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Report from the Working Group on Firm Governance and Incentives

Grant Callery (Chair)
Brandon Becker
Curt Buser
Joe Carcello
Larry Shover



Auditor Evaluations & Incentives

PCAOB Observations

PCAOB Release 2008-008, Dec. 5, 2008

In some instances, inspection teams found various matters that provided cause for concern about firms' partner evaluation and compensation processes. **These included situations where audit quality did not appear to be a significant factor in the partner evaluation process or its role in the process was unclear.** In some cases, partners received high ratings on technical competence even though there were significant deficiencies in their audits that were reviewed in the firm's internal inspection program or in the PCAOB's inspection program. In addition, inspectors observed situations where concurring review partners or internal inspectors were not held accountable for failing to identify significant deficiencies in audits they reviewed and where partners' quality ratings were affected significantly by the results of client satisfaction surveys or the profitability of their audits or their ability to increase revenues.

PCAOB Observations, cont.

PCAOB Release 2008-008, Dec. 5, 2008

For some firms, **the PCAOB inspectors noted that technical personnel who were responsible for audit quality were reporting to and evaluated by those whose responsibilities included maintaining and growing the audit practice.** This may compromise the objectivity of the technical personnel and may increase the possibility that decisions on technical accounting and auditing matters may be inappropriately influenced by compensation considerations and the firm's desire to grow the size and profitability of its audit practice. In other instances, the technical personnel also had significant client responsibilities that may have led to conflicting priorities and to not having enough time to fulfill their responsibilities for audit quality.

Auditor Evaluations & Incentives

- Inherent need to evaluate performance that drives a successful business:
 - Quality
 - People
 - Market leadership & growth
 - Operational excellence

Quality Must Be the Key Metric

- ❑ Firms should not rate their audit personnel higher than their quality rating
- ❑ Partners in other service lines should have metrics linked to the quality of their audit support
- ❑ Firm leadership should be evaluated based on the quality rating of the audit practice

Quality Must be Defined

- ❑ Definitions of quality must be clear & consistent
 - PCAOB initiative on quality indicators is key
- ❑ Standards and training should be aligned with quality definition
- ❑ Quality in technical accounting and audit methodology must both be evaluated
- ❑ Culture must:
 - Encourage continuous improvement
 - Celebrate quality

Quality Evaluation Process Should:

- ❑ Be clearly linked to quality indicators
- ❑ Provide for rewards and punishment
- ❑ Be assessed by those in the audit practice
- ❑ Address global operations
- ❑ Equate to economic and psychological compensation
- ❑ Be transparent



Talent Acquisition & Retention

Essential Quality Ingredient

Is the Audit Profession Attracting & Retaining Talent?

- Is the profession attracting sufficient talent?
- Is sufficient talent retained?
 - Within the audit practice vs. migrating to other service lines?
 - Retention of top rated performers?
 - Retention of audit partners?

How is the Audit Profession Perceived?

- By management, investors, regulators, audit committees and auditors?
- How has the profession evolved?
 - More or less relevant?
 - Status?
 - Compensation?
 - Satisfaction?
 - Opportunity?
 - Stress?
- Has the audit been commoditized?
- How do we want the profession to be perceived?

Do We Know & Should We Care?

- ❑ Is talent acquisition and retention being measured?
 - If so, is there an issue?
- ❑ Are surveys being conducted across firms?
- ❑ What lessons or best practices can we learn to improve talent in the profession?
- ❑ Should the PCAOB assess the health of the profession?



Governance Issues

Tone at the Top – Positive – Firm Transparency Reports

□ Deloitte (2012)

- As part of the annual appraisal process, audit partners receive a rating that is a key consideration in deployment and earnings allocation, and performance with respect to audit quality figures prominently in determining this rating.
- Audit quality is our number one priority.

□ EY (2012)

- Setting the right “tone at the top” is a key responsibility of our senior leadership team.
- Our internal message consistently has been that no single client is more important than professional reputation.

Tone at the Top - Positive

□ KPMG (2012)

- Established a culture that reflects an absolute commitment to audit quality.
- Our policies reflect individual quality control elements to help KPMG partners and employees act with integrity, skepticism and objectivity.

□ PwC (2012)

- Firm leadership emphasizes its commitment to quality as its top priority
- For our assurance partners and other professionals, this process emphasizes our top priority of sustained audit quality, relative to other performance criteria

Tone at the Top - Negative

- ❑ “The commercialization of the audit profession has led to an ethos at the big professional firms that puts insufficient emphasis on their public interest remit.” (Editorial, *Financial Times*, 11-12-2012)
- ❑ Interests of investors are being neglected because they only play a small role in hiring audit firms compared with that of management (U.K. Competition Commission, as reported in *Financial Times*, 2-21-13)
- ❑ Misaligned incentives mean that auditors tend to focus on management interests over those of shareholders (Laura Carstensen, Chair, U.K. Competition Commission, as reported in *Financial Times*, 2-22-13)

Tone at the Top – Negative

- Fiolleau, Hoang, Jamal, and Sunder – Engaging Auditors: Field Investigation of a Courtship – 2009
 - Based on review of documents and interviews on RFPs issued by a publicly traded Canadian company as well as a Canadian government organization
 - “Auditors adopted both Client 1 and Client 2 mottos and slogans in developing proposals and presentations as they attempted to show a fit between their organizations with respect to culture, thinking, attitudes.”
 - “One particular dimension of reputation that interested Client 1 was whether other CFOs classified the auditor as either rigid (undesirable) or flexible (desirable).”

Tone at the Top - Negative

- ❑ “We saw no evidence of reputation with investors or any third party users of financial statements being a consideration.”
- ❑ “Client 1 made it clear that they wanted all complex accounting issues to be resolved by the engagement partner.”
- ❑ “Auditors 2 and 3 responded by promising that the final and binding decision on complex accounting matters will be made by the engagement partner. One firm promised that they ‘do not hide behind the head office’.”
- ❑ “No meeting between the prospective auditors and the audit committee as a whole was held without the presence of company executives.”

Advisory Committee on the Audit Profession

- ❑ Established by Treasury Department to examine sustainability of a strong and vibrant audit profession
- ❑ Issued Report in September 2008 containing more than 30 recommendations to improve audit profession
- ❑ Included Segment on Firm Structure and Finance

ACAP (CONTINUED)

- ❑ Recommendation 3 – urged PCAOB and SEC to study and enable, as appropriate, the feasibility of firms appointing independent members with full voting authority to firm boards and/or advisory boards
- ❑ Goal to improve governance and transparency of auditing firms

FRC/ICAEW Audit Firm Governance Code (UK) January 2010

- ❑ Financial Regulatory Council – UK's independent regulator promoting high standards of corporate governance
- ❑ Applies to eight firms in UK auditing 95% of companies listed on Main Market of the London Stock Exchange
- ❑ Provides for appointment of Independent Non-Executives

Audit Firm Governance Code Provisions

- Firms should appoint INE's to enhance shareholder confidence in public interest aspects of firm operations
 - Must be a majority on body that oversees public interest
- INE's have a duty of care to the firm - firms should disclose criteria for assessing INE impact on firm and their degree of independence
- INE's have rights to firm information and to disclose disagreements with firm

Governing Bodies – Independent Non-Executives – U.K. Experience

- Spoke with a senior ICAEW executive about U.K. firms' experiences with the Audit Firm Governance Code (specifically with respect to INEs)
 - Firms are quite positive about what they have done. They want implementation of the Code to be reviewed.
 - Firms have applied the Code in very different ways:
 - EY – global basis
 - KPMG – European basis
 - Deloitte – U.K. basis (but includes member firms in some Middle Eastern countries)
 - PwC – U.K. basis
 - The firms look at many issues differently after installing INEs – suggesting that behavior has changed.

Audit and Non-Audit – Revenues (per Transparency Reports)

	Audit/Assurance	Tax	Advisory/ Consulting
Deloitte	32%	20%	48%
EY	39%	31%	30%
KPMG	40%	27%	33%
PwC	43%	29%	28%

SEC VIEWS ON INTERNAL BUSINESS CONFLICTS

- Analogy can be drawn between securities market operators and audit firms
 - Audit Function = Regulatory Operations
 - Non –audit (consulting/tax) = market operations
- Actions and proposals relating to securities industry self-regulatory organizations may be instructive
- In SEC/NASD Settlement in 1996 of Nasdaq Price Fixing case SEC found
 - Lack of independence of NASD regulatory staff from Nasdaq market operations

SEC Views (CONTINUED)

- SEC 2004 SRO Concept Release examined “inherent conflicts” between regulatory obligations and business functions. Release asked for comment on
 - Whether as competition among markets grows are conflicts between SRO regulatory operations (cost center) and business interests exacerbated?
 - Has internal separation of functions addressed concerns?
 - Can these conflicts be effectively managed through governance changes to enhance independence of conflicted functions?