trust? One approach is to evaluate the "average" quality of audits in markets. Under this approach, one would think about sampling a random set of audits to be inspected. The average rate of deficiencies could serve as an unbiased metric for the overall weakness in the audit process prevailing in the economy. Therefore, it could point to whether the overall activities of the PCAOB achieve its mission. Another approach, driven by the desire to not miss another Enron, would rely on a risk-weighted sampling focused on areas where failures are likely to occur. The published deficiency rates under this regime would not be a good indicator of the overall achievement of the PCAOB mission because they are likely to reflect a higher-than-average rate of deficiencies. As such, they might not be congruent with the PCAOB's mission.

The leadership of the new PCAOB chose the latter approach.[25] The transcripts of *U.S. v. Middendorf and Wada* indicate that the PCAOB staff designed an inspection program based on a risk-based selection process where the audit firms, audit engagements, and audit focus areas are selected for inspection based on the likelihood of violations of auditing or accounting standards. It was an approach that former Big 4 professionals — the majority of those hired in the PCAOB's first ten years — were familiar with. External auditors have been using a top-down, risk-based

[25] Although the PCAOB chose the risk-based approach to reduce the risk of another highly-publicized audit failure, Cullinan (2004) notes that the main provisions of SOX, such as Section 404, don't address why the auditors missed the frauds because "most of the audit-related provisions of the Sarbanes-Oxley Act are concerned with strengthening auditor independence."

approach to develop the scope of tests performed to support opinions on the financial statements of public company clients.

The PCAOB's DRI developed its audit engagement inspection targeting process internally, focused on "high visibility/high risk targets." The risk factors used for targeting engagements for inspection appear to draw from the academic literature on audit quality indicators (e.g., Defond and Zhang 2016; Knechel et al. 2013; Lennox and Wu 2018) and on PCAOB-developed "red flags," which are not publicly known, even to the audit firms.[26] DRI uses a simple aggregation of flags (flag count) to determine overall issuer risk; the higher the flag count the riskier the issuer is deemed. The ultimate decision on audit engagement inspection selection is made by the Associate Team Lead, the U.S. Team Lead, and Global Team Lead in DRI (*U.S. v. Middendorf and Wada* 2019, p.451-452).

The DRI process appears only partially informed by the recommendations of the PCAOB's Office of Risk Analysis (ORA).[27] Serving as a consultant to DRI and not a key decision-maker regarding which audits are targeted for inspection, ORA prepares *recommendations* or *referrals* for inspection targeting (i.e., star referral system) and DRI has the final decision rights for which client engagements are selected.[28] DRI's apparent marginalization of ORA in the inspection planning process is confirmed by a 2012 report by the PCAOB's Office of Internal Oversight and Performance (IOPA). Specifically, IOPA's report states:

> Certain ORA products are *neither well understood nor considered particularly valuable* to Inspections while others appear to be pushed toward, rather than requested by, the customer. In addition, *inspectors told us they often contain*

[26] That did not stop the firms from trying to guess the PCAOB's flags, to beat the inspectors at their own game (*U.S. v. Middendorf and Wada* 2019, p.2568).
[27] This unit is now known as Office of Economic and Risk Analysis (ERA).
[28] ORA three star referrals are always selected for inspection and a high percentage of 2 star referrals are incorporated into the referral plan. ORA also prepares random selections for the inspections. (*U.S. v. Middendorf and Wada* 2019, p.436-439).

significant amounts of information beyond what is considered relevant and actionable" (PCAOB 2012, emphasis added).[29]

In the early 2010s, the PCAOB included deficiency rates in the public reports of the audit firms and the media dutifully reported each new set of numbers (Rapoport 2010, 2011a, 2011b). As discussed previously, this deficiency rate is not intended to reflect the overall health of the audits of publicly traded companies in the United States. The misinterpretation of this non-congruent performance metric may have led to several unintended consequences that collectively made the PCAOB vulnerable to several sources of criticism.

First, the risk-based inspection selection process together with the consistent and wide dissemination of deficiency rates left the PCAOB vulnerable to criticism from audit firms and academics. Both groups argued that the risk-based inspection selection process was not a valid way to measure or monitor the level of audit quality delivered to U.S. issuers (e.g., Peecher and Solomon 2014; Palmrose 2013). Palmrose (2013, p.789) noted other potential (unobservable) weaknesses in the inspection selection approach including "changes in selection criteria and inspection approach over time, cross-sectional and time-series differences in inspection teams (including their expertise), and changes in the criteria for and other factors that influence decisions on comments and, in turn, impact the number and nature of comments included in inspection reports and the thresholds for classifying comments as Part I versus Part II or excluding them altogether."

Second, the persistent publication of chronically high deficiency rates risked creating an impression with the public that the financial information of issuers audited by poorly performing firms is not reliable. Ironically, if high inspection deficiency rates persisted, a perception could

[29] See 2012 IOPA report at: https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/internaloversight/documents/2012_research_and_analysis.pdf?sfvrsn=207c875_0.

develop that the PCAOB's inspection and disciplinary programs are not effective in improving audit quality and protecting investors, thereby preventing it from claiming to have achieved its mission.[30]

In a November 2018 speech, PCAOB Board member Kathleen Hamm stated a consensus had developed among some board members that the inspection performance of the biggest accounting firms' had plateaued, with deficiencies "at an unacceptably high rate" despite the PCAOB's inspection process and ongoing disciplinary and enforcement activities. "For example, over the last several years, we have seen roughly the same percentage of audit deficiencies year over year during our inspections of the largest audit firms," Hamm told the audience. The solution to that problem, delivered by PCAOB Chairman William Duhnke to the American Law Institute's Accountants' Liability 2018 Conference was for the PCAOB to do more to publicize the positive. "To effectively prevent audit deficiencies, we need to spend as much time discussing audit 'successes' and what leads to them, as we do reporting about audit 'failures' and the deficiencies that cause them," Duhnke told lawyers who defend the audit firms from private and regulatory lawsuits.

The audit firms, and others, criticized media reporting of the deficiency statistics as often misleading. They thought the deficiency percentage results did not reflect overall firm audit quality because of the PCAOB's approach of inspecting the riskiest clients. Relatedly, critics argued that the format by which the information was presented by the PCAOB, where the deficiency rates were broken down by firm with implied comparisons between audit firms, pitted the audit firms

[30] One former PCAOB inspection specialist who now consults with firms trying to improve their PCAOB performance thinks the regulator doesn't do enough to help firms fix chronic problems and may be causing them to persist. "Identifying the same deficiencies year after year and not providing significant new guidance is almost complicit in the audit industry's failure to address these deficiencies." Dane Dowell, November 17, 2020. Available at https://www.jgacpa.com/repeat-findings-will-the-pcaob-ever-be-satisfied

against one another.[31,32] To counter this sentiment, the PCAOB cautions the public in its inspection reports against making comparisons or extrapolating inspection results to the industry's audit quality. For example, PCAOB (2021) states that "….our inspection findings are specific to the particular portions of the issuer audits reviewed. They are not an assessment of all of the firm's audit work nor of all of the audit procedures performed for the audits reviewed." In 2021, the PCAOB said it would increase "significantly" the percentage of public-company audits it selects randomly versus on a risk-basis for inspection, reportedly in response to the necessities of auditing during the Covid-19 pandemic. The Wall Street Journal, however, noted in December 2020 that the change wasn't all about the pandemic. "The PCAOB expects the increased element of surprise to help raise audit quality. 'We think that will cause audit firms to focus consistently on performing quality audits across the practice, rather than on those perceived to have a greater chance of being selected for PCAOB inspection,' said [Megan] Zietsman, who was sworn in as the group's newest board member Nov. 20."

The focus on deficiency rates might have also created a mindset within the PCAOB and its inspection staff that their ultimate goal is to uncover deficiencies. This might have contributed to an "us vs. them" mentality both inside and outside of the PCAOB. PCAOB Board member Hanson explained that the PCAOB inspections teams often went too far and had a "gotcha" mentality toward their work with the audit firms (*U.S. v. Middendorf and Wada* 2019, p.47). This testimony

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[31] "PCAOB inspection reporting should provide a better understanding of the overall quality of the inspected firm's audit practice. Today, while the PCAOB tries to discourage it, there is a tendency to evaluate firms by counting the number of Part I findings in inspection reports. This occurs because the board provides few other metrics to judge quality" (Goelzer 2021).

[32] As recently as 2017, one PCAOB board member encouraged comparisons of deficiency rates by creating graphs of trends for the Big 4. "The *Exhibit* shows the inspection results for the U.S. Big Four firms, and these lines represent the percentage of issuers inspected that ended up in Part 1 of our inspection reports, meaning that we found audit deficiencies, such that we thought that the auditor did not do enough work to issue the opinion. The good news here is, we're finally starting to see a downward trend" (Franzel 2017).

is consistent with anecdotal evidence of widespread disrespect for the PCAOB among audit firms, exemplified by an adversarial tone audit firms had developed when communicating with the PCAOB and its staff (e.g., Westermann et al. 2019; Ege et al. 2020; Johnson et al. 2019).

In summary, measuring whether the PCAOB has been achieving its goals is a complex endeavor. One highly publicized performance metric is the deficiency rate discovered through the inspection process. It has the potential to reflect whether the PCAOB is achieving its mission by evaluating the absolute level of audit weaknesses in the marketplace and by tracking changes to the deficiency rates over time. However, the approach used in the inspection process, namely a risk-based approach, created deficiency rates that may not have been congruent with the overall level of audit quality in the economy. As a result, several unintended consequences, including criticism by academics, investors, the audit firms, and another observers weakened the PCAOB.

Furthermore, this potentially created a misalignment between the task of enhancing trust in the audit profession and internal performance evaluation within PCAOB, as warned against by Ouchi (1980). That is, the PCAOB inspectors may have perceived that they are at least partially evaluated by how many audit deficiencies they have found, which did not necessarily contribute to the perception of creating "trust" in the financial statement. Instead, it might have sent an inaccurate message that PCAOB inspectors played "a gotcha" game.

4.2.2 Performance measurement and monitoring of PCAOB staff

4.2.2.1 Horizon problems and regulatory capture

The PCAOB's initial hiring strategy was to attract inspectors with extensive audit experience. The natural candidates were retired partners and senior level professionals who sought better work-life balance and may have viewed the PCAOB position as their last career role before

full retirement.[33] However, the PCAOB's ambitious risk-based inspection program grew rapidly, especially during and immediately after the financial crisis of 2008-2009. DRI's inspection program actual headcount at the end of 2008 was 258, according to data obtained from PCAOB budget packages submitted for approval to the SEC. By the end of 2014, when KPMG recruited Brian Sweet, inspection staff had nearly doubled, to 507 professionals.

The demand for additional qualified personnel was intense, with actual hires almost always falling short each year of budgeted hires. The PCAOB's growth goals consistently exceeded the number of potential hires in the market. Notes accompanying the 2008 PCAOB budget submission state that "the market for experienced accountants has been highly competitive and the PCAOB has faced challenges in meeting its staffing goals" (PCAOB 2007). In 2011 the PCAOB paid signing bonuses to new hires throughout the agency and established an employee referral bonus program, according to the PCAOB budget package submitted to the SEC for its approval . However, the regulator fell short of paying out all that it had budgeted nearly every year, according to its budget package submitted to the SEC,.

This may have led the PCAOB to hire a disproportionate number of employees, especially in the inspections division, with misaligned incentives. For example, the PCAOB hired mid-career audit professionals whose horizons are far longer than of those who are close to retirement and who, therefore, may have viewed the PCAOB role as a resume-builder that provided a jump in

[33] "From the outset of the PCAOB's existence, its staff reflected considerable longevity and a low turnover rate." (KLS, 2021, page 8) and "The benefits that we offer, I think, are very comparable to the benefits that you have at the firm. It's a nice, rich package of benefits. Big difference, you have the ability to enjoy the benefits that we offer when you work here at the PCAOB. We work, and we have life. To us, work life balance is just that. It is work, but we're really working hard on an inspection, working well as a team, coordinating, interested in what it is that we are doing and focused on that. And when we're not working, we're not working." Interview with Helen Munter, former Director of DRI (Newquist 2015).

salary and cash to sign. By 2015, most PCAOB inspectors were managers (or above) hired from the Big Four firms with a minimum level of experience of only five years (Newquist 2015).

PCAOB Director Helen Munter, who led the inspections division from 2011 to 2018, described the candidates she preferred to hire without ever emphasizing criteria such as an independent mindset, an ability to stand in the investor's shoes regarding audit quality expectations, or the ability to demonstrate professional skepticism and challenge auditors during the inspection process (Newquist 2015). Munter openly suggested that PCAOB work experience as an inspector is a valuable addition to a resume, particularly if the PCAOB is a stepping stone along a career path (Newquist 2015). The PCAOB's hiring practices during its high growth years created a revolving door problem, a view that the PCAOB experience was a temporary role and a springboard to a more lucrative career back in the accounting and auditing industry.

PCAOB inspectors may have arrived with or developed a horizon problem (e.g., Farrell et al. 2008; Dikolli 2001) where their long-term goals did not necessarily overlap with the PCAOB's mission. As Dikolli (2001) hypothesizes, the shorter the employees' employment horizon, the greater the demand for short-term incentives that focus on the organizations long-term success. In the case of the PCAOB, incentives that recognized inspectors' short-term annual productivity and effectiveness — number of inspections completed on schedule, number of reports issued timely and minimization of disputes over comments and deficiencies cited — would not only provide immediate rewards to the professionals but engender good relations with the audit firm and the wider investor stakeholder community ensuring ongoing viability of the organization. If short-term incentives that reward farsighted perspectives on performance are not sufficient for professionals, the horizon problem can result in professionals vulnerable to the temptation to appease potential

future employers (i.e., the audit firms) while still working for the PCAOB to obtain larger rewards for eventually jumping to a new job.

Exacerbating the horizon problem, the PCAOB may have further narrowed career choices for its inspectors by grouping them by industry auditing experience. To optimize staff performance in conducting firm and engagement inspections, inspectors with particular industry auditing experience may work on more than one designated team assigned to each Global Network Firm or GNF (*U.S. vs. Middendorf and Wada* 2019). While this arrangement provides an opportunity for an inspector to become familiar with the inspected firm, its professionals and its clients in particular industries, it also has the potential to breed overfamiliarity with the regulated firms and complacency regarding future career options. Economic theory also suggests PCAOB inspectors can use their industry specialization to signal their ability to firms, as prior work suggests that "aggressive monitoring may become an effective way to signal her qualifications for the industry job" (Che 1995). PCAOB inspectors can attract future outside opportunities as a result of the additional expertise developed from this industry concentration and by acting as tough regulators by finding more audit deficiencies.

The PCAOB ethics code prohibits new hires from participating in the inspections of their former employers for one-year, but after that cooling-off period inspectors could be assigned to inspect former employers (Hendricks et al 2022). That may have impaired some employees ability to act independently. That is especially true if the new hires saw the PCAOB as a resume builder, and an opportunity to go through the revolving door back to the former firm at more senior positions. Hendricks et al. (2022) find evidence that the intensity of hiring of former PCAOB employees by audit firms is positively associated with audit firms' prior inspection deficiency levels. However, the authors demonstrate that improvements were limited to performance in

PCAOB inspections, and were not present in overall audit quality as measured by other variables (e.g., restatement rates). This suggests that the audit firms' primary objective in hiring former PCAOB inspectors was to immediately improve their inspection deficiency rates with broader audit quality improvement, perhaps, expected to follow.

Macey (1992) argues that critical challenges develop when a government agency focuses on a single industry because the likely future employees of choice for single-industry regulators work for the industry they would regulate. From the perspective of an inspected audit firm, an inspector with deep knowledge, expertise, and experience in the industries they audit, and who is familiar with the regulator's perspective on how the firm should audit those industries, is an ideal candidate to recruit from the regulator. Brian Sweet is a prime example. Sweet worked on the KPMG inspection team at the PCAOB for several years. Sweet was hired away from the PCAOB by KPMG because he was perceived as a highly competent inspector specializing in financial services — where KPMG had a significant market share and where the firm was having the most trouble from the PCAOB's perspective (McKenna et al. 2022). In the four months ending April 29, 2015, KPMG recruited five PCAOB inspectors and, by January 2017, KPMG had hired approximately a dozen former PCAOB employees (*U.S. v. Middendorf and Wada* 2019, p.1966-1968, p.2106). Krishnan et al. (2020) indicate audit firms hired at least 85 former PCAOB employees between 2010 and 2016 and, in 2016, the vast majority, 76, were employed by the 12 audit firms in their analysis.

A natural concern that arises when the challenges discussed above are present is regulatory capture. There are two kinds of regulatory capture — material capture and cognitive capture (Rilinger 2021). Brian Sweet and others traded their PCAOB inspection process expertise and confidential data in exchange for lucrative jobs at KPMG and other audit firms. They were

materially captured, to the detriment of the public interest (Carpenter and Moss 2013). The example of PCAOB inspection personnel stealing data to help KPMG, and of Board members Hanson and Franzel sympathizing with the audit firms over treatment by PCAOB inspectors may suggest that PCAOB Board members and professionals are not immune to the temptation to adopt the perspective of the regulated, a form of cognitive capture.

Bó (2006) writes that providing positive incentives to regulators, such as promises of future employment, is not the only way to influence, or corrupt, regulators. When a regulated entity causes "trouble" for the regulator, it may create reputational damage for the regulator that affects its pool of talent. Indeed, the PCAOB always had difficult hiring inspectors given unclear career paths, the uncertainty surrounding the agency until the Supreme Court decision, and some professionals' fear they would be shunned if they over-criticized the audit firms.

4.2.2.2. Solutions to the incentive problems

The standard solution to the horizon problem is to evaluate professionals on forward-looking performance measures (e.g., Yanadori and Marler 2006; Farrell et al. 2008). In for-profit companies the forward-looking metric might be earnings performance, adjusted for the effects of long-term investment, such as R&D expenditures (e.g., Dikolli 2001). However, it is difficult to conceptualize such a long-term measure at a nonprofit quasi-government corporation like the PCAOB. As discussed in the previous section, evaluating whether the PCAOB achieves its mission was garbled by the overuse of the inspection deficiency rates that were the premier gauge published by the PCAOB starting in early 2010s. If there was an attempt to link this metric to the performance of individual staff members, then that might have created additional problems with the incentives of individual inspectors. However, absent a direct mechanism linking inspection deficiency rates to compensation, an indirect link could have shaped the mindsets of staff in the inspection division.

Paying PCAOB inspectors a salary competitive with non-regulatory options is one way to address the problem of a lack of talent and to reduce the incentives for professionals to leave the PCAOB and return to the audit industry. The PCAOB claims to pay market rates for inspector compensation (Newquist 2015). However, the opportunity for higher salaries at the public accounting firms appears to have motivated Brian Sweet and Cynthia Holder, both former PCAOB inspection staff hired by KPMG. Sweet, an Associate Director of Inspections at the PCAOB, more than doubled his compensation from $240,000 to $525,000 when he was hired as a direct admit partner into KPMG (*U.S. vs. Middendorf and Wada* 2019, p. 752). Furthermore, Sweet explained that former PCAOB employees willingly volunteered confidential inspection data to him hoping to procure KPMG employment (*U.S. vs. Middendorf and Wada* 2019; pp.808-809).

One way some agencies reduce incentives for employees to go through the revolving door — a symptom of regulatory capture — is by establishing a "cooling off" policy. Many government agencies impose one-year cooling-off periods to prevent U.S. federal employees from working in specific jobs for a year after leaving government. Other examples from federal and state government include limited or even lifetime bans on "switching sides," or representing a private party in a matter in which the employee has represented the government (Wallheimer 2017). In the audit industry, Section 206 of SOX requires a one-year "cooling off" period before a member of an audit engagement team can accept certain employment positions with a client.

The PCAOB's "cooling off" rules were unclear. It appears those rules were not present when the audit inspection scandal broke, allowing PCAOB staff to return to the audit firms (e.g., Hendricks et al. 2022). When the scandal broke the PCAOB told media it would implement a new cooling-off period for senior inspection staff. However, the PCAOB has not yet implemented these stricter rules. Policies and rules that slow or stop the revolving door can also have unintended

consequences. "Cooling off" periods might constrain agency recruiting because they limit potential employees' career choices (Kempf 2020; deHaan, Kedia, Koh, and Rajgopal 2015; Lucca, Seru, and Trebbi 2014).

To summarize, the PCAOB's choices for how it rewarded employees left the organization vulnerable and contributed to undermining its credibility and authority. It appears the PCAOB faced great difficulties in constructing an effective formula to incorporate performance measurement into the compensation of inspection staff that would allow them to establish viable careers at the PCAOB and resist going through the revolving door back to the audit firms. By not recognizing the potential for a horizon problem, the PCAOB exposed itself to massive departures to the industry it is supposed to regulate. Coupled with weaknesses in controls over data (discussed in the next section), the PCAOB was vulnerable to losing confidential regulatory data stored in its systems, contributing to the audit inspection scandal of 2017.

4.3 Fourth pillar: Organizational culture

Organizations are vulnerable to pillar misalignment when substantial conflicts of interests and incentive incompatibilities develop within their midst. What is unique about the PCAOB is that organizational misalignments were built into its foundation — how SOX designed and expected the PCAOB to be organized. We argue the PCAOB's culture was hurt by rapid organizational growth that contributed to weak institutional governance and low employee morale. In this section, we describe how the PCAOB's organizational structure resulted in task assignments, incentives, and compensation policies that exacerbated these misalignments rather than mitigating them and contributed to an ineffective culture at the PCAOB.

To be effective, the PCAOB's Ethics Code had to outline for Board members and employees the core mission and values SOX envisioned and the public and other stakeholders

expected. The PCAOB's culture would be grounded in standards of conduct and ethical practices that promote trust among various stakeholders. Internally, articulation of standards of conduct and ethical practices would build trust and a positive workplace environment between Board members, between the Board and management, and between management and employees. Codes of conduct and ethics codes set the stage for strong culture. However, if too vague, not communicated well, or enforced inconsistently, these policy statements can have the opposite effect.

4.3.1 The impact of the PCAOB's organizational structure on its culture

Created in 2002, the PCAOB began conducting inspections the following year by examining the Big Four audit firms. The organization's growth accelerated quickly. When organizations grow rapidly, internal control structures have a difficult time keeping pace with emerging risks (e.g., Doyle et al 2007; Bentley-Goode et al. 2017). For example, the PCAOB faced one of its first major challenges five years after its founding with the financial crisis of 2008. The financial crisis increased the complexity of accounting and auditing issues and made PCAOB inspections more challenging. Specifically, the PCAOB acknowledged in its 2010 budget proposal package sent to the SEC that:

> "Changes in the economic environment may exacerbate certain pressures on auditors, including pressures to maintain audit practice profit margins, accommodate audit clients facing deteriorating economic and business conditions, and reduce audit fees. Given these risks and challenges, the PCAOB has found that its inspections are more challenging, and its need for thoughtful risk assessment is greater…In addition, since the financial crisis began, the PCAOB's inspections have resulted in increased referrals to its enforcement program...Investigations and disciplinary proceedings involving complex transactions and accounting and auditing issues will likely consume more resources than have many of the PCAOB's past disciplinary cases."

Effective communication at and between all levels of an organization is a key component of leadership effectiveness and internal control (Felner, et al. , 1995). The audit inspection scandal further demonstrates that sufficient governance and technology controls were never implemented

at the PCAOB. Senior PCAOB executives had consistent communication breakdowns with SEC staff, resulting in SEC staff members who felt the PCAOB was not forthcoming on its strategy and direction (KLS 2021, pp. 129-130).

The PCAOB also had weak controls over its technology and data systems, an environment that created an opportunity for its employees to steal confidential regulatory data to enhance their future employment prospects.[34] For example, Sweet — the main perpetrator of stealing the KPMG inspection data — transferred inspection data and other confidential documents onto an external hard drive and, along with other paper documents, removed them from the PCAOB on his last day of employment (*U.S. v. Middendorf and Wada* 2019, p. 754). Sweet also encouraged Holder, another PCAOB staff member hired at KPMG, to steal PCAOB inspection data to help her succeed at KPMG (*U.S. v. Middendorf and Wada* 2019, pp. 799-800). It was also revealed that other PCAOB employees within the inspection division volunteered confidential inspection data to Sweet hoping to procure KPMG employment (*U.S. v. Middendorf and Wada* 2019, pp. 808-809).

The PCAOB's unusual governance structure, one that resulted from the way the entity was originally established by statute, also contributed to task assignments, incentives, and compensation policies that weakened culture. The PCAOB Chair is effectively the "CEO" of a not-for-profit corporation. The PCAOB board members, including the Chair, are responsible for corporate governance oversight but are also, legally, vice-presidents of the not-for-profit corporation. Individual Board members did not understand their responsibilities, in part because of a lack of a formal job description (KLS 2021, p.69). This confusion in authority and

[34] Since the audit inspection scandal, the PCAOB has reportedly restricted access to inspection data to prevent inappropriate use and has implemented a data loss prevention system to create a digital record of file location (KLS 2021, p.120).

responsibility within the organization manifested in disagreements among board members and resulted in significant difficulties in sharing responsibility and exercising authority.

Based on interviews of PCAOB staff, KLS (2021) document that former PCAOB employees recalled that in the early years of the PCAOB it "operated collaboratively, and shared responsibilities seamlessly, among its staff members," based on the shared goal of getting the regulator up and running and fulfill its critical mission of investor protection. The dynamic shifted in 2006 and the pressures of dramatic growth created new tension and conflict. KLS (2021) attribute a gradual "softening (and diminution) of its employees' initial fervor, mission-driven culture, and clear commitment to promoting—in the case of the PCAOB—the standards and performance of the auditing profession" to a culture of mistrust that developed among board members, spread throughout the organization, and to some extent continues today. [35]

As discussed earlier, the PCAOB's hiring approach and its staff compensation and benefits policies were mismatched with its mission. More hiring of less experienced professionals, based on enormous growth pressures due to overambitious regulatory, and enforcement and standards programs constantly in flux, left the PCAOB vulnerable to regulatory capture and the revolving door problem. PCAOB staff strongly identified with the firms they were recruited from, and were tasked with regulating these same firms. When staff left the PCAOB to return to those audit firms, they justified better positions and compensation based on the knowledge and experience gained from the PCAOB, knowledge and experience the firms valued highly given their perception that the inspection program was arbitrary. This set of circumstances led to the serious legal and ethical violations that culminated in the KPMG-PCAOB audit inspection scandal of 2017.

[35] "Employees confronted with significant organizational changes tend to experience lower levels of job satisfaction and three times the amount of mistrust vis-à-vis their employers. Those general trends became a reality at the PCAOB in 2019, where the PCAOB's employee surveys evidenced considerable mistrust for the current Board." (KLS, 2021, page 9)

After the 2017 scandal, PCAOB leadership made significant organizational changes that included separations of the majority of the senior staff that had, in some cases served, since the establishment of the PCAOB (KLS, p.126-130). Inspection headcount dropped dramatically during 2017, after KPMG announced the scandal — to 477 professionals by the end of 2017 from 525 at the end of 2016.[36] Inspection headcount dropped again during 2018, after the SEC and Department of Justice announced the criminal charges against the KPMG and PCAOB professionals involved in the scandal — to 465 inspection professionals from 477. The 2019 budgeted headcount for 2019 was only 480 inspection professionals, an 8.5 percent decline from the end of 2016 when the inspection division was at its highest staffing level in the history of the agency. Professionals it had paid more than $500,000 in employee referral bonuses and more than $200,000 in signing bonuses in 2016 to recruit may have left in 2017 and 2018.

The 2019 PCAOB employee culture survey described by KLS (p.23) reflected a lack of trust in the Board. In May and September of 2019, whistleblower complaints filed with the SEC demonstrated a high level of mistrust, and raised concerns of hidden agendas, motives and intentions regarding the Board's proposed organizational changes.

4.3.2 The impact of the PCAOB's Ethics Codes on its culture

SOX mandates public companies have a code of conduct for top executives. The New York Stock Exchange and the Nasdaq followed suit in 2003 and require listed companies to adopt and disclose a "code of business conduct and ethics" applicable to all employees and directors. Codes of conduct and codes of ethics help employees understand an organization's values and desired

[36] "As part of the effort to drive PCAOB-wide cost reductions towards a baseline that is 5% less than the 2017 Budget, DRI has reduced its staff by 26 positions…The 2017 Budget assumed DRI would have 528 staff members at the end of this year, but the current year-end headcount estimate is 491 staff members, following the headcount reductions from both the VEIP *[a Voluntary Exit Incentive Plan initiated by PCAOB Chairman Duhnke]* and routine staff turnover. These staffing shortages have challenged the Division…" Text of the PCAOB's 2018 budget submission package delivered to the SEC for its approval in November 2017.

culture. When employees see management promoting ethics and integrity in the organization via a code of conduct and code of ethics, it helps them understand the culture and conduct the organization values and helps explain management's actions. When there's a gap between the culture and values represented in codes of conduct and ethics and "how things really work around here," the organization's culture and effectiveness will deteriorate (Pittman and Navran 2003).

As a quasi-governmental agency and a regulator that establishes and enforces standards of conduct and ethics for the audit industry, one of the first tasks the PCAOB accomplished after it was formed was to establish a formal ethics code for its employees and Board. The PCAOB's ethics code for its employees and Board was approved by the SEC in November of 2003.[37] The PCAOB's former ethics officer, Barbara Bulger Hannigan, testified: "The [PCAOB] ethics code is a set of conduct rules that apply to the board and the staff to ensure that they avoid conflicts of interest or even appearance of conflicts of interest, to ensure that the public will have confidence in the work—the independence and integrity of the work we [the PCAOB] do" (*U.S. v. Middendorf and Wada* 2019, p.1697).

Employees are introduced to the PCAOB ethics code early in the employment process (i.e., in offer letters). PCAOB employees receive ethics training on the first day of employment, which culminates in employees certifying their compliance (*U.S. v. Middendorf and Wada* 2019, pp.1706, 1708-1709, 1723). PCAOB inspectors also receive ethics training as part of their annual inspection training, which covers "financial and personal conflicts of interest, interactions with accounting firm personnel, social interactions, confidentiality, just the full gamut" (*U.S. v.*

[37] See "PCAOB Rulemaking: Public Company Accounting Oversight Board; Order Approving Proposed Code of Ethics," Securities and Exchange Commission, Release No. 34-48755; File No. PCAOB-2003-04. November 7, 2003. Available at https://www.sec.gov/rules/pcaob/34-48755.htm and at https://pcaobus.org/news-events/news-releases/news-release-detail/board-adopts-ethics-code_39.

Middendorf and Wada 2019, pp.1714-1715). Prior research demonstrates that high quality ethics policies enhance corporate conduct (e.g., Chen et al. 2018; Erwin 2011; Raiborn and Payne 1990).

The PCAOB's code of ethics is unambiguous regarding the highly confidential nature of inspection planning data, unless disclosure is specifically authorized by the Board.[38] The PCAOB ethics code also requires disclosure of any prospective employment negotiation between the Board members and professional staff and public accounting firms, issuers, and brokers-dealers and recusal from any matter creating a conflict as a result of any prospective employment negotiations (*U.S. v. Middendorf and Wada* 2019, p.1702). On the surface, the PCAOB ethics code covers the typical potential ethical issues that PCAOB employees might encounter. It has clear guidelines for conflicts of interest as well as outside employment search. It is unequivocal with respect to confidentiality requirements.

Yet, the behavior of Sweet, Holder, and other PCAOB employees suggests some did not take the PCAOB ethics code seriously, before and after leaving the PCAOB and after joining KPMG. Jeffrey Wada, and many others who didn't get the chance to leave the PCAOB for KPMG or another audit firm, ignored it while using their PCAOB experience and access to secure jobs one of the audit firms.[39] Why?

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[38] "Unless authorized by the Board, no Board member or staff shall disseminate or otherwise disclose any information obtained in the course and scope of his or her employment" (*U.S. v. Middendorf and Wada 2019*, pp. 1699-1700).

[39] U.S. Attorney Rebecca Kramer questioning Brian Sweet during the trial of Jeffrey Wada and David Middendorf.
Q. Did you ever try to get confidential information from your former colleagues at the PCAOB?
A. Yes.
Q. What kind of information did you try to get from them?
A. I would sometimes ask, you know, probing questions such as, hey, you're traveling anywhere fun next year, you know, overseas? And if I knew they worked for -- on the KPMG Inspection Team and they said, yeah, I'm going to be going to this country, then that was a pretty big tip off to me that, well, they are likely going to be looking at a bank in that country, or, you know, how they were doing on their inspections with, you know, another firm, sometimes they would tell me.
Q. What did you do when you got that information?
A. Generally every time I would go back and tell others at KPMG. (*U.S. v. Middendorf and Wada* 2019, pp. 952)

One possible answer is that compliance with ethics rules are stress-tested when there are powerful incentives to defy them. Sweet may have perceived the expected benefits of a criminal violation to exceed its expected costs (Becker 1968). The financial incentives for Sweet to ignore the ethics code — he more than doubled his salary when he moved to KPMG — were significant. It is possible this financial incentive was enough for Sweet to justify a violation, given the prevalence of short horizon issues in the inspections division of the PCAOB. Holder was close with Sweet and saw an opportunity to gain a position in KPMG's National Office while Wada was upset about not getting a promotion at the PCAOB and pessimistic about his future at the PCAOB.

As was discussed earlier, "cooling off" rules — ones that would have discouraged revolving door behavior — were not part of the ethics code when the audit inspection scandal broke. This allowed PCAOB inspection staff, in particular, to return to the audit firms (e.g., Hendricks et al. 2022). When the scandal broke, the PCAOB told media it would implement a new "cooling-off" period for senior inspection staff. The PCAOB never implemented these rules.

4.3.3 The impact of the PCAOB's poor culture on internal and external trust in the regulator

Organizational trust is a key element of organizational effectiveness (e.g., Mayer et al. 1995). This is because organizational trust is key to creating a "commonality of purpose" and "goal congruence" among employees (Ouchi 1980). Internally, trust is necessary to build a positive and productive work environment. Externally, trust enables relationships with the SEC, legislators, other regulators, the regulated audit firms, investors, issuers, and the general public. Lack of organizational trust could be a key contributor to organizational dysfunction.

In the 2019 PCAOB employment surveys, PCAOB staff members reported the existence of an untrusting culture within the PCAOB (KLS 2021, p.3). In congressional testimony in January 2020, former PCAOB Chair Duhnke acknowledged the serious cultural issues at the PCAOB, and

how they had negatively affected external stakeholders' trust in the PCAOB, including the loss of the public's trust:

> "The PCAOB had, in many respects, *lost the public's trust*…It had not matured significantly since opening its doors in 2003. During that time, it developed a *culture that lacked internal accountability*. And, its integrity had been compromised in 2017 by employees leaking confidential inspections information to those we are charged to regulate" (Duhnke 2020, emphasis added).

5. Conclusion

We analyze the causes of organizational misalignment at the PCAOB using the Four Pillars Framework. These misalignments have likely contributed to the significant organizational challenges the PCAOB has experienced since its establishment by SOX. Specifically, we argue the SEC's approach to its PCAOB oversight role left the PCAOB nearly subservient to the SEC, particularly its Office of Chief Accountant (OCA). This created a dependence of the PCAOB on the SEC that undermined the PCAOB's authority and allowed the Big 4 audit firms to overrule the PCAOB's authority by appealing to the SEC directly.

In addition, we contend there was a mismatch between PCAOB staff employment horizons and its hiring approach, staff compensation, benefits, and other incentives. This left the PCAOB vulnerable to regulatory capture and the revolving door problem. PCAOB staff identified with the firms they came from, and then participated at regulating these same firms at the PCAOB. Often they left the PCAOB to return to the firms when they could justify better positions and compensation based on their PCAOB knowledge and experience. The PCAOB Code of Ethics, human resources policies, and other cultural norms were not robust enough to overcome the economic incentives created by, for example, the appeal of the revolving door between the PCAOB

and the audit firms. This set of circumstances introduced serious ethical and independence challenges that culminated in the 2017 audit inspection scandal.

Our analysis suggests the PCAOB's organizational misalignments are severe enough to result in organizational failure. In the past these misalignments have led other organizations to existential crises and declines and, ultimately, organizational failures (Zimmerman and Forrester 2021).[40] The PCAOB is past the existential crisis and decline stage at this point. McMillan and Overall (2017) note that organizational failure is a "state with scarcity of resource slack, unstable goal preferences, and poverty of strategic options" (p.272). McMillan and Overall (2017) also argue that "organizational failure is a social pathology that stems *from internal organizational dysfunctions and misalignments*" (p.272, emphasis added), which resembles the PCAOB's organizational structure and culture misalignments outlined in our analysis.

While the PCAOB does not suffer from a lack of resources due to its funding model (Palmrose 2013), we present evidence that hints at unstable goal preferences, driven by the mismatch between its singular mission to protect investors and the SEC's need to balance investor protection with promoting capital formation and ensuring efficient and stable markets. Ongoing debate on whether the PCAOB should even exist as an independent agency suggests there is a "poverty of strategic options" for the PCAOB.

As we mark the 20th anniversary of the establishment of the PCAOB by SOX in July 2022, we should reflect on the history of this unique regulator and on the importance of its intended role as a regulator of the audit firms and the practice of auditing. Our paper provides an important

[40] McMillan and Forrester (2017) make the following distinction between organizational decline and organizational failure: "We conceptualize organizational failure as a cumulative process of decision misalignments in three levels, namely simple and complex failures that eventually lead to catastrophic failures….Organizational decline is a time-related process in which symptoms of organizational misalignment, mental rigidities, and weak sense-making of event cycles can be observed" (pp. 272-273).

contribution for understanding the design and implementation of financial regulation, in general, and regulation of audit firms and audits, in particular. We seek to highlight what makes such a regulator successful but also what can and did stand in the way of the PCAOB being as successful as investors wanted it to be.

The primary lesson of our analysis is that there is a small window for the new PCAOB Board to overcome the significant challenges that developed as a result of the agency's origins, and the crises that emerged in the PCAOB's not-so-distant past. If the PCAOB, with the support but not the interference of the SEC and Congress, fails to rectify the misalignments we have identified, the PCAOB's regulatory effectiveness will become permanently impaired. That may mean the PCAOB would be folded into the SEC, as was proposed many times in its history and most recently during the Trump administration. The Trump administration made a serious attempt to plan for the elimination of the PCAOB and folding its functions into the SEC (McKenna 2020). More recently GOP Rep. Huizenga of Michigan, the ranking member of the House Financial Services Committee filed H.R. 5489 Oct. 5, 2021 that "dissolves the Public Company Accounting Oversight Board and creates the Office of Public Accounting Oversight within the Securities and Exchange Commission" in response to SEC Chair Gensler's firing of PCAOB Chair Bill Duhnke (Flook 2022). Permanent impairment of the PCAOB may also mean a complete dissolution of the regulator and the return to industry self-regulation.

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