CAQ Update
Remarks of Cindy Fornelli
AICPA Conference on Recent SEC and PCAOB Developments
Monday, December 3, 2012

Good morning. Thank you for that kind introduction, Rich. Congratulations to Rich as the newly named Chair of the AICPA Board of Directors. I look forward to working with you.

And congratulations to Barry Melancon, the AICPA staff, Scott Pohlman and the rest of the planning committee for putting together such a consistently informative and respected event.

Over the past 12 months, the profession has been presented with its share of challenges as well as opportunities. Let me highlight some of those that are most relevant to the public company auditing profession.

As we all now know, for the past 18 months, the PCAOB has been soliciting stakeholder views on mandatory firm rotation as a means to enhance auditor independence. As will not surprise any of you, the CAQ is firmly opposed to mandatory firm rotation, as well as retendering, for several reasons, including that it would undermine the audit committee's statutory responsibility to oversee a public company's entire financial reporting process – and the audit committees' responsibility to hire, fire and oversee the external auditor. Mandatory firm rotation also would engender immense cost and disruption for issuers, and cause a scarcity in the choice of auditors for certain sectors and for some global companies. All this while neither the PCAOB nor any other party has been able to provide evidence that audit quality is tied to tenure.

We at the CAQ are not alone in our opposition to mandatory firm rotation – the PCAOB has heard from over 700 parties, either through the comment process or through participants in their public meetings, and the overwhelming majority from the *entire* range of stakeholders is opposed to mandatory firm rotation.

And yet, the CAQ and its member firms are committed to making continuous improvements in audit quality. Auditor independence, objectivity and skepticism are key attributes of a quality audit, and we share with the PCAOB and others, the goal of continuously strengthening these and all drivers of audit quality.

Regulators, the public company auditing profession, preparers and audit committees all share the same goals: robust and healthy markets in which investors have confidence to invest. With respect to financial reporting, the audit committee serves an essential corporate governance role through its oversight of a company's financial reporting process, including the hiring and oversight of the external auditor.

To that end, the CAQ is involved in several endeavors designed to enhance audit committee effectiveness and to foster auditor-audit committee communications.

First, the CAQ has partnered in an ongoing collaboration with a number of corporate governance organizations, including the National Association of Corporate Directors and the New York Stock Exchange's Corporate Board Member, to explore ways to strengthen audit committees across the range of publicly traded companies. In October, the group released a tool, the "Audit Committee Annual Evaluation of the External Auditor," a user-friendly, scalable tool to help audit committees assess the auditor's performance in order to make an informed recommendation to the Board of Directors whether to retain the auditor.

Also in October, the CAQ issued a Practice Aid on "Discussions with Audit Committees about Inspection Findings and Quality Control Matters." The Practice Aid encourages auditors to communicate with audit committees about their PCAOB inspection in a timely, forthright and robust manner – yet without waiving the confidentiality of the nonpublic parts of the inspection report. We have encouraged auditors and audit committees to refer to the Practice Aid in structuring discussions on recent PCAOB inspections.

In November, the CAQ published its *Guide to PCAOB Inspections*, which provides a high-level overview of the PCAOB's process for inspecting public company auditing firms. While not necessarily aimed at audit committees, the Guide highlights the process for selecting and reviewing audits for conformance to audit standards, and the assessment of a firm's quality control program.

Also, we held a Webcast featuring PCAOB board member Jay Hanson, auditor Joe Ucazaglu and Michele Hooper, a prominent audit committee chair, to inform auditors and audit committee members on the requirements of, and leading practices in, auditor-audit committee communications, based on the PCAOB's new AS 16 and our Practice Aid. The webinar is archived on our website, as are the Guide to PCAOB Inspections, the Practice Aid and the Audit Committee Assessment Tool.

The CAQ and the profession share with the PCAOB, preparers and audit committees the same goal of increasing auditor independence, objectivity and skepticism and enhancing audit quality. These initiatives are examples of the CAQ and the public company auditing profession's commitment to meeting that goal.

Audit firms themselves also are focused on ways to drive concrete identifiable improvements to auditor independence, objectivity and skepticism. Let me summarize just some of those initiatives. CAQ member firms are

- Making investments in additional quality resources focused on difficult and judgmental accounting and auditing matters, thereby fostering consistency and enhancing objectivity;
- They are providing additional resources for the internal inspection process and the process of using inspection findings to drive improvements in underlying audit performance;

- Firms are making changes to quality control programs to respond to issues identified through internal or PCAOB inspections that will enhance the quality of future audits and keep up with changing circumstances and emerging issues; and
- They are supplementing training and development programs to bolster auditor performance in areas most commonly identified for improvement through inspections and reviews.

These are just a few of the various programs, approaches and tools that CAQ member firms are deploying.

Let's focus for a few moments now on skepticism. Public company auditors have a duty to apply skepticism and judgment in their jobs. And, the complementary responsibilities of others in the financial reporting supply chain demand the exercise of skepticism and judgment across <u>their</u> roles. Otherwise, how can audit committee members, financial executives and internal auditors fulfill their financial reporting responsibilities?

To answer that question the CAQ has been involved with our collaborative partners to help focus on the exercise of skepticism. Working with the CAQ, FEI, and The IIA, the NACD took the lead to create a series of six webinars that helps *all* members of the financial reporting supply chain understand how they can better bring skepticism into their work and substantially contribute to audit quality.

Released over the course of 6 weeks, beginning in October, the series contains an introductory video, then webinars on the etiquette and ethics of skepticism (which is fascinating!), Skepticism and the Audit Committee, Skepticism and the Financial Executive, Skepticism and the Internal Auditor and Skepticism and the External Auditor.

So, what is "professional skepticism" with respect to auditors?

PCAOB standards seem to adopt a “neutral” approach to skepticism, that is, the auditor should neither assume that management is dishonest nor assume unquestioned honesty. This is similar to the “trust but verify” approach.

At the other end of the spectrum is the “presumptive doubt” approach, which is deployed during audits of areas in the financial statements that have had prior errors, pose a high risk of fraud or involve very complex accounting judgments.

Thus, there is an appropriate range to skepticism, depending on the facts and circumstances. But when determining the appropriate level of skepticism, other factors will come into play: your interpretation of the facts and circumstances is shaped by your subconscious and conscious minds; your personality; prior experience or inexperience, a particular industry or area of accounting or auditing; and, likely, the particular dynamic of the audit team. All of these impact your intent – or attempt – to apply skepticism in a truly unbiased and objective manner.

How can firms and regulators support the appropriate application of skepticism so that auditors know where on the continuum they should be?

As we discuss in the External Auditor webinar, tone at the top of the firm and within the audit team are keenly important, as are training and mentoring, lessons learned analysis, and a review system that measures and rewards the application of professional skepticism. Auditors also need an environment that allows sufficient time and resources to exercise skepticism.

In terms of supporting the proper application of skepticism, while regulators have yet to establish a judgment framework, a number of firms have developed judgment processes, which can be very useful for helping to overcome inherent biases.

In addition, regulators are in an ideal position to share insights and provide guidance on the application of skepticism. What are best practices? When is it appropriate to move up or down in the continuum of skepticism? What are some of the "traps" individuals and audit teams might fall into?

Regulators also might provide similar guidance to audit committees, management and others involved in financial reporting to raise awareness and promote a culture of improvement in this important area. I am heartened to have heard PCAOB board members publicly calling for such analysis and guidance in this and other areas and I hope that we might indeed see it in 2013.

While I think that the PCAOB, the audit committee community, preparers and the public company auditing profession have demonstrated through their actions a commitment to enhancing audit quality over the past year, there is still more to be done. The CAQ is committed to continuing to lead efforts and collaborate with stakeholders on new initiatives.

In the audit committee arena, the CAQ and our governance partners are considering additional tools suitable for audit committees across the spectrum of public companies. We are meeting with our partners tomorrow to discuss additional tools and ways we can support audit committees.

One thing we all agree on is that audit committees need to communicate more effectively about how they are fulfilling their responsibilities, which will help to assure shareholders and raise the performance level of less effective audit committees.

Another matter that we are focusing efforts on is measuring audit quality. There have been a number of attempts to define audit quality in the past, though little consensus on its definition or measurement. In the end, different views suggest different metrics.

The CAQ's work on defining and measuring audit quality is in the embryonic stage, but the goal is to develop measures that help to establish a definition of audit quality that incorporates the views of key capital markets stakeholders. We also hope to identify broad measures of audit quality and performance indicators with the hope of reaching consensus on common metrics to measure audit quality.

And we continue our anti-fraud effort, work on auditor reporting and disclosure framework, and other initiatives.

My remarks today have centered on efforts to enhance audit quality by all financial reporting stakeholders. All of us are working toward the same goal – strong markets bolstered by investor confidence and trust. And I believe it's working.

So let me close on a positive note: the CAQ's 2012 Main Street investor survey.

When we first surveyed individual investors in 2007, confidence in U.S. capital markets clocked in at 84 percent. Confidence fell to a low of 61 percent in 2011, when the economic recovery lagged behind expectations. This year:

- Investor confidence in U.S. capital markets rebounded to 65 percent, a statistically significant change from 2011;
- Confidence in investing in U.S publicly-traded companies remained steady at 71 percent and has remained above 70 percent over the past five years; and
- Investor confidence in audited financial information released by public companies held at 69 percent.

And here is the best part: 70 percent of investors said that, other than themselves, independent auditors of publicly-traded companies are most effective in looking out for investors' interests, followed by financial advisors and brokers, and independent audit committees.

The Main Street Investor Survey demonstrates a deeply-ingrained trust in independent auditors. A trust you have earned through hard work, integrity – and yes, through your independence, objectivity and skepticism.

As I close, it bears remembering that while investor confidence is on the rebound, it is not where it could and should be. Regulators and standard setters, preparers, audit committees and accountants and auditors all share the same goal of strong, robust capital markets in which investors feel confident. That is fundamental to our economy's continued improvement and the public company auditing profession and the CAQ will continue to do our part.

Thank you. Enjoy the conference.