"Strengthening the Ecosystem for Audit Quality"

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As prepared for delivery.

Thank you.

I would like to start by expressing my gratitude to the Accounting and Corporate Regulatory Authority (ACRA) for the invitation to address this distinguished audience on how we can strengthen the ecosystem for audit quality.

It's not often that I get to deliver a speech 15,000 kilometers from my home in Washington. For me, the trip is more than worth it.

For one, visiting Singapore gives me a chance to learn and explore—new sights, sounds, tastes, and points of view that may be wonderfully different from my own.

Yet, on the other hand, it's also encouraging for me to observe the strong similarities that Singapore and the United States share.

When it comes to corporate governance and auditing, the resemblance between our two nations is close indeed.

First, we both pride ourselves, rightly, on being leaders when it comes to corporate governance.

Singapore's leadership in governance has been well documented by organizations such as the World Economic Forum and the Asian Corporate Governance Association.

Just look at the Governance and Transparency Index, which measures the progress in practices of Singapore-listed companies. As most here know, that index has steadily climbed over the past few years and reached a new high in 2013.

Still—and this is another strong similarity—we both recognize the imperative of continuous improvement, especially when it comes to audit quality.
Here's a third similarity: In both Singapore and the United States, we strongly believe that a healthy ecosystem is critical to enabling that continuous improvement in auditing—and indeed in all activities across the financial reporting supply chain.

So how do we maintain a healthy ecosystem for audit quality? How do we strengthen it?

Today I'd like to share my thoughts on these questions. I look forward to hearing your thoughts and reactions in our next session.

But before that, here's a quick overview of what I'd like to cover with you over the next thirty minutes or so.

First, I'd like to quickly introduce you to my organization, the Center for Audit Quality.

Then I'd like to spend a few moments describing how we see the big picture in financial reporting and audit. Here's the short version: we believe public company auditing in the United States—and indeed in the world—is strong and getting stronger.

Finally, I'd like to examine how we are working to get stronger. I would suggest that there are three key factors to strengthening the ecosystem. They are:

- One, commitment to continuous improvement, such as through the creation of resources for the auditing profession;
- Two, collaboration with partners across the financial supply chain on key issues like strengthening audit committees and fighting fraud;
- And three, policy engagement on top issues, such as the development of audit quality indicators, enhancing disclosure, and the debate over mandatory retendering and rotation.

This morning, I will take a closer look at each of these factors.

But first, permit me to set the stage by telling you a bit more about the CAQ.

We are an autonomous, nonpartisan, and nonprofit public policy advocacy and membership organization.

Our founding, which took place in 2007, came as a direct response by the public company auditing profession to the turn-of-the-century accounting crisis in the United States, and the subsequent passage of the Sarbanes-Oxley Act of 2002. That law, as you know, aimed to foster more reliable financial reporting and improvements in audit quality.

Nearly 600 U.S. public company auditing firms are members of the CAQ. Our staff now numbers 22, including a team of certified public accountants.

The CAQ is governed by a 12-person Board that is made up of the CEOs from leading U.S. accounting firms and the American Institute of CPAs, as well as three independent Board members from outside the public company auditing profession.
As established by the Board, the CAQ has a simple overarching mission. We are dedicated to enhancing investor confidence and public trust in the global capital markets.

How do we do this?

- One, by fostering high quality performance by public company auditors;
- Two, by convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention;
- and three, by advocating policies and standards that promote public company auditor’s objectivity, effectiveness, and responsiveness to dynamic market conditions.

While we are a membership organization and appreciate that there is a potential conflict of interest in our structure, we overcome that by seeking input from our key stakeholders—including committees and investors—and collaborating with them on key policy issues, as I'll explain further.

To serve our members and to enhance investor confidence, the CAQ engages in a wide range of activities in the United States and across the globe.

We provide thought leadership on proposed rules and standards.

We conduct our own research, and we work closely with the academic community to facilitate outside independent research relevant to the auditing profession.

We offer webcasts, events, and tools for the profession and other members of the financial reporting supply chain. By the way, all CAQ resources are publicly available and free of charge at our website, TheCAQ.org. So I invite you to visit our site.

Finally, as I'll discuss more in a moment, we collaborate with members of the financial reporting supply chain, including outreach to retail and institutional investors.

So that’s what the CAQ does. But what is our view of the big picture?

Broadly speaking, our view is positive. We think public company auditing is in very good shape in the United States and globally. Arguably, it’s in the best shape it has ever been in.

Now, that doesn’t mean that everything is complete, and that we can stop our quest for improvement. As you know, all constituents in the financial reporting supply chain operate in an increasingly complex and challenging environment.

By why do I say that public company auditing is strong?

One important measure is the trends in restatements of public company financial statements.

Indeed, we think that preparers, auditors, and investors benefit greatly from being well-informed on the types of financial restatements, the accounting issues that resulted in the need for a restatement, and the severity of those issues.
That's why the CAQ recently commissioned a study on restatements. The study was authored by Professor Susan Scholz of the University of Kansas, who is an expert in financial restatements and has published on these issues extensively.

Her study for the CAQ is titled *Financial Restatement Trends in the United States: 2003–2012*. Here are a few key findings from the study, which is available on our website:

One, the number of U.S. restatements has declined significantly since its peak in 2006.

Two, the number of accounting issues underlying each restatement reported has also decreased.

Lastly, restatement reporting periods are shorter. They've declined from an average of two or more years in 2005 to less than 18 months in 2012.

In our view, the findings in Professor Scholz' study are encouraging. It is satisfying to see evidence that a major policy development like the Sarbanes Oxley Act—and private efforts working in the same direction—have helped to improve the environment for business and investors.

This study—and the Singapore Management University's research on audit adjustments—should inspire us to work as hard as we can to make sure the trends shown in the data are headed in the right direction.

As I mentioned restatements are one indicator of audit quality. Where else do we see evidence of the strength of public company auditing?

One key place is investor confidence.

Since 2007, the CAQ has commissioned an annual survey of American investors on four key confidence measures pertaining to capital markets.

We call it our Main Street Investor Survey, as it only targets individual investors—not institutional investors.

In recent years, our survey has shown a rebound in confidence in U.S. capital markets.

As you can see in the slide, post financial crisis, confidence dropped to 61 percent in 2011. A year later, investor confidence in markets outside the United States sunk to a low of 35 percent.

But for our 2013 survey, investor confidence moved up to 69 percent, with confidence in non-U.S. capital markets also showing improvements.

The research firm we work with on this project is currently polling investors for the 2014 edition of our survey. We expect to release the results next month.

In addition to broad confidence measures, our Main Street Investor Survey also tries to get a feel of how investors view various members of the financial reporting supply chain.

Since 2011, respondents in our survey have been asked how much confidence they have in a number of different entities when it comes to effectiveness in looking out for investors’ interests.
This slide shows the high degree of confidence that investors place in external auditors. Independent audit committee members also rank highly.

When asked in their own words why the audit is valuable to them, respondents mention a wide variety fostering transparency and trust.

So our big picture view, in a nutshell, is that public company auditing in the United States is strong. And that’s mirrored worldwide.

But I’m not here to talk simply about how we are strong now. My primary objective is to talk about how we can get even stronger in the future.

In my mind, strengthening the ecosystem for audit quality starts at a fundamental point: a strong and widespread commitment to continuous improvement.

Everyone involved in corporate governance must dedicate themselves to fostering an environment that protects and promotes capital markets.

We believe this commitment to improvement is widely shared by a variety of stakeholders. Policymakers and standard-setters are working together to develop standards that reflect the changing environment.

At companies, audit committee members, who represent investors, are empowered and engaged.

And audit firms are as dedicated as ever to a continuous cycle of improvement.

So how do we express our commitment to improve? One way, as I’ve already alluded to, is through study of our challenges. In this regard, I commend ACRA for its careful analysis of the retention issue here in Singapore, as well as its work on audit adjustments.

Another expression of our commitment to continuously improve is our development of resources to help our profession do its job even better.

Tomorrow, the CAQ will issue a new publication, titled the Professional Judgment Resource.

The publication is designed to provide auditors with a decision-making process to facilitate important auditing and accounting judgments in a professionally skeptical manner.

It can assist auditors as they proactively and constructively respond to judgment challenges arising from:

- the increasing complexity of business transactions,
- the development of principles-based auditing and accounting standards,
- and the increasing focus on estimates and other highly subjective elements.

To confront this complexity, the Resource outlines a decision-making process grounded in five essential actions that span from identification of an issue, to documenting the conclusion.
The *Resource* indicates, however, that the actions are not always sequential, as an auditor’s decision-making is often iterative and may require some steps to be combined, repeated, or considered in a different order.

Additionally, the *Resource* identifies several of the common potential judgment tendencies and traps that can lead to auditor bias and weaken professional judgment. It includes illustrative examples of these tendencies—as well as strategies to avoid them.

Let’s look at another way we can strengthen the ecosystem for audit quality: We can collaborate. We are stronger when we work together, as evidenced by the work that ACRA does.

At the CAQ, one area on which we've focused our collaborative efforts is the fight against financial reporting fraud.

A few years ago, we helped set up a formal group known as the Anti-Fraud Collaboration.

In this Collaboration, key players in financial reporting are represented: management, internal auditors, external auditors, boards of directors, and audit committees.

The Collaboration has its own website, which I encourage you to visit. AntiFraudCollaboration.org. The site provides updates and links to reports, webcasts, and other resources.

One resource you might find interesting is our series of case studies.

These are hypothetical fraud scenarios, presented in a format inspired by the Harvard Business School case method. Thus, people using the case study start with a set of facts about a fictional company.

In the first case study, which is called “Hollate Manufacturing,” the fact pattern involves a company that might have created an environment in which financial reporting fraud was allowed to flourish.

People using the case can discuss what could have been done to improve that environment and mitigate the risk of fraud.

We released our second case study in February. It's titled, "Carolina Wilderness Outfitters," and it focuses on what the various members of the financial reporting supply chain should do in the case where an accounting irregularity is suspected.

We’re developing a third case study, involving a financial institution, that will focus on how best to apply skepticism, which of course as you know is such an important part of the audit process and strong corporate governance.

Another area where we've focused our collaborative efforts is with audit committees.

Collaboration in this area is particularly important, given the vital corporate governance role that audit committees play in the United States and around the world.
In the United States, the Sarbanes-Oxley Act greatly increased the responsibilities of audit committees to oversee risk management at a company and to ensure that management sets a strong and ethical tone at the top.

The law required audit committees to be independent of management for all listed companies.

It required the independent audit committee, rather than management, to be directly responsible for the appointment, compensation and oversight of the external auditor.

And it required disclosure of whether at least one “financial expert” is on the audit committee.

Thus, the audit committee has become the hub for coordinating many financial reporting communications because it has primary reporting lines from management and the external auditor.

No surprise, our members tell us that a strong audit committee is an important element in delivering a high quality audit.

And, also no surprise, regulators are keenly interested in audit committees. They know that audit committees, together with the external auditor, are the nexus to audit quality.

In response to this rising interest from regulators and others, we formed the Audit Committee Collaboration in 2012.

In the group are major U.S. organizations and associations that have an interest in making sure audit committees perform at a high level.

Two years ago, the Collaboration released its first resource: the *Audit Committee Annual Evaluation of the External Auditor*.

This tool enables audit committees to objectively evaluate the auditor’s performance on an annual basis so the audit committee can make an informed recommendation to the Board whether to retain the auditor.

The *Evaluation* tool contains sample questions to gauge the quality of:

- services and sufficiency of resources provided by the auditor,
- communication and interaction with the auditor,
- and the auditor’s independence, objectivity and professional skepticism.

It also provides a sample form for obtaining input from company personnel.

I was very interested to see that ACRA, the Monetary Authority of Singapore, and the Singapore Exchange have recently updated the *Guidebook for Audit Committees in Singapore*. The new edition contains a sample checklist that serves much the same purpose as our *Evaluation* tool. And, as you might have seen, the *Guidebook’s* checklist even includes a section on "Commitment to continuous improvement" – another practical example of how we strengthen our audit ecosystem.
I'll also note that your Guidebook also contains helpful information on appointment and reappointment—topics that we are considering addressing when we update our Evaluation tool.

The Audit Committee Collaboration’s second major initiative revolves around disclosure. Last fall, the Collaboration published a document known as the Call to Action. It focuses on enhancing audit committees’ public disclosures.

I should be clear: The Call to Action does not say that audit committees must take on more responsibilities. We are well aware that audit committees carry a significant workload already.

Rather, it urges audit committees simply to provide insights to investors and others about the important work they are already doing.

To this end, the Call to Action highlights best practices from audit committees at leading companies like McDonald’s, Pfizer, and Citigroup.

These best practices are not meant to be prescriptive, or part of any mandate. Rather, they are intended to provide a broad, clear path of action that other audit committees can voluntarily follow to strengthen their own disclosures.

Thanks to the collective communications power of our collaborative partners, the Call to Action has stimulated a broad conversation around the effectiveness and the important work of public company audit committees.

We’re continuing that conversation through events, webcasts, and outreach. We’re also continuing our research. While last year’s Call to Action focused largely on the largest U.S. companies, we are now looking at emerging practices around audit committee disclosure at U.S. companies of all sizes. We hope to have that research published this fall.

Another quick word on the role of the audit committee. By law in the United States, Public Company Accounting Oversight Board (PCAOB) inspection findings are not made public or shared with audit committees except in extreme circumstances. Nonetheless, it is a best practice for auditors to engage in a robust discussion with the audit committee on the findings and how they are being addressed. Audit committees also have a responsibility to engage in this discussion.

I'd like to now to move to my third component of strengthening the ecosystem, and that is policy engagement.

Policymaking and regulation can be a disruptive force, so it's critical that we all work constructively with policymakers to get it right.

One area where we see a high degree of interest globally is disclosure effectiveness.

Take for example, the IAASB's proposal for a revised auditor reporting model. Broadly speaking, the CAQ is supportive of this and other efforts to update and enhance the auditor’s report.
We have worked closely with the profession and other stakeholders to identify potential improvements to the auditor’s report and to bring additional transparency related to the role of the auditor.

In letters to the IAASB and regulators at home, we have conveyed our view that updates to the auditor’s reporting model should be practical and operational. They should add value for investors, and enhance—or at least maintain—audit quality.

Beyond audit, disclosure effectiveness has also been a subject of great interest for U.S. Securities and Exchange Commission Chair Mary Jo White.

The CAQ shares Chair White’s view that disclosure can be improved.

Indeed, effective disclosure is a hallmark of world-class capital markets. We must all do our best to make financial disclosure meaningful, as tailored as possible, and optimized in terms of how and where it is delivered. To this end, I will note that the CAQ has launched a promising new initiative with the Institute for Corporate Responsibility at the George Washington University School of Business in Washington, DC.

It’s called the "Initiative on Rethinking Financial Disclosure." The Initiative harnesses the power of team competition: Several teams of graduate students at the School of Business are analyzing annual reports from prominent companies. This fall, they will present the SEC with their findings on how to improve these communications.

A winning team will be selected by a panel of experts. We are looking forward to seeing their insights.

Another policy area where we have been highly engaged is audit quality indicators, or AQIs.

Simply put, an AQI is a piece of data that may help audit committees and others assess the quality of an audit. For example, how much experience does the audit team have? How much training do they have? How many specialists do they have working on the audit?

The interest in developing a set of metrics along these lines is high among regulators, investors, and audit committee members.

For our part, the CAQ has been working on an AQI project since 2012. We have also been supportive of our profession's regulator, the PCAOB, as it has examined AQIs.

Internationally, we have provided our input to the IAASB, which in May 2013 issued a consultation paper on this issue.

All this engagement is particularly important, given the challenges presented by development of AQIs. Principally, views on audit quality vary quite widely among stakeholders—depending on the degree to which stakeholders have direct involvement in audits and the lens through which they assess auditor responsibility and performance.

At the CAQ, we are working through these issues to achieve consensus where possible.
Last April, the CAQ released a paper that sets forth in detail our initial thoughts on an approach to AQIs, along with a set of potential AQIs.

At the highest level, our Approach to AQIs flows from the notion that data has to be tailored to be meaningful and helpful.

We've also identified a few key factors, or guiding principles.

First, we believe communications of AQIs should be directed at audit committees. Thus, our approach recognizes the vital role the audit committee plays in providing oversight of the audit.

In this sense, AQIs can supplement other communications provided to the audit committee, including the auditor’s required communications under professional standards, as well as information included in the audit firm’s audit quality and transparency reports.

Second, we believe communication of AQIs should be focused largely on engagement-level indicators. Such a focus could drive actions that might help to maintain or to increase audit quality on an engagement—and may also assist the audit committee in evaluating the effectiveness of the engagement team and audit firm.

Additionally, AQIs may primarily be quantitative in nature. However, these indicators are more useful when supplemented by contextual, qualitative narrative and dialogue between the auditor and the audit committee.

Beyond these principles of communication, the CAQ has identified a set of potential AQIs that we believe, taken as a whole, could aid audit committees in their oversight of the audit.

These include a series of metrics under the following four topics: firm leadership and tone at the top; engagement team knowledge, experience, and workload; monitoring; and auditor reporting.

In our view, a critical step will be for audit firms to perform pilot testing of this AQI approach, obtaining feedback from auditors and audit committees.

Several of our member firms have begun such testing in a program that is currently underway. The program will continue through the completion of the 2014 audit cycle early next year.

This testing will help us to identify challenges, to assess whether communicating this information is helpful to audit committees, and to enable audit firms to provide insights to regulators and others.

A third and final policy issue I'll mention this morning is firm rotation and retendering.

As you know, UK reforms that became effective two years ago require large companies to either retender the external audit contract every ten years, or explain why retendering is not taking place.

And, under European Union audit reforms that were approved earlier this year, public companies must switch auditors at least every ten years, although this period can be extended to 20 years, provided a company has retendered the audit (or 24 years in the case of joint audits).

As the UK and EU audit reforms have unfolded, the CAQ has been outspoken in urging caution.
We’ve expressed our view that EU requirements, particularly regarding mandatory audit firm rotation, could undermine the role of independent audit committees. In the United States, as in Singapore, the idea of mandatory firm rotation has been considered and set aside for sound public policy reasons.

We are also concerned that the implementation of the EU reforms will generate inconsistencies across jurisdictions, which could affect companies, their auditors, and investors.

We hope that these new EU rules can be implemented with the greatest consistency possible across Europe with minimal extra-territorial impacts.

A development we all must watch is the ongoing impact of retendering and rotation on the audit profession, particularly regarding signs of downward pressure on audit fees. What are the implications of this trend, particularly for audit quality?

In June, I discussed these matters with representatives from companies and investors at the International Corporate Governance Network’s Annual Conference, held in Amsterdam.

In this discussion, I heard worry about that firms may further cut fees to remain competitive, while also bearing the added expenses of mounting more tender responses.

Many firms may not want to bear that expense, which could raise the question of whether there will be adequate choice in the tendering process. This was, ironically, a stated goal of the EC’s undertaking.

Given these concerns and others, this is clearly an issue on which all of us will need to remain engaged.

I’ve covered a good deal of ground with you. But to quickly recap.

The CAQ believes that the state of public company auditing is as strong as it has ever been. But we can—and must—further strengthen our ecosystem.

We can commit and recommit ourselves to continuous improvement.

We can work together with our key partners and stakeholders, joining forces to tackle critical issues from multiple angles.

We can engage in the policy process, working with regulators to ensure that the rules are effective, informed by marketplace realities, and operational.

If we do these things, both Singapore and the United States will remain leaders in corporate governance, and we will continue to serve as models for the rest of the world.

Our ecosystem will get stronger—to the benefit of our profession, our markets, and investors.

Thank you.