Value of the Audit: A Brief History and the Path Forward

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CAQ

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About the Center for Audit Quality

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 that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

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Introduction

Our capital markets are an important engine for driving and maintaining our economic and societal well-being. These remarkable markets harness the energy, creativity, thoughtfulness, and productivity of many participants, including investors and companies alike. Capital markets connect investors to a multitude of companies and supply them with capital for economic expansion to support innovation, scientific, and medical progress.

Capital markets operate on data, and audited financial statements have long been a critical element of this information dynamic for their accuracy, transparency, and reliability. Auditing is essential because of the information asymmetry between investors and the management of companies in which they invest. Investors are making decisions regarding whether to invest in or continue to invest, and their decisions depend on the information they receive from management. As a result, investors need—and in fact have long sought—an independent third party to provide assurance on the information provided by company management. Enhancing the trust in and reliability of company-reported information is a key aspect of the public interest role that public company auditors play worldwide—and it's a significant tenet of the auditing profession.

This paper examines in more detail the value of an independent audit. It first summarizes the importance of well-functioning capital markets to the economy, the historical importance of audited financial statements, and the roles and responsibilities of each key stakeholder in the US financial reporting supply chain. Next, the paper takes a close look at how two key cornerstones of audit quality—the expertise and independence of the external public company auditor—are supported not simply by the strength of the applicable professional and regulatory requirements but also by strong market-based incentives. We analyze why public policy proposals calling for more stringent requirements on auditor independence, with an objective to further increase audit quality, may in fact reduce expertise and result in a decrease in audit quality. Finally, the paper closes by recognizing the significant growth and demand for company-reported information outside of the historical financial statements, and how the independent public company audit construct can apply to these other key areas of information.

Importance of well-functioning capital markets to our economy

Our economy relies to a large degree on a well-functioning financial sector that not only pools domestic savings but also mobilizes capital from around the world to facilitate investments. Fair, orderly, and efficient capital markets help allocate capital to productive activities and create a level playing field for market participants. By promoting economic growth, our capital markets have a meaningful impact on Main Street, not just Wall Street. In short, maintaining well-functioning capital markets is imperative for overall economic well-being and stability.

For capital markets to function well, participants need transparent and trustworthy information—both financial and nonfinancial in nature. Current and potential investors require dependable data if they are to have confidence in the companies in which they are choosing to invest. Likewise, lenders need reliable information about the companies seeking to borrow from them. Transparent and reliable information not only facilitates these market activities, it reduces the cost of both debt and equity capital to the company.

Financial statements not only have served to fuel economic activity for centuries but have also been a part of the bedrock of the US financial markets for nearly a hundred years.[1] Transparent, reliable, and well-functioning capital markets reduce information risk and ultimately improve capital allocation efficiency and contracting efficiency for companies.

1 R. L. Watts and J. Zimmerman, "Agency Problems, Auditing, and the Theory of the Firm: Some Evidence," *The Journal of Law & Economics* 26, no. 3 (1983): 613–33.

Importance of audited financials to well-functioning capital markets and the economy

US market participants—primarily regulators, investors, company management, board members, and auditors—are working in a world of cooperative tension, meaning a world where everyone has a role and where those roles include oversight in the form of checks and balances.

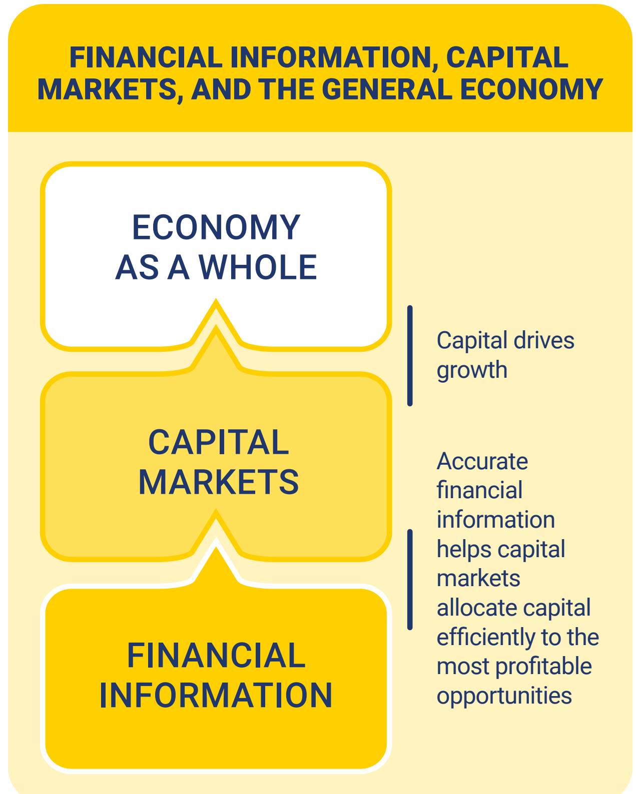
Although there is great value in management's production of a set of financial statements that investors use to make investment decisions, it is both a philosophical truth and an empirical fact that the reliability of those financial statements is enhanced by having the imprimatur of an independent and expert third party attached to them.[2] An independent audit that provides reasonable assurance that these financial statements are free of material misstatements, whether due to error or fraud, increases the reliability of that information and enhances investor and market confidence.

The demand for audits of a company's financial position was driven by investors; they offered the capital required to grow and support business, and they needed an independent third party to provide an assessment of the information that management reported. Even before the Securities Acts of 1933 and 1934 required audited financial statements of certain companies as a condition for them to publicly offer and trade their securities, many companies made available audited financial statements. For example, by 1926, more than 90 percent of companies trading on the New York Stock Exchange (NYSE) were audited by certified public accountants (CPAs) even though at the time audits were not a requirement to list companies there.[3] The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC), and this new agency required all companies to have their financial statements audited by independent CPAs.

2 See W. Wallace, *The Economic Role of the Audit in Free and Regulated Markets: A Look Back and a Look Forward* (Williamsburg, VA: William & Mary Scholar Works, 1980); and W. A. Wallace, "The Economic Role of the Audit in Free and Regulated Markets: A Look Back and a Look Forward," *Research in Accounting Regulation* 17 (2004): 267–98. These two resources provide a detailed history of how the audits of company-prepared financial information by third parties came to be viewed as an integral component of the financial reporting process.

3 S. A. Zeff, "How the U.S. Accounting Profession Got Where It Is Today: Part I," *Accounting Horizons* 17, no. 3 (2003): 189–205.

Today, providing audited financial statements has become an integral activity of many different types of businesses and organizations. Audited financial statements are required not only of public companies but likewise of companies regulated by government agencies other than the SEC; examples include banks, savings and loans, insurance companies, and utilities whose securities are not publicly traded. Importantly, widespread demand also exists for audited financial statements in unregulated sectors of our economy—private companies, nonprofits, and charities regularly provide them, too, whether in accordance with contractual agreements or voluntarily.[4] Independent audits are a cornerstone of our capital markets—and, by extension, the entire economy. When it comes to information, people everywhere want some measure of assurance—something they can trust. Independent audit builds trust by providing reasonable assurance about the integrity of financial statement information.



FINANCIAL INFORMATION, CAPITAL MARKETS, AND THE GENERAL ECONOMY

4 Many other types of entities likewise provide audited financial statement information. Examples include federal, state, and local governments and government agencies for their lenders and citizens; labor unions for their members; and pension funds for their contributors.

Roles and responsibilities in the US financial reporting supply chain

WHO PREPARES A COMPANY'S FINANCIAL STATEMENTS, AND WHAT IS REQUIRED TO PREPARE THEM?

It always has been—and continues to be—the case that, under the US financial reporting framework, management is responsible for preparing financial statements and furnishing financial information to relevant market participants. Management needs financial information to operate the business day in and day out—to decide what resources to allocate and where; to decide what goods or services to produce, at what price, and to whom to sell them; to decide on the number of employees and how to compensate them; and the list goes on. Managers have both firsthand knowledge of the organization and access to necessary information. In short, company management can provide financial statement information at the lowest cost.

To make all of this work, management needs an accounting/reporting system that processes transactions, accumulates the necessary information, and creates a summarized financial report that is comparable and consistent. In the United States, the contents of financial statements are guided by generally accepted accounting principles (GAAP). The intent of GAAP is to ensure consistency in the accounting for and reporting and presentation of financial information across the entire population of companies as well as disclosures in the notes to the financial statements of information necessary for understanding financial statement line-items and amounts. Since 1973, the SEC has recognized the Financial Accounting Standards Board (FASB) as the US GAAP standards-setter. Its mission is to establish and improve financial accounting and reporting and to set accounting standards to provide decision-useful information to investors and other users of financial reports.

Management is also responsible for designing, implementing, and monitoring needed controls—often referred to as internal controls—to ensure that valid data go into the accounting system, that the system is secure, and that the information coming out of the system is reliable and in accordance with US GAAP.

In 1977, the Foreign Corrupt Practices Act (FCPA) reinforced the long-standing requirement for companies to have adequate internal controls that provide reasonable assurance regarding the reliability of financial reporting. The Sarbanes-Oxley Act of 2002 (SOX) significantly strengthened the FCPA by demanding that, among other things, managers of public companies evaluate and annually report on the effectiveness of their internal controls over financial reporting (ICFR), and this annual report has since become a staple of the US financial reporting system.

This emphasis on ICFR by management, investors, independent auditors, and regulators differentiates US capital markets from others around the world. Empirical testing has found that effective systems of internal control lead to significant improvements in the quality of information to the capital markets.[5]

WHO OVERSEES THE FINANCIAL REPORTS PROVIDED BY MANAGEMENT TO THE MARKETS?

Corporate governance—the system by which companies are directed and controlled—has always been essential in management's provision of information to external parties. It is an important qualifying factor for companies to list their securities on the national securities exchanges. Boards of directors, as elected by shareholders to represent them, are responsible for the governance of their companies.

Audit committees are one important component of the board of directors. Audit committee responsibilities include oversight of the financial reporting process. The NYSE endorsed the audit committee concept in 1939; however, it did not become an obligation until 1977, when the NYSE adopted a listing requirement for companies to have audit committees—and that independent directors comprise those committees. With the passage of SOX, regulatory requirements expanded and formalized the oversight roles and responsibilities of audit committees to encompass the appointment, compensation, retention, and regular communications with the independent external auditor.

Audit committees carry out these duties in concert with the board of directors; yet what is most important to emphasize from a monitoring perspective is that audit committees have year-round communication with management on financial reporting and ICFR-related matters. Audit committee members should be well informed by management and privy to internal managerial financial information, as they are required to review the financial information that is released to the public.

WHO OPINES ON FINANCIAL INFORMATION PROVIDED BY MANAGEMENT TO THE MARKETS?

Financial statement audits are performed by audit firms with teams of trained accountants who have expertise in both accounting and auditing standards and are independent of the companies they audit. To perform audits of companies with global operations, larger audit firms have formed international networks of or affiliations with audit firms in other countries, as accounting and auditing is a locally regulated profession and many countries have restrictions on cross-border ownership of audit firms.

Overview

With the passage of SOX in 2002, public company auditing moved from its long history in the U.S. as a self-regulated profession to a regulated one. SOX created the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies and adopt standards for auditing, quality control, ethics, independence, and other standards related to the preparation of company audit reports. Further, the PCAOB has the authority to conduct inspections of audit engagements and audit firm quality control systems.[6] The PCAOB also has the power to investigate and discipline auditors and/or accounting firms for violations of laws, rules, or

5 Many studies support the efficacy of the internal control provisions (Section 404) of SOX. For a synthesis of the academic literature on this topic, see S. K. Asare et al., "Auditors' Internal Control Over Financial Reporting Decisions: Analysis, Synthesis, and Research Directions," *Auditing: A Journal of Practice & Theory* 32, S 1 (2013): 131–66.

6 In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act extended PCAOB oversight to include the registration, inspection, standards-setting, and disciplinary authority over the auditors of broker–dealers registered with the SEC.

professional standards. In short, PCAOB oversight is designed to promote the preparation of informative, accurate, and independent audit reports filed with the SEC.

The means and manner of auditing has, of course, evolved over the past hundred years, based on the scope and nature of records; the scale of the businesses being audited; technology; and, in part, changes in the regulatory environment.[7] That said, fundamentally, transactions that underlie a set of financial statements can be broken into two general categories: those that happen many times a day and can be processed in a systematic fashion, and those that are less frequent and processed in a nonsystematic fashion.

Those transactions that fall into the former category include processes for sales and the collection of sales, purchasing and paying for goods and services, tracking inventory and fixed assets, and compensating employees. Financial accounting systems, oftentimes sophisticated and steeped in information technology, maintain records of these transactions, supported by automated checks and balances that reinforce the integrity of the data. However, management override of a process or a lack of proper controls could result in material misstatement of transactions processed systematically. The auditor tests the effectiveness of these financial accounting systems, particularly where repetitive transactions are recorded. The auditor uses technology to examine the propriety of the data in these systems and identify individual items or groups of items that, if left undetected, could result in a material misstatement of the financial statements, whether due to error or fraud.

Conversely, accounting transactions that fall into the nonsystematic category are often complex, involve subjectivity, and require significant estimates and judgments. As a result, nonsystematic transactions can also present a risk of material misstatement. Several factors influence this risk, including the efficacy of management's estimation process and the reliability and validity of the underlying data that management used; it is also possible that the process that management employs to analyze the data may be flawed. Just as crucially, the risk exists that management could improperly override one or more steps in the process. Any or all of these conditions have the potential to impact the quality of the estimate.

For example, from time to time companies are faced with complex environmental issues—matters that may have arisen 40 or 50 years ago but that are now just manifesting themselves. If, for example, a company finds itself responsible for tens of thousands of barrels of industrial waste that were buried and now are leaking into the water table that supplies a town, the company needs to understand and evaluate what it must do to remediate the situation. It must employ environmental engineers to evaluate the site and develop a plan for remediation. The company has to estimate the costs of this cleanup—costs that will likely continue for 30 to 40 years given the regulatory oversight that exists now and will continue to evolve. Management may have to hire attorneys to understand whether former owners of the site bear some responsibility, and then make its own judgment as to whether those former parties have both the ability and the willingness to pay. Ultimately, the company must record on its financial statements an estimated liability that considers all of these judgments.

As part of the audit, an auditor has a responsibility to evaluate the reasonableness of management's estimate. Procedures the auditor may employ would likely include analysis of data used by the company, as well as consideration of other information that may be relevant; evaluation of the work of the company's engineers, which often requires auditors to engage experts to assist them in this judgment;[8] assessment of the views of outside counsel as to who has responsibility for what; and evaluation of the period of time of forecasted remediation and the related costs, including subjecting the estimate to a sensitivity analysis of plausible alternative scenarios

7 One of the many changes introduced by SOX required auditors to opine, on an annual basis, on management's assessment of the effectiveness of ICFR for certain-sized companies. Audit methodologies were revised so that the financial statement audit and the ICFR audit could be integrated.

8 Auditors are sometimes faced with circumstances—especially when dealing with accounting estimates, such as hard-to-value financial assets and liabilities—that require them to enlist specialists who possess a particular expertise. The supervisory responsibility over the work of the specialists remains with the audit engagement team (see "Expertise" on page 9).

THE TWO CORNERSTONES OF AUDIT QUALITY

* Independence refers to external auditors' interests being independent of those of company management

as a test of reasonableness. This is not the work for a machine or an automated program; this complex and detailed work requires many different sets of information to be considered. It requires expertise and the exercise of a great deal of professional skepticism and judgment.

Before diving into two of the cornerstones of audit quality—expertise and independence—it is important to dispel one of the greatest fallacies around audits: that the adoption of rote technological solutions such as blockchain will eliminate the need for auditors. No technology can replicate human judgment, analysis, and skepticism. An audit requires judgments and expertise as well as an ability to rationally understand a complex set of facts. Simply put, often the most important items in financial statements are not those that are clearly defined and tangible; they are those that are quite fuzzy and intangible. In order to evaluate such complexities, auditors need to be involved in analyzing and evaluating the data and judgments to reach appropriate conclusions. Technology does not take the place of the auditor; it simply better informs auditors and allows them to focus on the truly high-risk and complex areas of a company's financial statements. The proliferation of big data is not a boon because these data can automate an audit; it is a boon because, if that data are reliable, they allow auditors to obtain more evidence quickly and to better focus on transactions that pose more risk.

Expertise and Independence

As noted earlier, the value of obtaining third-party assurance on the information presented by management was recognized long before the exchanges or regulators required such assurance. Many factors lead to a quality audit, but it is the combination of auditor expertise and independence that bolsters the level of trust and confidence in company financial statements and forms the basis of audit quality—and, thus, value to capital markets.

Expertise

The audit of a company's financial statements requires capability in a wide range of areas. First and foremost is proficiency in accounting standards; such expertise allows auditors to fully evaluate whether the financial statements prepared by management are in accordance with GAAP.

Accounting is a state-licensed profession; its practitioners possess very specific skills that are assessed via a uniform proficiency examination, the successful passing of which determines who can become a CPA. Further, CPAs must meet their state's continuing professional education requirements to maintain their license. Examples of developments on which auditors may need to keep current include those related to accounting and auditing standards (such as new standards); SEC and PCAOB rules and regulations; ethical requirements; technology and technological innovations in accounting and auditing, such as data analytics and machine learning; cybersecurity; financial instruments, such as derivatives; new intangible assets, such as cryptocurrencies; and types of market transactions, such as special purpose acquisition companies (SPACs); and the list goes on.

Many types of complex accounting transactions often involve estimates with varying levels of uncertainty. As such, GAAP itself is very voluminous and often complex. In developing the accounting estimates necessary for GAAP financial reporting, management may use models, methods, data, and assumptions that entail a good deal of subjectivity and judgment. Auditors are likewise required to grasp the methods, assumptions, and data that management uses. At the same time, auditors must gain an understanding of the relevant controls that were present to ensure that all of these methods, assumptions, and data had been thoughtfully and carefully derived. This understanding informs the auditor's risk assessment and determines those audit procedures best suited for responding to the risks and obtaining sufficient appropriate evidence. And that evidence serves as the basis for the auditor's conclusions.

Public company auditors are also required to be experts in the auditing standards, which have been promulgated by the PCAOB since its creation in 2002. Audit firms have detailed audit methodologies that describe the processes and procedures that their audit teams are required to follow, so that there is a consistent application of the standards across engagements. Firm methodologies take a global perspective for audits of multinational corporations. As such, to provide a quality audit, firm methodologies take into account the highest common denominator between US standards of the PCAOB and the international auditing standards promulgated by the International Auditing and Assurance Standards Board (IAASB), which are used outside of the U.S. Firm audit methodologies are also subject to continuous review and improvement. As new or revised standards are implemented by the PCAOB and IAASB, audit firms update their methodologies to comply with the standards worldwide; firms will likewise revise their methodologies to address deficiencies that are identified in PCAOB inspections or as part of internal monitoring processes.

Audits involve more than accounting and auditing proficiency, and PCAOB auditing standards recognize this need for additional expertise. PCAOB auditing standards define as specialists those who possess a specialized skill or knowledge in a field other than accounting or auditing that is needed to support an audit. In multidisciplinary audit firms, specialists can reside in the tax or advisory services in addition to the audit and assurance line of business. Auditing standards also allow that specialists can be contracted by the audit firm—that is, they do not need to be employed by the audit firm, which is especially helpful for smaller audit firms. In all cases, auditing standards provide that the supervisory responsibility over the work of the specialist remains with the audit team.

Auditing skills do not only extend to financial statements. In addition to the requirement for management to assess and report on the effectiveness of the company's ICFR, SOX introduced a requirement for the financial statement auditor to also opine, on an annual basis, on management's assessment of ICFR.[9] Most audit firms revised their audit methodologies so that the financial statement audit and the ICFR audit could be integrated. The ICFR audit follows a top-down, risk-based approach that considers the entire system of ICFR but places greater attention on those controls that are most susceptible to material misstatement of the financial

9 Under SEC rules, this requirement applies to all public companies other than non-accelerated filers with public float of less than $75 million, or smaller reporting companies with public float between $75 million and $700 million and annual revenues of less than $100 million.

statements. It takes a great deal of experience to evaluate a control to determine that it adequately addresses the risk of material misstatement.

Because of all the complexities inherent in GAAP, audit firms often encourage their employees at all levels to develop expertise in certain areas of accounting or auditing. To illustrate, audit firm personnel can focus on areas of GAAP such as revenue recognition, lease accounting, fair value accounting, accounting for derivatives and hedging transactions, and so on. Because some industries, such as banking, insurance, and utilities, have unique accounting and auditing considerations, audit firm personnel can develop expertise along industry lines.

An industry focus can also extend to the audit firm. Many firms specialize in multiple industries with audit teams that have developed an in-depth understanding of the business processes, the range of accounting transactions, and the regulatory environment that may be unique to certain sectors. This expertise is vital to the execution of high-quality audits, especially in complex industries and accounting areas. Industry specialization improves an auditor's ability to assess audit risk and the risk of material misstatement. Audit firms that have developed industry expertise are often viewed as having a market advantage over those that do not possess such highly honed skills.

Independence

Auditor independence is one of the cornerstones of the profession and undergirds audit quality. It is critical that the interests of the external auditor who is providing reasonable assurance over the financial statements are independent of the company in both fact and appearance. It is foundational to external auditing and transcends any particular regulatory regime; arguably, it is the most important factor in establishing the credibility of the audit opinion.

At its most basic level, independence requires that the auditor not have any financial, business, or employment relationships with the company being audited. SEC rules preclude relationships or services that create a mutual or conflicting interest between the auditor and the audited company, that place the auditor in the position of auditing his or her own work, that result in the auditor acting as management or as an employee of the audited company, or that place the auditor in a position of being an advocate for management. There are certain non-audit services that the auditor is expressly not allowed to furnish to audit clients. These include internal audit outsourcing services, financial information systems design and implementation, management and human resources functions, and bookkeeping. Auditors cannot provide audit clients with actuarial, appraisal, broker–dealer or other investment adviser services, nor can they provide legal services.

In addition, the PCAOB has auditor independence rules that apply, such as prohibiting contingent fee arrangements that may be associated with tax services, whereby the client pays a fee only if a specific finding or result is attained.[10] Auditors of public companies must affirm compliance with SEC and PCAOB independence rules to audit committees and in the annual audit report (i.e., the audit opinion).

Aside from regulatory requirements on auditor independence, other significant safeguards, including market-driven incentives, further fortify the independent mindset of auditors.[11] An independent mindset is important in driving audit quality and in satisfying the requirement for auditors to exercise due professional care in planning and performing the audit under auditing standards. Professional skepticism is a key component of due professional care, which involves a questioning mindset and a critical assessment of audit evidence. What are these safeguards that further incentivize audit firms and individual auditors to keep an independent mindset and perform high-quality audits?

- First is oversight of the external auditor by the **audit committee** of the company's board of directors. As noted above, SOX stipulates that the audit committee has responsibility for the

10 Professional organizations, such as the American Institute of CPAs, state CPA societies, state boards of accountancy, and federal and state agencies, along with foreign jurisdictions around the world, also have auditor independence standards and rules for CPAs providing third-party assurance services under their purview.

11 See M. Nelson, "A Model and Literature Review of Professional Skepticism in Auditing," *Auditing: A Journal of Practice & Theory* 28, no. 2 (2009): 1–34.

appointment, compensation, retention, and oversight of the company's independent external auditor and must preapprove all non-audit and audit services provided. It is important to stress that the audit committee is responsible for the level of fees (i.e., compensation) paid to the independent auditor.

+ **Reputation risk** is the risk of damage to an audit firm's or an individual auditor's reputation. An impaired reputation impedes an audit firm's ability to attract and retain clients as well as personnel, and it hurts the audit firm's bottom line. For an individual auditor, a damaged reputation can hurt both advancement opportunities and job prospects.

+ **Litigation risk** exposes auditors to potential financial penalties, which are often significant. In the U.S., there are also rigorous private litigation mechanisms, such as the ability to bring class action lawsuits against an audit firm.

+ **Regulatory risk** is the threat of new regulation or other regulatory interventions that subject auditors to sanctions, which include fines, debarment brought by the SEC and/or the PCAOB, and, in some instances, criminal charges brought by the Department of Justice.

Independence is not just a compliance exercise; rather, it is an appropriate mindset that is critical to the success and reputation of audit firms. The above forces provide strong incentives for auditors to have an independent mindset, yet they are often overlooked in public policy debates and news stories discussing auditor independence. Overlooking such strong market-based incentives (e.g., reputation, litigation, regulatory incentives) can lead to unsupported predictions in those public policy proposals that advocate for a change to the existing auditor engagement model in the U.S., where the company pays the fees—as negotiated and overseen by the audit committee of the company—of the auditor (referred to as the auditor pay model). Any analysis of a public policy proposal not taking into consideration the impact of these strong safeguards and market incentives is at least incomplete—and most likely misleading—in prediction.

Balancing Expertise and Independence

From time to time, there have been calls to implement more stringent requirements on auditor independence. Below we discuss the pitfalls of some of these public policy proposals and the resulting tradeoffs between expertise and independence.

First, the most stringent proposals to ensure audit independence call for a model similar to that of the IRS audits of tax returns (i.e., a regulatory/governmental agency). Under these proposals, audits would be performed by an agency that is not paid by the companies being audited. This approach is supposed to address any threat to auditor independence posed by the auditor pay model. What such a proposal fails to acknowledge is that pushing auditor independence requirements to the extreme would also lead to a decrease in expertise. A regulatory agency is unlikely to possess the resources needed to stay completely up to date with the newest technology and audit methodology or have access to specialists, and could face challenges auditing components in non-US jurisdictions, at a minimum. Although this model may strengthen auditor independence, it could significantly reduce the expertise needed to perform a quality audit and obtain reasonable assurance on a company's financial statements and ICFR.

Second, there have been proposals calling for banning all non-audit services provided by the external auditor, under the premise that non-audit services threaten auditor independence. However, such a premise is inconsistent with the academic evidence, which suggests non-audit services provided by the auditor may create "knowledge spillovers" that actually *increase* audit quality.[12] In particular, tax-related non-audit services are associated with higher audit quality (e.g., fewer restatements, less earnings management, more accurate going-concern opinions, and more accurate tax reserves). If the benefits of improved expertise outweigh the costs of reduced independence, then banning non-audit services may reduce audit quality and efficiency.

Third, some countries have adopted mandatory firm rotation to reduce auditor tenure, based on the premise that the longer an auditor performs audit services for a company, the more likely the auditor becomes "captured" by the company and thus less independent. However, academic research suggests that long tenures actually improve audit quality.[13] Although long tenures may be perceived to breed a familiarity that threatens auditor independence, they also increase client-specific knowledge. It should be noted that, in the U.S., SOX requires that the individual audit partner within the audit firm primarily responsible for the audit on a company's financial statements (often referred to as the lead engagement partner) and the concurring review partner must rotate off of the audit every five years.[14] The audit committee of the company is often heavily involved in the selection of the new engagement partner.

In summary, no conclusive evidence attests that the auditor pay model, non-audit services provided by the auditor, or a long audit tenure in fact impair auditor independence and thus audit quality. What

12 A large majority of academic studies using measures of audit quality based on attributes of audited financial statements finds no evidence that non-audit services impair audit quality. See T. B. Bell, M. Causholli, and W. R. Knechel, "Audit Firm Tenure, Non-Audit Services, and Internal Assessments of Audit Quality," *Journal of Accounting Research* 53, no. 3 (2015): 461–509, which includes a synthesis of published studies dealing with both tenure and non-audit services and direct empirical testing of both topics using refined methodologies. Within the literature that examines investors' perceptions, certain studies indicate that investors perceive non-audit services as impairing quality; see J. L. Higgs and T. R. Skantz, "Audit and Nonaudit Fees and the Market's Reaction to Earnings Announcements," *Auditing: A Journal of Practice and Theory* 25, no. 1 (2006): 1–26. However, such perceptions are not consistent within the collective evidence from research based on measures of actual audit quality.

13 There is a large body of academic literature on this topic. As examples, see J. V. Carcello and A. L. Nagy, "Audit Firm Tenure and Fraudulent Financial Reporting," *Auditing: A Journal of Practice & Theory* 23, no. 2 (2004): 55–69; and C. Y. Chen, C. J. Lin, and Y. C. Lin, "Audit Partner Tenure, Audit Firm Tenure, and Discretionary Accruals: Does Long Auditor Tenure Impair Earnings Quality?," *Contemporary Accounting Research* 25, no. 2 (2008): 415–45.

14 There are also rotation requirements for certain other partners who serve on an audit, such that they must rotate off an engagement after seven years.

previous public policy proposals advocating to change the US auditor pay model typically omit is an underappreciated fact that there is often a tradeoff between auditor expertise and independence. Attempts at increasing independence requirements may lead to reducing expertise, and result in a decrease in audit quality.

Moreover, such proposals ignore the strong market-based incentives (e.g., reputation, litigation and regulatory incentives) for auditors to have an independent mindset. These incentives are powerful motivators for auditors to perform a high-quality audit, applying their expertise, objectivity, integrity, and professional skepticism. The implication for public policy is that a single-minded focus on merely increasing auditor independence requirements, while ignoring both the market-based independence incentives and the potential negative impact on auditors' expertise, may not generate the expected effect.

Rather, it is the expertise together with independence of the public company auditor that make up the essential components for the value of the audit and audit quality. Both expertise and independence are necessary, and neither is sufficient. Having an independent third party with the relevant expertise to opine on the financial statements prepared by company management has long been a pillar that provides confidence in the information being reported.

The portability of the independent audit construct to certain information other than GAAP financial statements and ICFR

SIGNIFICANT GROWTH OF COMPANY-REPORTED INFORMATION OUTSIDE OF HISTORICAL FINANCIAL STATEMENTS

The discussion above relates to information in the form of GAAP financial statements and the effectiveness of ICFR. Yet, increasingly, public companies are providing other information that investors and other financial statement users are asking for, and relying on, in evaluating a company and making investment and capital allocation decisions. This other information may consist of other financial information, such as non-GAAP measures, key performance indicators (KPIs), or nontraditional financial and other similar information relating to a company's environmental, social, and governance (ESG) data.

Non-GAAP Measures and KPIs

Though based on GAAP information, non-GAAP financial measures are numerical metrics of a company's historical or future financial performance, financial position, or cashflows. They adjust GAAP amounts in some fashion, and these measures are intended to supplement the company's GAAP disclosures. Some of the more common non-GAAP financial measures include adjusted earnings, adjusted earnings per share, and EBITDA or Adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization). Free cashflow is another frequent non-GAAP financial measure that companies present. KPIs, however, are metrics that are typically company or industry specific. These data points provide insights into the tools a company deems important to monitor its overall health. Examples of KPIs include number of stores, number of customers, or measures that are calculated using a GAAP amount and a data point, such as sales per square foot and same store sales.

Companies often furnish non-GAAP financial measures and KPIs because they provide the opportunity to portray other elements of the company's performance, including how management internally evaluates its performance. Importantly, such measures may also be used to determine executive compensation. In addition, investment analysts consider these different measures to better understand the company's underlying business performance or to forecast the company's long-term value in the analysts' proprietary models. As such, non-GAAP measures and KPIs can offer useful information to investors and other stakeholders, particularly as these measures are often compared with those of other companies in the same industry.

ESG

Another important set of information that companies are increasingly disclosing is environmental, social, and governance (ESG) information. The "*E*," or environmental component, could include how a company is exposed to and manages risks and opportunities related to climate change, natural resource scarcity, pollution, waste, and other environmental factors. The "*S*," or social component, may include information about the company's employee health and safety, product quality and safety, and diversity and inclusion policies and efforts. The "*G*," or governance component, incorporates information about a company's corporate governance, such as the structure and diversity of the board of directors as well as policies on lobbying and political contributions.

In recent years, ESG information has become increasingly important to investors.[15] Investors focus on ESG information because they find such information helpful in understanding a company's long-term value creation story, and the information enables them to manage their investments based on ESG risks. Other stakeholders, such as customers and suppliers, may also base their decisions to buy a product on the company's sustainability practices. Moreover, credit-rating agencies, such as Fitch, Moody's, and S&P, incorporate ESG factors into their calculations. In addition, many proxy advisers, such as ISS and Glass Lewis, incorporate ESG information into ratings and voting recommendations. The wide range of users of ESG information demonstrates the growing importance of its availability. The global COVID-19 pandemic has further accelerated the interest in company-reported ESG information, bringing to the forefront social issues such as occupational health and safety, worker protection, and supply chain issues. In the U.S in 2020, $51.1 billion flowed into ESG-rated funds and accounted for more than 25 percent of all money invested, according to a Morningstar report.[16]

THE SUCCESS OF THE FINANCIAL STATEMENT AUDIT AND ICFR REGIME: IMPLICATIONS FOR OTHER COMPANY-REPORTED INFORMATION

Non-GAAP financial measures, KPIs, and ESG disclosures are not subject to the same independent auditor review as the company financial statements or ICFR. That is not to say that the independent auditor is able to turn a blind eye to such information. For example, if the information is contained in SEC filings that include a set of financial statements, the independent auditor is responsible for reading and considering the information in order to understand whether it is inconsistent with the information disclosed in the financial statements or represents a material misstatement of fact. But it is clearly the case that investors and market participants are making capital allocation and similar decisions based on information that has not benefited from the financial reporting framework—including the expertise, independence, and level of trust and assurance provided by the public company auditor.

As demonstrated in this paper, our capital markets operate on information, and the reliability of that information is enhanced by having the imprimatur of the auditor—an independent and expert third party—attached to it. This has been the case for audited financial statements for well over 100 years, and for ICFR beginning in 2004 when SOX required an auditor attestation on an annual basis of management's assessment of ICFR effectiveness for certain sized companies. Given that financial restatements are at an all-time low in the United States,[17] independent auditor involvement—combined with the involvement of the other key

15 Major investment corporations such as BlackRock and State Street have stressed the importance of company ESG information and sustainable investment options. The reallocation of capital into sustainable assets between January and November of 2020 resulted in investments of $288 billion globally, a 96 percent increase over all of 2019; see Larry Fink's 2021 letter to CEOs.

16 Morningstar, *Sustainable Funds U.S. Landscape Report*, February 10, 2021.

17 Audit Analytics, *2019 Financial Restatements: A* Nineteen Year *Comparison*, July 2020, http://auditanalytics-2019restatementreport-j.pagedemo.co/.

stakeholders in the financial reporting system (e.g., audit committees)—has a track record of producing high-quality, consistent, and reliable financial reports.

What makes public company auditors a viable option for companies, audit committees, investors, and other stakeholders seeking assurance on the reliability of other company-reported information, such as ESG information, non-GAAP financial measures, and KPI disclosures?[18] The answer is simple.

Regulated Profession. Through its standards-setting, inspections, and enforcement powers, the PCAOB oversees the public company audit profession. Further, the SEC and the PCAOB establish—and enforce—quality control and independence requirements for auditors. Audit firms must maintain a system of quality control designed to provide them with confidence that their auditors complied with professional standards and that reports issued by the public company auditor are appropriate.

Expertise. Through experience gained from financial statement and ICFR audits, auditors are already skilled in gaining an understanding of a company, its business cycles and processes, and how it creates value. They are steeped in standards-based analysis—a skill that is transferable to other standards and frameworks. Auditors must adhere to high ethical standards and uphold continuing professional education and experience requirements, including specialized training.

Independence. In addition to the rigorous independence standards set by the SEC and PCAOB, including criteria requiring the exercise of professional skepticism and due professional care, other significant safeguards and market-driven incentives—including litigation, reputational, and regulatory risk—further strengthen the independent mindset of auditors.

Access to Specialists. To the extent auditors need to engage a specialist in areas requiring differing skillsets or knowledge (e.g., evaluation of greenhouse gas emissions or carbon footprints), they have the ability to do so, whether within their firms or outside—and, importantly, there are standards to regulate the use of specialists in the assurance engagement.

The long tradition of providing financial statement, then ICFR, audits by independent and expert professionals supports the value of having audit firms provide assurance to other information like ESG to enhance users' confidence in it. Reinforcing this value is the multidisciplinary audit firm model itself with its tradition of building and deploying specialized expertise to meet the needs of the market.

18 Assurance on company reported ESG information in particular is happening and expanding. CAQ analysis of the most recent ESG disclosures for S&P 100 companies through March 12, 2021, revealed that 80 companies had some level of assurance/verification. The Governance & Accountability Institute, Inc.'s *2020 Flash Report S&P 500,* reported that 29 percent of the S&P 500 subjected some or all of their ESG information to some sort of third-party assurance, whether via certification services from engineering and consulting firms or, to a lesser extent, by an independent audit firm.

Conclusion

Our capital markets are an important engine for progress and maintenance of our economic and societal well-being. Capital markets connect investors to a multitude of companies and supply them with capital. The information that fuels these markets must be reliable. Third-party assurance of company-provided information benefits all stakeholders— investors, lenders, regulators, and others—because of the information asymmetry between stakeholders and company management. This indispensable element, this crucial process of checks and balances, ensures that the engine of our capital markets keeps humming.

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