AUDIT FEES, PCAOB SANCTIONS, SANCTION RISK, SANCTION RISK PREMIUMS, AND PUBLIC POLICY: THEORETICAL FRAMEWORK AND A CALL FOR RESEARCH

Wm. Dennis Huber
Capella University
Minneapolis, MN, USA

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Abstract

The Sarbanes-Oxley Act of 2002 (SOX) was enacted to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws…" The Public Company Accounting Oversight Board (PCAOB) was created as part of SOX and given a duty to impose monetary sanctions on PCAOB registered accounting firms for intentional, knowing, or reckless conduct that results in violation of the statutory, regulatory, or professional standards of auditing, or for repeated instances of negligent conduct. This creates a new risk for both individual auditors and auditing firms separate and distinct from business, audit, and litigation risk—sanction risk. This paper establishes the legal and economic bases of sanction risk and proposes that research be conducted to determine whether sanction-risk premiums are being incorporated into audit fees and passed on to clients by registered accounting firms

> thereby subverting the intended purpose of the sanctions.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX) was enacted to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." The Public Company Accounting Oversight Board (PCAOB) was created as part of the Sarbanes-Oxley Act. Its function is "to oversee the audit of public companies…in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors"[1]

To fulfill its mandate, the PCAOB is not only authorized and empowered to impose both disciplinary and remedial sanctions on auditing firms for violations of relevant laws and regulations, it has an affirmative duty to do so:

> The Board ***shall***…conduct inspections of registered public accounting firms and conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms…" (15 USC 7211 Sec. 101(c), emphasis added)

The ability of the PCAOB to impose sanctions introduced a new risk into audit engagements—sanction risk. While auditors were, and continue to be, subject to penalties by the SEC, the nature of penalties by the SEC differ from sanctions by the PCAOB, thus posing a new type of risk.

The purpose of this paper is establish the conceptual framework of sanction risk in order to explore whether registered

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[1] Sarbanes-Oxley Act of 2002, Public Law 107–204—July 30, 2002, 116 STAT. 745.

accounting firms are able to pass on to their clients a sanction risk premium. If accounting firms assess a sanction-risk premium on their clients, then sanctions are not effective as a disciplinary or remedial measure designed to obtain compliance with the law and regulations. A sanction risk premium would be contrary to public policy.

IMPORTANCE AND CONTRIBUTION OF THE PAPER

The answer to the question "do registered accounting firms pass on to clients a sanction risk premium" carries important ethical and public policy implications. If accounting firms are able to pass on to their clients through higher fees a sanction risk premium, then the firms may have less motivation to comply with securities laws and regulations. If accounting firms are not motivated to comply with securities laws and regulations, then other methods must be implemented to motivate compliance. It would also be highly unethical for accounting firms to transfer to their audit clients by higher fees the costs of their malfeasance

The question of sanction risk and sanction risk premiums is also important for both clients and consumers. If auditing firms are able to pass on to their clients through higher audit fees a sanction risk premium, then clients' costs increase, which may, depending on the structure of the clients' industry, be passed on to consumers in the form of higher prices thereby reducing consumer surplus.

Sanctions imposed by the SEC were recognized as a risk separate from, and in addition, to litigation risk by Brumfield, Elliott, and Jacobson (1983), and later by Huber (2013), but neither established the legal and economic bases of sanction risk, or explore the possibility of sanction risk premiums, particularly under the PCAOB. This paper contributes to the literature by extending the proposition of the existence of sanction risk by examining the potential for sanction risk premiums in addition to litigation risk and other premiums. Third, it introduces sanction risk as a new area of research. Fourth, it can provide audit clients with knowledge they can use when negotiating future audit fees. Finally, the research proposed by this paper can guide policy

makers in designing more effective methods of enforcing compliance.

SANCTIONS

Sanctions imposed by the PCAOB are both disciplinary and remedial for violations of relevant laws and regulations. Sanctions can include "a civil money penalty for each such violation, in an amount equal to—(i) not more than $100,000 for a natural person or $2,000,000 for any other person [i.e., registered accounting firm]" and "not more than $750,000 for a natural person or $15,000,000 for any other person…" However, the sanctions and penalties

> "only apply to (A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard" (Sec. 105.(c)(4)Sanctions).

Definitions of "sanction" include: "3. the detriment, loss of reward, or coercive intervention annexed to a violation of a law as a means of enforcing the law; 4…(b) a mechanism of social control for enforcing a society's standards…" (Merriam-Webster, 2012). Black's Law Dictionary defines "sanction" as

> "A penalty or punishment provided as a means of enforcing obedience to a law. In jurisprudence, a law is said to have a sanctions when there is a state which will intervene if it is disobeyed or disregarded... A conditional evil annexed to a law to produce obedience to that law" (Black's Law Dictionary 1968).

The PCAOB also considers non-monetary actions as sanctions, such as a written notice of disapproval of a completed application for registration (15 USC 7211 Sec. 102). The PCAOB may "impose such disciplinary or remedial sanctions as it determines appropriate" if it finds that

> "a registered public accounting firm or associated person thereof has engaged in any act or practice, or omitted to act, in violation of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards" (Sec.105(c)(4) Sanctions).

On April 5, 2011, for example, the PCAOB imposed by settlement a money penalty of $1,500,000 against "Price Waterhouse [sic] Bangalore, and Lovelock & Lewes." On February 8, 2012 it imposed, also by settlement, a penalty of $2,000,000 against Ernst & Young. One of the earliest settled sanctions was a revocation of registration imposed on May 24, 2005 against Goldstein and Morris, CPAs, P.C. and Edward B. Morris, CPA (PCAOB, 2012).

Since sanctions take the form of either monetary penalties, or the imposition of additional professional education or training, it can be assumed that monetary penalties are more disciplinary in nature, while the imposition of additional professional education or training is more remedial.[2] As with any disciplinary action, the question arises, are monetary sanctions imposed on registered accounting firms as disciplinary fulfilling that purpose? As disciplinary measures, are the auditing firms[3] actually being "punished" by sanctions, or are they transferring their "punishment" (i.e., the sanction) to their clients in the form of higher fees by including a sanction risk premium—a premium to compensate for the risk of the PCAOB imposing a sanction on the firm for "engaging in any act or practice, or failing to act when it

[2] Remedial sanctions are not costless since they may involve, e.g., costs for additional training. However, the actual costs incurred by an auditing firm for remedial sanctions is not known. In addition, the loss of reputation resulting from publicized sanctions could negatively impact current and future revenues.

[3] The terms "auditing firm," "accounting firm," and "registered accounting firm" are used here interchangeably.

should have acted, in violation of the statutory requirements of SOX, the rules of the PCAOB or professional standards?" If firms are able to transfer to their clients the punishment or the risk of punishment imposed by the PCAOB, then they may not take the threat of enforcement seriously (Shafer & Morris, 2004; OECD, 2009).

While there is substantial similarity between the sanctions and penalties by the PCAOB and the SEC, there are also significant differences. Under the SEC regime in place since 1934, the Commission ***may*** "censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before [it]" (emphasis added) if it finds a person engaged in "improper professional conduct," which is defined as:

> "intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; and (2) negligent conduct in the form of— (A) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which the registered public accounting firm or associated person knows, or should know, that heightened scrutiny is warranted; or (B) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission" (15 USC § § 78d–3.).

This is authorization only, and not an affirmative duty. Furthermore, the power of the SEC to impose penalties is broad. Penalties can include temporary or permanent injunctions, disgorgement of profits obtained by unjust enrichment (including audit fees), monetary penalties, barring individuals from serving as officers or directors, cease-and-desist orders, and fines (http://www.sec.gov/rules/final/33-7593.htm). Also, the SEC may seek penalties in either a civil proceeding in Federal District Court or in an administrative proceeding with an Administrative Law Judge. For example, from 1998-2010, the SEC sanctioned directly,

or through court or administrative proceedings, 81 auditing firms and individual auditors for violations of Rule10(b)(5). Civil fines totaled over $92 million and disgorgement over $10.6 million. There were 19 firms permanently barred and 54 firms temporarily barred from practice before the SEC (Beasley, Carcello, Hermanson, & Neal, 2013).

Sanctions under the PCAOB are narrower. The PCAOB does not impose sanctions through District Courts or administrative proceedings with an Administrative Law Judge. The PCAOB is not similarly authorized to impose cease-and-desist orders, or obtain injunctions.

LITERATURE REVIEW

Audit Fees, Litigation Risk, and Sanctions

Litigation risk is a significant cost driver of audit fees (Simunic, 1980), and audit fees vary with variations in the degree of perceived litigation risk faced by auditing firms (Simunic & Stein, 1996). Furthermore, Simunic and Stein argued that since audit fees cannot be adjusted to cover actual litigation losses, auditors have a strong incentive to incorporate expected litigation losses into their fees. By incorporating a litigation risk premium into their fees, auditing firms are essentially transforming the litigation risk premium into an insurance premium.

Venkataraman, Weber, and Willenborg (2004) reasoned that since litigation risk is substantially higher under the Securities Act of 1933, auditors should receive higher fees and provide higher quality audits for IPO audits. They found that evidence that audit fees reflect litigation risk differences across liability regimes and audit fees were higher in pre-IPO audits.

Houston (1992) notes that another factor contributing to audit fees is related to sanctions imposed by regulatory agencies. Sanctions are costly to auditors in terms of both monetary costs (Brumfield, Elliott, & Jacobson, 1983; PCAOB, 2012), and the loss of reputation (Brumfield, Elliott, & Jacobson, 1983; Files, 2012). The same reasoning applied to litigation can be applied to sanctions. That is, auditors also have a strong incentive to

incorporate into their fees expected losses due to potential sanctions, i.e., a sanction risk premium, just as they incorporate a litigation risk premium for litigation risk.

Shafer and Morris (2004) investigated auditors' perceptions of sanction threats for audits of private companies. They found that while prior to the enactment of SOX "private company auditors perceived a relatively high likelihood of sanctions being imposed for fraudulent reporting," they did not perceive the threat of criminal conviction or loss of their CPA licenses as highly likely. They concluded that sanctions did to some degree deter fraudulent reporting, but the threat of criminal conviction or loss of license did not. The authors acknowledged that study had limited applicability to public company audits, however, and they urged accounting researchers to continue to investigate the effectiveness of sanction mechanisms against auditors of public companies and the deterrent value of such mechanisms, a goal of this paper.

The structure of the audit industry and market for audit services

Market structure affects the behavior and performance of firms within the audit industry (Yeardley, Kauffman, Cairney, & Albrecht, 1992). The ability of a producer[4] to raise prices depends on several factors, including the structure of the market, the price elasticity of demand, and the availability of substitutes. In a highly competitive market, where demand is price elastic, or where substitutions are readily available, it is difficult for producers to increase prices without loss of revenue and thus profit. On the other hand, in a monopolistic market, a market with inelastic demand, or where there are few substitutes, prices can be raised more easily.

Huber (2013) has persuasively argued that no existing model of industrial organization applies to the auditing (public accounting) industry. Perfect competition does not exist, and since

[4] The terms "producer," "provider," and "supplier" are used interchangeably. Likewise, "customer," "consumer," and "client" are used interchangeably.

there is more than one supplier in the auditing industry and the suppliers do not have exclusive control over prices, the auditing industry is not a monopoly. That leaves two possible models to describe the industry. But whether the industry is a monopolistic competitive industry or an oligopoly is problematic. Evidence has been found for both, but as Huber has demonstrated, it is neither since both supply and demand for audit services are simultaneously regulated. At a minimum, both the supply and demand curves are highly inelastic. Nevertheless, even if neither model applies, whether the industry reflects some elements of either model is instrumental in determining whether auditing firms can incorporate a sanction risk premium into their fees.

Bierstaker, Houston, and Wright (2006) found that the audit industry experienced intense competition between the Big N firms, as did Hermanson, Dykes, and Turner (1987). If the auditing industry is competitive, then the ability of firms to increase audit fees by a sanction risk premium is reduced. Similarly, the GAO (2003) found that the high degree of concentration in the public accounting industry as defined by the Herfindahl–Hirschman Index is not inconsistent with a price-competitive environment. Yet even if the auditing industry does exhibit some degree of competitiveness, the fact that both supply and demand are highly inelastic makes increases the ability of auditing firms to raise their auditing fees.

Many find the auditing industry is better described as oligopolistic because it is dominated by the now Big 4. The Herfindahl–Hirschman Index defines the industry as an oligopoly based on industry concentration.[5] Oligopolists may compete on the basis of price or output, but may be unable to raise prices since producers may follow price decreases, but not price increases (Hall

[5] The HHI is highly criticized on various theoretical grounds, including definitions of the relevant market (Lijesen, 2004). Both the Index and its criticisms are beyond the scope of this paper.

& Hitch, 1939; Sweezy, 1939; Waldman & Jensen, 2006; Baye, 2010). But the auditing industry does not *behave* an oligopoly.[6]

Apart from the market structure, the choice of engaging an independent auditor is further constrained by the size of the corporation. Only a handful of auditing firms (i.e., the Big 4) have the capacity and resources to conduct audits of large, multinational corporations (OECD, 2009; Feldman, 2006; Dunn, Kohlbeck, & Mayhew, 2011; GAO, 2003). In addition, not all of the Big 4 firms are able to audit every corporation since there are, for example, prohibitions concerning conflicts of interest (GAO, 2003; OECD, 2009). Since the availability of substitutes is severely restricted it can be difficult for large clients of a Big 4 auditing firm to change auditing firms when the firm that conducts its audit increases its fees making it easier for firms to increase their fees.

Potential judgments is a risk that must be factored into audit fees (Cheffers & Whalen, 2011) in order to cover long-run marginal costs, earn a risk-adjusted rate of return, and remain economically viable (Brumfield, Elliott, & Jacobson, 1983; Wallace, 1989). Auditing firms thus include a litigation risk premium in their fees. A more pertinent question for purposes of this paper, however, concerns potential penalties imposed by regulatory agencies, in particular the PCAOB. Monetary sanctions imposed by regulatory agencies are a risk that must be considered by auditing firms (Houston, 1992). Litigation and judgments are issues between private parties, and both auditing firms and their clients are jointly and severally liable for a judgment and thus both share in the cost of a judgment (Simunic, 1980; OECD, 2009). Sanctions, however, involve the government and its ability to enforce compliance with laws and regulations.

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[6] There is a saying that if something looks like a duck, walks like a duck, and quacks like a duck, it must be a duck. In this case, the auditing industry may look like an oligopoly, but it does behave like an oligopoly.

AUDIT FEES, SANCTION RISK, AND PUBLIC POLICY

Audit fees after Sarbanes-Oxley

In the wake of the passage of Sarbanes-Oxley in 2002 and the subsequent collapse of Arthur Andersen there was a period of uncertainty and instability as companies scrambled to meet the internal control requirements imposed by the Act. Auditing firms' resources were likewise taxed in meeting the increased demand from both the scope of audits required by SOX and the increased number of new clients acquired from Arthur Andersen (although the increased demand was partially offset by the remaining Big 4's absorption of Arthur Andersen's former employees). The collapse of Arthur Andersen shifted both the demand and supply curves of individual firms, but not of the audit industry as a whole. Compliance with the internal control requirements imposed by Sarbanes-Oxley also resulted in higher audit fees. The higher fees are attributable in part to the additional effort required to study and document the effectiveness of internal controls (Ebrahim, 2010), and in part to the requirement for greater technical skills by auditors (Ghosh & Pawlewicz, 2009).

Audit fees and audit risk

Audit risk (AR) is "the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated" (AICPA, 2006, AU 312.02). Inherent risk (IR) is the susceptibility of an assertion by management to a material misstatement assuming that there are no related controls, while control risk (CR) is the risk that a material misstatement in an assertion will not be prevented or detected on a timely basis by the entity's internal control. Inherent and control risks are functions of the client and exist independently of the audit of financial statements (AICPA, 2006, AU 312.27). Detection risk (DR) is the risk that the analytical procedures and other relevant substantive tests performed by an auditor would fail to detect material misstatements in financial statements. It is a function of the effectiveness of auditing procedures and their application by the auditor (AICPA, 2006, AU 312.27), and applies

only to auditing firms. Methods for managing risk auditing risk, including litigation risk, include avoidance (not engaging in audits), self-protection (taking steps to minimize risk), transference (transferring the risk to a third party via the market), and self-insurance (Ehrlich & Becker, 1992; Folami & Jacobs, 2002).

As observed by Houston (1992), auditors have an inclination to charge risk premiums based on the nature of the perceived risks present in the audit. Auditors will increase their fees above the cost of conducting the audit (i.e., audit effort) as risks increase. In addition to AR, IR and DR, a major risk that auditors face is the risk of litigation (Simunic, 1989). As with anything involving risk, the expected reward must be sufficient in order to induce auditors to accept the risk of an audit (Wallace, 1989). Simunic and Stein (1996) subsequently found evidence that indicates audit fees vary with litigation risk.

Auditors can purchase malpractice insurance to insure against losses due to negligent auditing and resulting litigation. Malpractice insurance premiums and litigation risk premiums must be factored into audit fees in order to earn a risk-adjusted rate of return (Wallace, 1989). While auditors often self-insure against audit risk, nevertheless, self-insurance also requires a self-insurance premium that is passed on to clients in the same manner that litigation risk premiums and malpractice insurance premiums are passed on to clients. However, there are certain risks that cannot be insured against other than by self-insurance as a matter of public policy.

Sanction risk and public policy

Litigation is a matter between a firm and its clients, and the client and auditor are jointly and severally liable for judgments resulting from negligent audits (Simunic, 1980). Whether a litigation risk premium, a malpractice insurance premium, or a self-insurance premium, the risk premium associated with a particular risk is passed on to the client through higher audit fees.

All insurance policies, including malpractice insurance, exclude coverage for losses due to fines or penalties that are the

result of wrongful acts due to the moral hazard such insurance presents (*Mortenson v. National Union Fire Insurance*, 249 F.3d 667, 2001). PCAOB sanctions apply only to the auditing firm for failure to comply with applicable laws and regulations and are not shared with the client as is litigation risk. Since sanctions by the PCAOB are a penalty, they cannot be insured against and insurance companies are not permitted to cover such losses as a matter of public policy.

PCAOB sanctions are as much a risk as is litigation, perhaps greater since the process is simplified[7] even if the sanctions are less than potential judgments resulting from litigation. Wallace (1989) suggests that risk premiums may be hidden within the audit fees. Therefore, if an auditing firm cannot insure against sanctions, and sanction risk is not a risk that is shared with the client, the possibility clearly exists that auditing firms may be incorporating hidden sanction-risk premiums into their audit fees.

CONCLUSION AND CALL FOR RESEARCH

The purpose of this paper was to establish the economic and legal basis for sanction risk, and to develop the groundwork for research in sanctions, sanction risk, and sanction-risk premiums. Sanction risk is a risk faced by auditors just litigation is a risk. Thus, just as litigation risk is factored into audit fees by litigation risk premiums, rationality suggests not only that sanction risk would also be incorporated into audit fees through sanction risk premiums, but that sanction risk premiums would, unlike litigation risk premium, be hidden.

The ability of an auditing firm to pass on to clients a sanction risk premium is heavily dependent on the market structure of the auditing industry. Current models of industry structure fail to adequately describe the auditing industry due to the distortion in the market caused by government regulations. It is clear that the

[7] For example, formal rules of evidence do not apply in a PCAOB sanction proceeding.

auditing industry neither perfectly competitive, nor a monopoly since there is more than one firm. Furthermore, the industry does not meet the criteria to be classified as monopolistic competition, and other than the presence of a few large firms, it meets none of the criteria to be an oligopoly and therefore cannot rightly be classified as an oligopoly. Demand for auditing services is created and imposed by government, and supply of auditing services is restricted by government, thus rendering current models incapable of explaining the behavior of auditing firms (Huber, 2013). Since both supply and demand are regulated by government and are therefore highly inelastic, the ability of firms to raise fees by incorporating a hidden sanction risk premium is increased.

This paper has established the legal and economic basis for sanction risk premiums. As a matter of public policy, further research is necessary to determine whether firms actually do charge a sanction risk premium. If future research reveals the existence of sanction-risk premiums, it can be concluded that sanctions, and the threat of sanctions, are not having the intended disciplinary effect. Sanction risk premiums would negate the purpose of the sanctions and thwart the intention of public policy to increase the quality of audits. Thus, either new or stronger sanctions would have to be adopted to prevent registered accounting firms from passing on to their clients through higher fees either actual sanctions or the risk of sanctions. Auditing firms alone must bear the burden of sanctions.

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