PCAOB Public Meeting on
Auditor Independence and Audit Firm Rotation

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Center for Audit Quality

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Introduction

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors’ objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to participate in the PCAOB’s public meeting on auditor independence and audit firm rotation. As is obvious by the sheer number of thoughtful comment letters – well over 600 letters were submitted on the PCAOB’s Concept Release on Auditor Independence and Audit Firm Rotation (PCAOB Rulemaking Docket Matter No. 037) (concept release) – the topics of auditor independence, objectivity and skepticism – and audit quality broadly – are of great interest to all financial reporting stakeholders. The CAQ’s remarks today are consistent with the CAQ’s December 14, 2011 comment letter on the concept release, which we are attaching to this statement for inclusion into the record of these roundtables. Moreover, these remarks represent the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Overview

Auditor independence, objectivity and skepticism are critical attributes that underpin a quality audit, and these attributes can and should be continuously improved. As stated in our comment letter, the CAQ is wholly committed to enhancing these and all drivers of audit quality.

The PCAOB’s concept release asks whether mandatory audit firm rotation is a possible means of enhancing auditor independence, objectivity and skepticism. As explained more fully in our comment letter, we believe the issue of mandatory firm rotation could actually decrease audit quality and has become a distraction from the real issue raised by the PCAOB -- how each of us can and should use our respective roles to continue to enhance audit quality, particularly independence, objectivity and professional skepticism. The CAQ stands ready to work with the PCAOB and others as we seek meaningful enhancements to these important attributes.

In this statement, we set forth principles for continued improvement to auditor independence, objectivity and skepticism, make observations regarding the key checks in the current systems, specify areas for further focus by the major participants in the system of auditor oversight, and discuss our opposition to mandatory firm rotation.

Principles

In evaluating our ideas and those put forth by the PCAOB and others to enhance auditor independence, objectivity and skepticism, the CAQ identified a set of overarching principles to guide the identification of suggestions meriting further consideration. The CAQ invites all stakeholders’ views on whether these or other principles constitute the right framework for assessing changes of potentially great impact. In our view, any enhancements to auditor independence, objectivity and skepticism should (1) improve audit quality; (2) not diminish the role of audit committees; and, (3) have benefits that outweigh the costs.
Impact of SOX Reforms

Acknowledging the potential conflicts that are inherent to the issuer-pay model, the Sarbanes-Oxley Act (SOX or the Act) made a number of changes that have significantly mitigated those potential conflicts. First, it places significant independence requirements on auditors, reinforced by related SEC and PCAOB rules and requirements. One of these is lead audit partner and engagement quality control review partner rotation, which requires the financial statements to be audited by a “fresh set of eyes” every five years. Certain other partners involved with a company’s audit must be rotated after seven years.

In addition to the independence requirements, SOX made an important change to the reporting relationship between the external auditor and management by shifting responsibility for hiring, firing, and overseeing the external auditor to the audit committee. In addition, the audit committee was strengthened by requiring each member of the audit committee to be independent, requiring the audit committee to pre-approve any permissible non-audit services, such as tax services, and requiring disclosure of whether at least one member of the audit committee is a financial expert. The elevation of the audit committee and the delegation of responsibility for engaging and overseeing the external auditor have significantly mitigated the risks posed by the issuer-pay model. We believe these enhancements have over the past 10 years contributed to the overall increase in the quality of audits.

Another contribution to increased audit quality was the creation by SOX of the PCAOB. Through standard setting, inspections and enforcement, the PCAOB has a very clear role to play in ensuring that auditors perform quality audits with sufficient independence, objectivity and skepticism.

While distinct, the roles of the PCAOB, audit committees, and auditors require constructive coordination if we are to maintain the high standard of quality expected of public company auditors.

Enhancing Audit Quality and Independence, Objectivity, and Skepticism

Audit Firms

In order for the audit committee to oversee the audit and integrity of the company’s financial reporting, there must be frequent, open and substantive communication between the audit committee and the external auditor, with the auditor bearing much of the responsibility for this communication.

The CAQ supports the PCAOB’s current consideration of a revised auditing standard on the auditor’s communication with the audit committee. The revised standard would expand current requirements and encourage constructive dialogue between auditors and audit committees on significant audit and financial statement matters that require judgment, such as critical accounting policies, practices and estimates, as well as significant unusual transactions, risks and going concern considerations. As discussed further below, we are working with organizations that educate and support audit committees to assist audit committee members in better understanding these important communications and in using them productively.

While communications with audit committees are important, firms must constantly strive to enhance their application of independence, objectivity and skepticism throughout the audit. They must be sensitive to time pressures and constantly assess individual competencies on particular accounting or auditing issues, training, and methodology. Ultimately, it is a firm’s responsibility to address the “root cause” of audit deficiencies, whether identified by the PCAOB or through its own internal review programs.

Firms continuously seek to identify ways to improve quality control systems and thereby strengthen their audit practice. In order to enhance their communications with audit committees about these important
systems, many of the larger firms intend to expand distribution of the annual report on their internal quality control systems as currently required by the listing standards of the New York Stock Exchange, to the audit committees of all public companies they audit so that they may use that information in assessing the auditor. In addition, the PCAOB could consider requiring audit firms to annually update the description of the firm’s quality control systems contained in their original registration statements, and make them available on the PCAOB’s public website so that all interested parties may access the information.

Firms are continuing to emphasize the importance of independence, objectivity and skepticism in the day-to-day ethos and practice of the firm, reinforced through a continuous cycle of improvement that incorporates training, testing, evaluation, engagement quality reviews, and internal quality reviews, which is informed by feedback from the results of PCAOB and internal inspections. Information gained through these activities informs appropriate modifications to methodologies, training and other elements of the firm’s quality control system.

Auditor training is an important driver of audit quality and the auditor’s exercise of independence, objectivity and skepticism even more so. In addition to training on changes in U.S. GAAP, firms specifically train on auditing standards as their auditors adjust to new PCAOB standards and quality control expectations. Recognizing this, firms are continuing to focus on objectivity and skepticism in their training programs to help fortify technical competency in auditing. Firms also are challenging themselves to assess how well independence, objectivity, and professional skepticism are engrained in both training course content and delivery. For example, in today’s environment many firms are providing specific training on assessing the appropriateness of the assumptions and models used by management to support its fair value estimates. Stressing the need for and providing experience-appropriate training on how to apply the concepts of objectivity and professional skepticism in evaluating management judgments is critical. The most effective training is coupled with “on the job” reinforcement through supervision and a “lead by example” culture.

At all levels, the skills and behaviors expected must be carefully and effectively communicated, and then evaluated. Compensation practices for all audit professionals should reward behaviors that contribute to audit quality, and behaviors which harm audit quality should be dealt with appropriately. These practices should be apparent to all auditors within each firm and to the PCAOB when it performs inspections.

In the final analysis, it is up to each individual on the audit team to discharge his or her professional responsibilities to perform a quality audit, and for their firms to cultivate an environment where independence, objectivity and skepticism are visibly valued attributes, reinforced by their internal systems of quality control.

Audit Committees

As many commenters acknowledged, a critical element of SOX is the responsibility it gave audit committees in overseeing the external auditor on behalf of investors. The CAQ believes that audit committees should be further strengthened and encouraged to take an even more proactive role in their oversight of the independent auditor.

While there is a more detailed discussion in the CAQ’s comment letter, a few key areas deserve highlighting. We do not mean to suggest that all audit committees are not highly effective – many are highly effective, and many are already engaged in the activities discussed below. Just as the skill sets for auditors can be continuously improved, so too can those of the independent audit committee members. We believe that some ideas for enhancing audit committee performance, particularly those that foster
stronger alignment of auditors, audit committees, independent audit regulators and shareholders, could be highly effective as best practices that become the norm, as appropriate, for each publicly traded company.

The CAQ is actively engaged with a number of organizations that provide education and support to audit committees to explore these and other ways to strengthen audit committees across the range of publicly traded companies. We also note that the SEC and the securities exchanges, through their listing requirements, may have opportunities to strengthen audit committees through outreach, identification of best practices and rule-making.

One area for potential enhancement through best practices is the audit committee’s involvement in the selection of the lead engagement partner. While audit committees are not charged with selection of individual audit partners, we think that audit committees could be more engaged in this process. One way to become more involved would be for audit committees to specify the critical attributes the lead engagement partner needs for that particular audit and be a part of the interview process. Attributes could include such things as type or level of technical expertise, experience, and application of objectivity and skepticism. By being involved in interviews of candidates and providing feedback to the audit firm regarding the selection of the lead engagement partner, audit committee members can be satisfied that the partner has the technical competence and relevant experience required for the particular audit. This would set an important tone for the lead engagement partner’s relationship with the audit committee.

Another area we think calls for identification of best practices is the audit committee’s annual assessment of the external audit firm, which is an important component of the audit committee’s oversight of the financial reporting process and its determination of whether to retain the auditor. This is an area that may be improved through additional tools and training for audit committees as the protocols and processes for conducting the assessment can vary widely. By leading and “owning” the process by which the auditor is assessed, the audit committee would be better able to assess whether the auditor is performing high quality work that conforms to PCAOB requirements. The process might include a review of technical competence (including inspection results for the specific company, and those that bear on the audit firm as a whole), compliance with independence requirements, and importantly, the application of objectivity and professional skepticism, which would enable the audit committee to decide whether improvements in auditor performance are needed, or whether the audit should be put out for tender.

It is important for the investors, to whom audit committees are responsible, to be informed about this important work – and have a way to compare their work to that of other audit committees. There are audit committee reports that are robust and provide a clear lens into the oversight process, while others simply assert compliance with the requirements of the audit committee’s charter. Accordingly, the CAQ supports efforts to enhance audit committee performance, as well as communications to shareholders through the audit committee report and otherwise. If there are legal or practical impediments to expanding the audit committee report provided in the proxy, we believe it would be useful also to consider examples of “best practice” reports (not part of the proxy materials) – as well as explore additional communication opportunities that might be available.

Also, we believe that the definition of Financial Expert should be strengthened for purposes of who qualifies according to section 407 of the Act. The current definition of a “financial expert” allows professionals with executive experience to qualify as a “financial expert” even if they have limited accounting or auditing expertise. As the complexity of financial reporting and auditing continues to increase, it is critical that audit committees have a member with direct financial accounting or auditing experience. In addition, we believe that all audit committee members should receive specific training on the financial statement audit and an overview of PCAOB independence, quality control and other applicable rules.
The creation of an independent regulator for registered public accounting firms has improved audit quality. The PCAOB inspection process and the dialogue that ensues, along with the public inspection report and, if necessary, disciplinary follow-up, provide a process for firms to make additional enhancements to their auditing processes. The PCAOB’s work to improve audit standards and respond to the audit issues found in the range of public companies is as important as inspections and enforcement. Standard-setting is a key means for the PCAOB to improve audit quality. Moreover, the implementation and application of auditing standards is brought to life through PCAOB guidance (audit alerts, 4010 reports, roundtables on technical issues, firm-specific communications, etc.) in addition to inspections and enforcement actions.

The PCAOB’s standard-setting agenda accelerated since standard-setting on internal control over financial reporting was completed in late 2006, a project that resulted in the promulgation and replacement of Auditing Standard (AS) No. 2 with AS No. 5. Since then, numerous new standards – including requirements for engagement quality reviews and eight new standards on risk assessment – have been adopted but only recently implemented, applying to audits for fiscal years ending after December 15, 2009 (EQR) and after December 15, 2010 (risk assessment).

In the coming months, the PCAOB’s agenda includes potential standards on the auditor’s reporting model, auditor communications with audit committees, audit firms’ quality control systems, the confirmation process, fair value measurement of financial instruments, the use of specialists, related party transactions, audits performed in part by other auditors, and the assignment and documentation of firm supervisory responsibilities. These new standards are expected to drive further improvements to audit quality as they are incorporated into auditing processes over the next few years.

With the objective of strengthening the direct linkage between audit quality and auditor objectivity and skepticism, perhaps the PCAOB could consider ways to explicitly include references to these traits in certain new standards where applicable and appropriate. Monitoring the effects of the new and forthcoming standards upon auditor independence, objectivity and skepticism and audit quality, and guiding implementation of new standards using the range of communication tools available to it (e.g., by providing guidance, holding roundtables on difficult auditing issues, issuing 4010 reports), the PCAOB would, in our view, improve audit quality. The PCAOB might also explore ways to share with the firms more about its own analysis of inspections findings.

Mandatory Firm Rotation

The PCAOB’s concept release raises the question of whether mandatory firm rotation is a means of enhancing auditor independence, objectivity and skepticism in the context of its concerns regarding length of auditor tenure and an increase in the number of PCAOB’s inspections findings. However, the concept release states that “[p]reliminary analysis of that data appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports.” There is also a lack of correlation between mandatory firm rotation and enhanced audit quality. Commonly cited studies of experience with mandatory firm rotation in other jurisdictions reveal significant costs, including diminished audit quality, and suggest that the benefits of mandatory firm rotation are speculative at best.

Mandatory firm rotation would limit the statutory authority of audit committees to hire and fire the auditor, engender cost and disruption for issuers, cause a scarcity in the choice of auditors for certain sectors and for global companies, and have a potentially negative impact on audit quality. As many audit committee commenters acknowledged, mandatory firm rotation would unquestionably dilute a critical element of SOX, and hinder the ability of audit committees to oversee the external auditor on behalf of
investors. The CAQ believes that audit committees, instead, should be further strengthened and encouraged to take an even more proactive role in their oversight of the independent auditor.

**Conclusion**

The CAQ appreciates the opportunity to be a part of the PCAOB’s careful examination of ideas to enhance auditor independence, objectivity and skepticism. We believe these traits are as important as an auditor’s technical competence, and thus strongly agree with the objective of improving these attributes.

We believe the current system of investor protection put into place by SOX is fundamentally sound, and we support continuous improvements made under that system. The auditing profession is committed to working with all stakeholders to continually improve audit quality and enhance the confidence investors and others place in the integrity of audited financial statements.

I appreciate the opportunity to be part of this important discussion.
Resource Index

a) *A Restatement Analysis of the Russell 1000 Companies: The Extent to Which the “Fresh Eyes” of a Newly Engaged Auditor Provided Assistance in the Discovery of the Misstatement*, Audit Analytics (February 2012).


c) *Are Auditors Skeptical of Management’s Level 2 versus Level 3 Fair Value Classification Judgments?* Christine Earley, Vicky Hoffman, and Jennifer Joe (March 2012).

d) *Audit Fees and Non-Audit Fees*, Audit Analytics (May 2011).


h) *Auditor Industry Specialization and Earnings Quality*, Steven Balsam, Jagan Krishnan, and Joon S. Yang (September 2003).


m) *Does Auditor Tenure Improve Audit Quality? Moderating Effects of Industry Specialization and Fee Dependence*, Chee-Yeow Lim, Singapore Management University, and Hun-Tong Tan (September 2009).


o) *Exploring Attitudes to Audit Quality and Potential Reforms*, YouGovStone European Audit Committee Chair and CFO Poll, PwC (June 2011).

p) *Mandatory Audit Firm Rotation and Audit Quality*, Andrew B. Jackson, Michael Moldrich, and Peter Roebuck (July 2007).

q) *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market*, Soo Young Kwon, Youngdeok Lim, and Roger Simnett (19 November 2010).


t) *Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services (November 2003).

