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## **STANDING ADVISORY GROUP MEETING**

### **PCAOB STRATEGIC PLANNING – MEASURING THE PCAOB'S SUCCESS**

**OCTOBER 5, 2006**

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#### **Introduction**

The Standing Advisory Group ("SAG") will discuss ways of measuring the success of the Public Company Accounting Oversight Board ("Board" or "PCAOB") in achieving the PCAOB's mission under the Sarbanes-Oxley Act of 2002 ("Act"). The discussion will focus on possible critical success factors for the PCAOB and suggested methods of measuring its success. This briefing paper provides background information on the Board's strategic planning process and introduces certain success factors and measurements the Board discussed as part of its strategic planning process. The Board members will facilitate the discussion and seek input from SAG members in this area, drawing on the SAG members' various backgrounds and perspectives as practicing auditors, preparers of financial statements, investors and others.

#### **Background**

The Securities and Exchange Commission ("SEC" or "Commission") recently amended its Informal and Other Procedures to add a rule that facilitates Commission review and approval of the budget and accounting support fee for the PCAOB.<sup>1/</sup> The new rule requires that the PCAOB maintain, and make available to the Commission upon request, a strategic plan as well as other records that support the PCAOB's

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<sup>1/</sup> See Amendments to the Informal and Other Procedures; Public Company Accounting Oversight Board Budget Approval Process, Securities Exchange Act Release 54168 (July 18, 2006).

This paper was developed by PCAOB staff involved with the strategic planning process to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.

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budget.<sup>2/</sup> The rule provides that the PCAOB must utilize a comprehensive five-year strategic plan with respect to its budget no later than its budget submission for fiscal year 2008.

As part of the process of developing a comprehensive strategic plan, the Board has had preliminary discussions as to success factors that are critical to achieving its mission under the Act.<sup>3/</sup> Among the various critical factors raised, the Board identified the following three factors to discuss with the SAG: (1) high investor confidence in the auditing profession, as indicated by increased reliance on audit reports and strong confidence in audit quality, (2) less involvement by auditors in financial scandals than in the past (or in the alternative, greater frequency with which auditors directly detected or prevented financial scandals from occurring), and (3) stability in the business model of the accounting profession (e.g., lack of volatility in the profession, no large firms on the edge of failure, ability to attract needed talent, absence of artificial barriers to market competition).<sup>4/</sup> While the Board may have an important role to play with respect to these

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<sup>2/</sup> The SEC budget rule defines strategic plan as –

[T]he PCAOB's overarching plan for accomplishing its strategic goals, including forecasts for the current and four following years; estimates of the effect that reasonably foreseeable changes impacting the auditing profession and securities markets could have on program levels; and a discussion of the impact that program levels and changes in methods of program delivery, including advances in technology, could have on program operations and administration. 17 CFR 202.11(b)(9).

<sup>3/</sup> Section 101(a) of the Act sets forth the Board's mission "to oversee the audit of public 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 for companies the securities of which are sold to, and held by and for, public investors. Section 101(a) of the Act; 15 U.S.C.7211(a). Implicit in the Act's language is the assertion that more informative, accurate and independent audit reports on the financial statements of public companies will result in increased protection of the interests of investors and furtherance of the public interest.

<sup>4/</sup> For purposes of the discussion, the SAG may consider the following four components of the business model, among others: obtaining revenue (including

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outcomes, it should be noted that these outcomes depend on a variety of factors, some of which may not be under the control of the PCAOB.

While recognizing that other external factors may impact these outcomes, the Board has given some initial thought as to the ways in which the achievement of these factors can be assessed qualitatively and/or measured quantitatively. The Board is sensitive to the fact that inappropriate performance metrics can result in counterproductive behavior within the PCAOB or impair the ability of the PCAOB to achieve its mission. Many of the metrics listed below, however, may not serve as direct measures of the success factors, but instead can help inform the Board as to certain trends and developments related to the identified success factors. Some possible measures for the success factors identified above include –

1. High investor confidence in the auditing profession, as indicated by increased reliance on audit reports and strong confidence in audit quality
  - Results of PCAOB-sponsored or other surveys of sophisticated investors, financial analysts relying on audit reports, academicians, and/or audit partners;
  - PCAOB or market analyses (e.g., significant fluctuation in the equity risk premium as compared to historical norms (i.e., that premium above Treasury bonds that investors expect from stocks, due to the increased risk of the equity markets); comparison of U.S. market premium to non-U.S. market premium; cost of capital; analysis of auditor changes by issuer clients; analysis of the number, nature and magnitude (i.e., effect on reported financial statements and on market capitalization) of restatements);

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whether audit services are priced based on time spent or on the risk associated with a particular audit engagement); obtaining and developing personnel resources (recruiting, training, evaluation and compensation, discipline, management of retention); sources of capital (organizational structure, insurance, partner investment); and management of audit quality and risk (acceptance/retention of clients, incentives for quality work, including performance measures used by the firm, measurement and monitoring of quality of work, policy development and implementation, independence, control of foreign affiliates, management of workload, management of litigation and claims, regulatory oversight, design, performance and completion of audits.)

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- Analyses based on PCAOB inspections or other actions (e.g., results of the PCAOB inspection remediation process; number and nature of proactive initiatives by auditing firms to improve audit quality, including but not limited to those resulting from the PCAOB inspection process; analysis of trends in quality control and deviations from auditing standards identified through the PCAOB inspection process over time);
  - Other studies or analyses (e.g., analysis of number and nature of lawsuits filed against accounting firms/number and nature of settlements with accounting firms; analysis of changes in enrollment of college students pursuing work in the accounting profession; analysis of Congressional, press, and interest groups' reaction to the PCAOB's work).
2. Less involvement by auditors in financial scandals than in the past (or in the alternative, greater frequency with which auditors directly detected or prevented financial scandals from occurring)
- Analysis of defendants in lawsuits and other pending investigations relating to financial scandals;
  - Analysis of number and severity of financial scandals.
3. Stability in the business model of the accounting profession
- Results of surveys (e.g., surveys on accounting profession/student enrollment; surveys of academicians in accounting field);
  - Results of direct inquiry and evaluation of accounting firms' business models and actual financial results in connection with PCAOB inspections;
  - Analysis of trends in auditing firm hiring and turnover;
  - Analysis of consolidation of/expansion in number of accounting firms auditing public companies.

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### **Discussion Questions**

1. From the differing perspectives of investors, practicing auditors, preparers of financial statements and others, are there other critical success factors that the PCAOB should define and/or measure? Are there other measures, in addition to those listed above, that the PCAOB should consider?
2. In measuring success, how might the PCAOB determine the acceptable level of success (i.e., how good do we have to be) in achieving the success factors under discussion?
3. Are there academic or other outside groups that would have an interest in studying the three success factors identified? Are there academic or other studies that have been performed or that are currently underway that could assist in developing performance metrics for the PCAOB?
4. What types of internal or external constraints may impact the PCAOB's ability to achieve the success factors under discussion?
5. How can the PCAOB avoid developing inappropriate performance metrics that could lead to counterproductive behavior within the PCAOB or impair the PCAOB's ability to achieve its mission?

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports.