

## **Views To Strengthen Auditor Independence and Skepticism**

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We are very pleased to provide our views today on ways to strengthen auditor independence and skepticism for consideration by the PCAOB. These views are based on research findings for studies we have conducted as well as studies conducted by others. We understand that a major issue under discussion today is the advisability of requiring audit firm rotation to enhance audit quality. The research we have conducted over the last decade has focused on corporate governance and its impact on financial reporting and audit quality, and in particular the interactions between management, the audit committee, and external auditors. Our research provides specific avenues for improving the effectiveness of audit committees, and thereby strengthening audit quality and, in the end, financial reporting quality. Therefore, we will focus our remarks on improving the strength of corporate governance as it affects the audit process and audit quality.

We conducted two interview studies that captured auditors' experiences in working with audit committees and management; one of these studies was before the Sarbanes-Oxley Act (Cohen et al. 2002) and one post-SOX (Cohen et al. 2010). Pre-SOX, auditors often found audit committees to be ineffectual, but post-SOX auditors indicated a dramatic improvement in terms of audit committee expertise, authority, power, and diligence. However, one potentially disturbing finding is that despite the audit committee's legal authority for hiring and firing auditors of public companies in the post-SOX era, a majority of auditors in our study still indicated management as playing the most dominant role for these decisions. Thus, despite the apparent compliance with regulation, management is able to circumvent the spirit of the rule by influencing the audit selection and retention decision. This suggests that management can potentially influence the extent to which the financial reporting process may be monitored by the auditor which may in turn reduce the quality of the financial reports. This finding, if pervasive, has potentially detrimental consequences for auditor independence and it is unclear if audit firm rotation can help mitigate potential concerns in this regard. Auditor independence is greatly strengthened when the audit committee is the party that hires and is the principal party overseeing the audit function. This is greatly diminished if the auditor believes that, in fact, the party they must answer to is management and not the audit committee.

Our research has validated the very important role the audit committee plays in enhancing audit and financial reporting quality. For instance, auditors obtain significantly greater negotiation power with management when dealing with a contentious reporting matter if they are bolstered by a strong audit committee that can serve as an ally (Brown-Liburd and Wright 2011; Ng and Tan 2003). Related research also finds that management concedes to a more conservative reporting stance in the presence of a strong audit committee (Agoglia et al. 2011; Brown-Liburd et al. 2012).

Our research also indicates ways in which audit committees can be further strengthened to enhance audit quality. For example, we find that in many instances audit committees are seen to play a passive role in helping to resolve disputes with management. The auditor and management often try to resolve issues before it comes to the attention of the audit committee. The role of the audit committee in dispute resolution is not well formulated; should this be an active or a passive role? In our view, the audit committee can be more effectual if it takes a more active role in understanding and working to resolve contentious accounting and disclosure matters. Audit committees must be active in protecting the substantive independence of the auditing firm by serving as an ally in ensuring a high quality financial reporting process.

Second, we have also examined the issue of the independence of the audit committee in “form” versus in “substance”. That is, Sarbanes-Oxley prohibits audit committee members from having economic ties to the company or its management. However, audit committee members may have social or professional ties, that although in full compliance with SOX and related regulations, may nevertheless potentially threaten their independence in substance. These connections can take the form of either social ties (e.g., belonging to the same country club) or professional ties (e.g., having worked together or served on boards together at other companies). While professional ties can, in some instances, be beneficial, we find (Cohen et al. 2011) that auditors are more willing to stand firm in disputes with management if auditors perceive an audit committee to be substantively independent as opposed to an audit committee that merely is in place to fulfill regulatory requirements but is still under management’s influence. Further, prior associations between management and board members can be problematic as demonstrated by Carcello et al. (2011) who report that companies are more likely to have restatements when the CEO has influence over the nominations committee that selected audit committee members. Perhaps if companies were required to disclose the social ties that management has with board members this could mitigate the influence that management may have over the substantive independence of these members.

Finally, as indicated, we find audit committees have been greatly strengthened in expertise, particularly in terms of accounting or financial expertise. While audit committees may have strong financial expertise, the committee may, nonetheless, lack sufficient industry expertise to understand and thus properly monitor complex industry specific accounting issues. For instance, industry expertise in the retail industry may assist audit committees to ensure that companies take an adequate write-down of inventory when their products face potential obsolescence. Similarly, revenue recognition, a prominent source for accounting manipulation, entails an evaluation and understanding of the earnings process, which is tied to a company’s business processes and is often industry specific. Recent research we have conducted (Cohen et al. 2012) finds that industry knowledge on the audit committee significantly and incrementally improves financial reporting quality. While the finding emphasizing the importance of industry knowledge may not be totally surprising to those serving on boards or to auditors, it is important to recognize that there is no current SEC requirement for audit committees of public companies to have members with industry expertise. By encouraging or even requiring audit committees to have members with industry expertise, the SEC can help enhance the monitoring abilities of audit committees in overseeing financial reporting.

In all, our research findings highlight the importance of the audit committee in strengthening the independence and effectiveness of the audit function. We identify four areas in which the audit committee may be strengthened. These are:

- fulfilling its function as the primary party that hires/fires the auditor and oversees the audit function;
- playing an active role in working to resolve accounting disputes;
- ensuring audit committee members do not have social or professional ties with management that could impede audit committee independence in-fact or in appearance; and
- appointing members with industry expertise.

We appreciate this opportunity to share our research findings and insights with the PCAOB.

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