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# Report from the Working Group on How to Improve Audit Quality and the Relevancy of the Audit

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# How to Improve Audit Quality and the Relevancy of the Audit

## Recommendations

- ❑ Implement an expanded audit report that provides meaningful, incremental information to investors
- ❑ Require the audit report to include the name or signature of the lead engagement partner
- ❑ Implement a rebuttable presumption that the auditor of an issuer will be inspected if audit fees decline by  $X\%$  and/or if size- and industry-adjusted audit fees are more than two standard deviations away from the mean

# How to Improve Audit Quality and the Relevancy of the Audit

## Recommendations

- ❑ Enhance audit firm governance by requiring independent directors (with full voting powers) and/or advisory boards with meaningful governance responsibilities
- ❑ Heighten the existing auditing standard regarding the auditor's going concern evaluation
- ❑ Allow shareholder proposals to address auditor issues, including auditor ratification and the audit report

# How to Improve Audit Quality and the Relevancy of the Audit

## Implement an Expanded Audit Report

- Audit quality will improve because if the client's accounting is pushing the bounds of acceptability the auditor can highlight such in the report
  - As a result, client is likely to temper accounting that is "too close to the line"
- Including meaningful, incremental information in the report would make the report more relevant for both investment and stewardship purposes, by helping investors better evaluate and price risk
- Such expanded auditor reporting exists in the UK and appears to be working well
  - Example: Rolls Royce
- An expanded audit report was recommended by the Advisory Committee on the Auditing Profession (ACAP)

# How to Improve Audit Quality and the Relevancy of the Audit

## Require the Signature or Identification of the Engagement Partner

- ❑ Audit quality will improve because personal identification, which fosters enhanced personal accountability, makes individuals more careful and diligent
- ❑ Audits are done by teams of individuals – the partner is the team leader – market (and ACs) would have better information for auditor selection since the engagement partner's industry-experience and prior performance history would now be transparent
- ❑ Growing body of research finds a number of salutary benefits associated with audit partner identification (e.g., Carcello and Li 2013 TAR; Knechel et al. Forthcoming CAR)
- ❑ Partner signature or identification was recommended by ACAP

# How to Improve Audit Quality and the Relevancy of the Audit

## Implement a Rebuttable Presumption that Abnormally Low Audit Fees will Result in Inspection

- ❑ Audit quality is inversely correlated with audit hours, and prior research finds a strong positive relation between fees and hours: higher fees, more audit work – no evidence of rent seeking (e.g., Eshleman and Guo 2014 AJPT; Blankley et al. 2012 AJPT)
- ❑ If issuers know that abnormally low fees will result in their auditor and engagement being inspected, such low-balling behavior will be mitigated
- ❑ A reduction in low-balling behavior will increase audit quality in the short run
- ❑ A more profitable profession will attract better entrants, improving audit quality in the long run

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## Auditor Switches and Audit Fee Changes

Analysis below based on Audit Analytics data from 2010 to 2013:

From	To	N	Average Change in Fees
Firms 1-3	Firms 4-6	130	(14.2%)
Firms 4-6	Firms 1-3	85	6.5%
Firms 1-3	Firm 4	85	(7.3%)
Firm 4	Firms 1-3	67	6.4%
Firms 5-6	Firm 4	11	26.6%
Firm 4	Firms 5-6	15	(18.3%)



# How to Improve Audit Quality and the Relevancy of the Audit

## Enhance Audit Firm Governance by Requiring Independent Directors on Firm Governing and/or Advisory Boards

- Audit quality will improve because independent directors will be an advocate for the public interest and will act as a disciplining mechanism on firm decisions and actions
  - The salutary benefits of effective corporate governance are well documented in the corporate community
- A greater diversity of thought usually increases the quality of decisions
- Independent non-executives (INEs) have been required for firms in the UK for a number of years and individuals in the UK are generally quite positive as to their effects (both at the FRC and ICAEW)
- INEs on firm governing boards was recommended by ACAP

# How to Improve Audit Quality and the Relevancy of the Audit

## Heighten Auditor Going Concern Reporting

- ❑ Audit quality is better if investors are provided with an early warning of impending firm failure
- ❑ Investors are particularly concerned with fraud and bankruptcy given the large dollar losses typically triggered
- ❑ Need for improvement – very few financial institutions received GC reports before the financial crisis
- ❑ Any reduction in auditor GC reporting would clearly reduce the information set received by investors
- ❑ Some have expressed concerns of impact of new FASB standard on related auditing standards

# How to Improve Audit Quality and the Relevancy of the Audit

## Allow Shareholder Proposals on Auditor Issues

- ❑ We recognize that this is an SEC issue, not a PCAOB issue
- ❑ Nevertheless, substantial, enthusiastic support for this recommendation among the sub-committee
- ❑ Audit quality would improve by more closely aligning the auditor's incentives with those of users of the audit services, investors
  - We expect more informative audit reports, produced by higher quality auditors, fairly compensated
  - In many ways, this one recommendation, particularly if mutual funds were required to attend to, addresses a number of the other issues in our presentation
- ❑ Enables private ordering, rather than one-size-fits-all regulations, which has the benefit of greater tailoring to individual issuer-auditor circumstances
- ❑ Provides investor feedback to regulators

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## Questions

