

Audit Quality, Investor Protection, and the Public Interest

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- ❑ The views I express today are mine alone, and do not necessarily reflect the views of the Board, other Board Members, or PCAOB staff.

PCAOB Mission

- ❑ The PCAOB mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.
- ❑ The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

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PCAOB Responsibilities

- ❑ **Register** public accounting firms that audit issuers or broker-dealers;
- ❑ Establish auditing, independence, ethics, and quality control **standards** for registered public accounting firms;
- ❑ Conduct and report on regular **inspections** of registered public accounting firms that audit issuers or broker-dealers; and
- ❑ Conduct **investigations and disciplinary proceedings** in cases where registered public accounting firms or persons associated with those firms may have violated provisions of the Sarbanes-Oxley Act, the rules of the PCAOB and the SEC, and other laws, rules, and standards for audits of issuers, brokers, and dealers.

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Registered Firms



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Registered Firms

PCAOB Registered Firms & Number of Issuer Audit Opinion in 2012

Firms Issuance of Audit Reports	U.S.	Non-U.S	Total
Firms that issued no issuer audit reports	999	716	1,715
Firms that issued audit reports for 1-5 issuers	265	144	409
Firms that issued audit reports for 6-10 issuers	66	25	91
Firms that issued audit reports for 11-25 issuers	62	19	81
Firms that issued audit reports for 26-50 issuers	36	4	40
Firms that issued audit reports for 51-100 issuers	15	3	18
Firms that issued audit reports for >100 issuers	9	0	9
Totals	1,452	911	2,363

- Of all the registered firms as of December 31, 2012, approximately 750 report that they audit issuers and another 90 report that they play a only substantial role in auditing issuers.
- Another 783 firms issued audit reports for brokers and dealers, including about 480 that report auditing brokers and dealers but no issuers.
- Approximately 853 registered firms (507 foreign and 346 U.S. firms) report that they perform no audit work for issuers or brokers and dealers and do not play a substantial role in auditing issuers.



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Firms that Audit Brokers and Dealers

Number of Audits per Firm	Number of Firms	Percentage of Firms
1	363	46%
2 to 5	293	37%
6 to 50	113	15%
51 to 100	8	1%
More than 100	6	1%
Total	783	100%

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Inspections

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Inspections Conducted

	2010	2011	2012	2013
Issuer Firm Inspections				
Domestic Annual	9	10	9	9
Domestic Triennial	181	161	167	166
Foreign Triennial	64	42	77	54
Total Issuer Firm Inspections	254	213	253	229
Brokers-Dealer Firm Inspections		20	43	60

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PCAOB Inspections: Common Findings

□ Common Audit Deficiency Areas (Part I)

- Revenue (Multiple Areas)
- Auditing Management Estimates
- Auditing Fair Value Measurements and Disclosures
- Testing and Evaluating Internal Controls
- Related Party Transactions
- Inventory
- Fraud Risk
- Equity Financing Instruments

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PCAOB Inspections: Common Findings

□ Common Audit Firm Quality Control Deficiency Areas (Part II)

- Management Structure and Processes (e.g., Tone at the Top);
- Partner Management
- Client Acceptance Policies and Procedures
- Monitoring Quality and Performance
- Independence
- Expertise, Skepticism, and Other Systemic Issues

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Inspection Results - Domestic Small Firms

- Issued "Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies" on February 25, 2013 ("2010 report")
- Previously issued "Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms" on October 22, 2007 ("2007 report")
- Comparison of the two reports shows reduced levels of reported significant audit performance deficiencies (Part I):
 - 61 percent of **firms** in 2007 report compared to 44 percent in 2010 report
 - 36 percent of **audits** in 2007 report compared to 28 percent in 2010 report
 - 55 percent of firms in first inspection compared to 36 percent in second inspection (for firms with second inspection in 2010 report)

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Inspections Big Four Firms: 2012 Reports (Issued in 2013)

Firm	Issuer Audits Inspected	Issuers with Part I Deficiencies	Percentage of Audits Inspected with Part I Deficiencies
Deloitte	52	13	25%
E&Y	52	25	48%
KPMG	50	17	34%
PwC	54	21	39%
Total	208	76	37%

Inspections Big Four Firms: 2011 Reports (Issued in 2012)

Firm	Issuer Audits Inspected	Issuers with Part I Deficiencies	Percentage of Audits Inspected with Part I Deficiencies
Deloitte	53	22	42%
E&Y	56	20	36%
KPMG	53	12	23%
PwC	63	26	41%
Total	225	80	36%

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Potential Root Causes

Potential root causes contributing to audit deficiencies:

- Due professional care, including professional skepticism
- Technical competence
- Partner and professional staff work load
- Client acceptance and continuance
- Engagement quality control review

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Standards

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PCAOB Audit Standards Agenda

- **Recently Adopted**
 - Communications with Audit Committees
 - Audits and Attestations of SEC-registered Brokers and Dealers
- **Proposed Standards**
 - Auditor's Reporting Model (Aug 13, 2013)
 - Related Parties and Significant Unusual Transactions (May 7, 2013)
 - Framework for Reorganization of PCAOB Auditing Standards (March 26, 2013)
 - Audit Transparency (Oct. 11, 2011)
- **Other Active Projects- Oct. to March 2014**
 - Auditors' responsibilities with respect to Other Accounting Firms, Individual Accountants, and Specialists (proposal)
 - Going Concern (proposal)

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PCAOB Audit Standards Agenda

□ Other Active Projects – Timing To Be Determined

- Quality control standards, including assignment and documentation of firm supervisory responsibilities
- Auditing accounting estimates, including fair value measurements and related disclosures
- Confirmations
- Subsequent events

□ Concept Releases

- Auditor Independence, Objectivity, and Professional Skepticism

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Auditor's Reporting Model and Auditor's Responsibilities Regarding Other Information

□ On August 13, 2013, the PCAOB issued two proposals:

- *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which would supersede portions of AU sec. 508, *Reports on Audited Financial Statements*
- *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, which would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*

□ The proposed auditor reporting standard is intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report.

□ The proposed other information standard is intended to improve the auditor's procedures and to enhance the auditor's responsibilities with respect to other information.

□ Comment period through Dec. 11, 2013

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Auditor's Reporting Model

- ❑ The Board's proposed auditor reporting standard would retain the pass/fail model and the basic elements of the current auditor's report, but would require the auditor to communicate a wider range of information specific to the particular audit.
- ❑ The proposed standard would require:
 - Communication of critical audit matters that would be specific to each audit
 - Addition of new elements to the auditor's report related to –
 - Auditor independence
 - Auditor tenure
 - Auditor's responsibility regarding other information that is included in documents containing the audited financial statements and the related auditor's report
 - Enhancements to existing language in the auditor's report related to the auditor's responsibility for fraud and notes to the financial statements

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Critical Audit Matters

- ❑ Critical audit matters are those matters addressed during the audit that:
 - Involved the most difficult, subjective, or complex auditor judgments;
 - Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
 - Posed the most difficulty to the auditor in forming the opinion on the financial statements.
- ❑ Critical audit matters ordinarily are matters of such importance that they are required to be:
 - Documented in the engagement completion document, which summarizes the significant issues and findings from the audit;
 - Reviewed by the engagement quality reviewer;
 - Communicated to the audit committee; or
 - Any combination of the three.
- ❑ The proposed standard provides a list of factors the auditor should take into account to determine critical audit matters.

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Auditor's Responsibilities Regarding Other Information

- ❑ The proposed other information standard, among other things, would:
 - Apply the auditor's responsibility for other information specifically to annual reports filed with the SEC under the Securities Exchange Act of 1934 that contain the audited financial statements and related auditor's report;
 - Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;
 - Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements; and
 - Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

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Investigations and Enforcement

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Investigative Authority

- The PCAOB may investigate possible violations by registered public accounting firms or their associated persons of:
 - Any relevant provision of the Sarbanes-Oxley Act
 - The rules of the Board
 - The provisions of the securities laws relating to the preparation and issuance of audit reports
 - Professional standards

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Common Types of Investigations

- Violations of professional standards
 - Audit failures: *e.g.*, failure to obtain sufficient audit evidence, exercise due care and professional skepticism (ignored red flags)
 - Failure of firm quality control procedure to operate effectively
- Independence violations
- Failure to cooperate with an inspection or investigation

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Settled and Adjudicated Disciplinary Proceedings

- ❑ To date the Board has settled or completed adjudication on over 40 disciplinary orders
- ❑ These orders have resulted in the following sanctions:
 - Bars (Firms and auditors)
 - Suspensions
 - Censures
 - Civil money penalties

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Other Initiatives and Priorities

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Staff Audit Practice Alert No. 10 – *Maintaining and Applying Professional Skepticism in Audits*

- ❑ Practice Alert No. 10 was issued on December 4, 2012.
- ❑ PCAOB oversight activities continue to raise concerns about whether some auditors consistently and diligently apply professional skepticism.
- ❑ Reminds auditors of the critical importance of professional skepticism to effective audits.
- ❑ Describes potential impediments to professional skepticism.
- ❑ Describes steps that audit firms, engagement partners and auditors can take to enhance professional skepticism in audits.

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Audit Quality Indicator Project (AQI)

- ❑ Inform PCAOB regulatory processes and policy-making with additional insight into audit quality
- ❑ Possibly provide audit committees, investors, management, audit firms, other regulators, or the public with AQIs
- ❑ Provide firms with additional incentives to compete based on audit quality
- ❑ Next milestone: concept release around year-end

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AQIs - Examples

Inputs	Processes	Results
<ul style="list-style-type: none"> • Staffing leverage • Partner workload • Staff utilization • Industry expertise • Outsourcing to service centers 	<ul style="list-style-type: none"> • Tone at the top: survey of firm personnel • Audit firm internal quality review results • PCAOB inspection results • Senior personnel compensation rewards for audit quality 	<ul style="list-style-type: none"> • Frequency and impact of financial statement restatement for errors • Timely reporting of internal control weaknesses • Reasonable warning of going concern • Material frauds discovered and reported • Trends in Board and SEC enforcement proceedings

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AQIs - Potential Users

Customer	Benefits
Audit Committees	<ul style="list-style-type: none"> • Demonstrate due diligence • Assess risk and audit quality • Retain and compensate auditors
Investors	<ul style="list-style-type: none"> • Assess risk • Proxy voting
Audit Firms	<ul style="list-style-type: none"> • Assess risk • Monitor audit quality • Facilitate root cause analysis to improve remediation efforts
PCAOB	<ul style="list-style-type: none"> • Inform policy making • Assist root cause and quality control projects • Stimulate public discussion of and market demand for quality

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Fraud Task Force

Phase one: summarizing existing research regarding:

1. The economic consequences of fraud
2. The effectiveness of audits in detecting fraud
 - risk assessments and identifying "red flags"
 - Impediments to fraud detection
 - Auditor responses and actions
3. Potential mechanisms to improve the effectiveness of audits in detecting fraud

Phase two: focus on recommendations for specific actions (informed by phase one)

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Center for Economic Analysis

Nov. 6, 2013 – PCAOB announced the establishment of a Center for Economic Analysis, which will

- study the role and relevance of the audit in capital formation and investor protection.
- advise on the use of economic theory, analysis, and tools to enhance the effectiveness of PCAOB program areas, including standard setting, inspections and other oversight activities.
- promote and encourage economic research in the academic community relating to the role of the audit in capital formation and investor protection.

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Center for Economic Analysis (cont.)

- ❑ The Center will host a conference on economic research relating to the role of the audit in the capital markets in 2014. It will issue a call for research papers and provide more conference details in the near term.
- ❑ The Center is expected to begin operations in early 2014.
- ❑ founding director, Luigi Zingales, University of Chicago Booth School of Business.

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The Board's Near-Term Priorities for 2013

- Improving the timeliness, content and readability of inspection reports;
- Improving the timeliness of remediation determinations and providing additional information about the PCAOB's remediation process;
- Initiating a project to identify audit quality measures, tracking such measures, reporting collective measures over time;
- Enhancing the PCAOB's processes and systems to improve analysis and usefulness of PCAOB inspections findings, including comparative analysis across firms and over time, to better understand audit quality in firms and better inform the PCAOB's standard-setting and other regulatory activities;

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The Board's Near-Term Priorities for 2013 (cont.)

- Enhancing the framework for the PCAOB's standard-setting process in order to improve the effectiveness of the process as well as the standard-setting project tracking information provided to investors and the public; and
- Enhancing PCAOB's outreach to and interaction with audit committees to constructively engage in areas of mutual interest, including auditor independence and audit quality.

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