

PCAOB Concept Release on Auditor Independence and Audit Firm Rotation

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Caveat

- ❑ The views expressed are our own views and do not necessarily reflect the views of the Board, individual Board members, or the staff of the PCAOB.

Overview of the Concept Release

- ❑ In August 2011, the Board issued PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation*.
 - The concept release sought to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced, including through consideration of auditor term limits.
- ❑ Independence, objectivity and professional skepticism are critical to the viability of the auditing profession.
 - The concept release notes that auditor independence, objectivity and professional skepticism remain subject to a significant inherent risk in that accounting firms are paid by the companies being audited.
 - The concept release also notes that there may be risks in both the relatively new audit that the auditor may hope to turn into a long-term engagement, as well as the very long engagement that no partner wants to be the one to lose.

Overview of the Concept Release (cont.)

- ❑ SOX included a number of significant provisions designed to bolster the auditor's independence:
 - Audit committee oversight.
 - Further limitations on non-audit services.
 - Partner rotation requirements.
 - PCAOB oversight.
- ❑ Congress also considered audit firm rotation during the debates that led to the Act.
 - Decided that the idea required more study and directed the General Accounting Office to prepare a report.
- ❑ Although SOX has made a significant, positive difference to audit quality the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.

The Board's Oversight Activities – Inspection Observations

“[The inspection results] suggest that the audit partners and senior managers [of the inspected firm] may have a bias toward accepting management's perspective, rather than developing an independent view or challenging management's conclusions.”

“In a number of engagements, the [f]irm's support for significant areas of the audit consisted of management's views or the results of inquiries of management. The lack of professional skepticism appears to stem from the [f]irm's culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence.”

“The deficiencies identified by the inspection team suggest that [the inspected firm's] engagement teams may be placing too much reliance on management's responses to the teams' inquiries and not sufficiently challenging or evaluating management's assumptions, and that they may not be applying an appropriate level of professional skepticism in subjective areas susceptible to management bias.”

The Board's Oversight Activities – Disciplinary Order

Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA

- ❑ The Board found, among other things, that certain of the firm's audit partners accepted the company's reliance on an exception to GAAP for reserving for expected future product returns even though doing so conflicted with the plain language of the exception and the firm's internal accounting literature.
- ❑ The partners were aware of, but did not appropriately consider, contradictory audit evidence indicating that the returns were not eligible for the exception.
- ❑ This illustration of a lack of professional skepticism reappeared in the firm's response when the issue was questioned by the firm's internal audit quality reviewers. Although certain of the partners involved determined that the company's reliance on the exception to GAAP did not support the company's accounting, they, along with other firm personnel, formulated another equally deficient rationale that supported the company's existing accounting result.

Inspection Findings – International Regulators

- The PCAOB is not alone in identifying concerns regarding professional skepticism:
 - Regulators in countries such as Australia, Canada, Germany, the Netherlands, Singapore, Switzerland and the United Kingdom have cited concerns about professional skepticism in public reports on their inspections.

"Insufficient Professional Skepticism ... is undoubtedly the most common finding — that auditors are too often accepting or attempting to validate management evidence and representations without sufficient challenge and independent corroboration."

(Source: Compilation of inspection results from Canada, the U.S., the U.K. and Australia, prepared by the Canadian Public Accountability Board)

PCAOB Outreach Activities

- ❑ Discussions with the Board's Standing Advisory Group and Investor Advisory Group.
- ❑ More than 680 comment letters received.
- ❑ Three public meetings held:
 - Washington, DC – March 21-22, 2012.
 - San Francisco – June 28, 2012.
 - Houston, TX – October 18, 2012.

Views on Auditor Independence and the Sufficiency of SOX Reforms

- ❑ Commenters generally recognize the fundamental importance of auditor independence in underpinning confidence in the auditing profession.
 - More than two-thirds of the comment letters and almost all panelists at public meetings have expressed support for the Board's interest in ensuring or enhancing the auditor's independence, objectivity and professional skepticism.
- ❑ Many agree that SOX made a significant difference to audit quality, pointing specifically to changes such as PCAOB oversight and partner rotation requirements.
- ❑ Many panelists agreed with Joe Echevarria, CEO of Deloitte LLP at the public meeting in Washington:
 - “The status quo is not an option.”

Views on Auditor Independence and the Sufficiency of SOX Reforms (cont.)

- ❑ Most auditors, issuers and audit committee chairs asserted that the SOX reforms represent a sound basis for safeguarding the objectivity of the auditor.
 - Almost all auditors, issuers and audit committee chairs oppose audit firm rotation.
 - Suggestions for improvement provided by auditors, issuers and audit committee chairs included further strengthening audit committees and enhancing audit firm systems of quality control.

Views on Auditor Independence and the Sufficiency of SOX Reforms (cont.)

- ❑ Many investors, academics, former regulators and others expressed a view that much more needs to be done:
 - Approximately half of this group expressed support for audit firm rotation.
 - Some asserted that rotation by itself is not enough.
 - Some asserted that the importance of skepticism in audits is increasing:

"We are at a point in our history where unprecedented levels of judgment about values enter our financial statements, and consequently, there is unprecedented potential for management's unintentional and intentional biases to influence financial statements. Furthermore, the level of judgment and discretion in financial reporting can only be expected to increase as businesses evolve and engage in ever more complex transactions and contractual arrangements, as businesses increase their global reach and as accounting standards converge globally."

(Maureen McNichols, Marriner S. Eccles Professor of Public and Private Management and Professor of Accounting, Graduate School of Business, Stanford University; Affiliated Faculty, Rock Center for Corporate Governance, June 28, 2012).

Audit Firm Rotation: Views on Potential Advantages

- May reduce the risk of over-familiarity and self-interest threats and provide freedom from management pressure:

“Due to the often-subjective nature of accounting and the close relationships that exist between accounting firms and their clients, even the most honest auditors can be unintentionally biased in ways that mask a client company’s true financial status, thereby misleading investors, regulators, and even the company’s management.”

(Prof. Max Bazerman, Jesse Isidor Straus Professor of Business Administration, Harvard Business School, March 21, 2012).

“The ten or so largest audit relationships of any of the Big Four firms could have an aggregate present value of several billion dollars assuming continued incumbency. That’s an immense sum for any professional firm, and it helps explain why the issue of auditors trying to please the largest clients continues to arise, notwithstanding how many inspections the PCAOB performs. The largest audits support the audit firm’s core existence, and they pay the pensions of the partners. That is something that every audit partner understands, whether you tell them that explicitly or not.”

(The Hon. Richard C. Breeden, former SEC Chairman, March 21, 2012).

Audit Firm Rotation: Views on Potential Advantages (cont.)

□ Potential benefit of a “fresh look” conducted by a new audit firm:

“The knowledge that another audit firm will soon be looking over the books provides a particularly strong incentive to get the audit right, since a new audit firm will have little if any reason to cover up or excuse a predecessor’s lax practices.”

(Barbara Roper, Director of Investor Protection, Consumer Federation of America).

“Partner rotations have often proved ineffective. The ineffectiveness flows from several factors including: (1) The new partner is self-selected by the audit firm and sometimes by the client. This selection process often assures continued acquiescence of flawed accounting practices by the client; (2) The new partner is rotating into an engagement which if he or she finds that the client’s previously issued financial statements have been materially misstated, then a restatement of those financial statements will be required. This will likely result in great cost to the firm, as well as to certain of its partners and others that had worked on the prior audits. The costs can include the expense of litigation, loss of reputation, the loss of the client and perhaps the ability of the involved auditors to continue to perform audits. Such consequences bring great pressure on the new partners to accept the continued use of improper accounting by the client.”

(Paul Regan, Chairman, Hemming Morse LLP, June 28, 2012).

Audit Firm Rotation: Views on Potential Advantages (cont.)

□ Improves Perception of Independence and Confidence in the Audit:

“The financial crisis highlighted certain shortcomings, especially with regard to the stability of the financial system. And auditors have an important role to play in that system. Many banks revealed huge losses from 2007 onwards. Several of them have been bailed out by Member States of the European Union. Many citizens and investors fail to understand how auditors could have given clean audit reports to their clients for those periods.”

(Nathalie Berger, Head of Unit, Audit and Credit Rating Agencies, European Commission, Oct. 18, 2012).

“Many of the major financial frauds were discovered by “short-sellers” before they were found by the audit firm. We have to ask ‘why’? It isn’t always that the short sellers have more information, or that they have better analysis. It is because they do the industry analysis and ask the ‘why’ question.”

(Larry Rittenberg, former COSO Chair, Oct 18, 2012).

“Audit firm tenure over a period of many decades can create, at a minimum, the perception of a decreased level of auditor objectivity.”

(Stephen Chipman, CEO, Grant Thornton LLP)

Audit Firm Rotation: Views on Potential Disadvantages

□ Impact on Audit Quality:

- Importance of institutional knowledge vs. a “fresh look”?
- Impact of rotation on auditor industry expertise?
- Impact on ability of audit firms to recruit and retain high-quality personnel?
- Might the volume of auditor switching exceed the system’s capacity?

□ Cost and Disruption:

- Impact on audit costs and audit efficiency? To what extent are investors willing to pay for greater independence?
- Impact of disruption to company personnel and business processes?
- Consequences if rotation is required at a particularly disruptive time?
- Considerations for smaller issuers and smaller audit firms?

Audit Firm Rotation: Views on Potential Disadvantages (cont.)

- Potential Limitations on Auditor Choice:
 - Number of firms with the requisite industry expertise and geographic reach?
 - Impact of existing independence rules?
 - Impact of rotation on competition and concentration in the profession?
- Authority of the Audit Committee:
 - Would audit firm rotation weaken or undermine the authority of the audit committee?
 - Is audit firm rotation an unnecessary distraction?

Rotation and the Audit Committee

- The Board's public meetings have included much discussion of the role of the audit committee in ensuring auditor independence:

- To what extent are audit committees able to address issues of auditor bias?

“Would a vigilant audit committee, discharging its responsibilities under Sarbanes-Oxley have discovered the lack of skepticism, bias, and lack of independence identified in the PCAOB audits? My belief is no. Not likely. Not systemically. If the relationship between management and auditors is harmonious, let alone cozy, how is the audit committee to effectively probe behind it? What questions could it ask and what consultants could it employ to get behind the harmonious responses it would receive from the management and the auditor that would have surfaced the conditions and failures identified in the Board audits?”

(The Hon. Harold M. Williams, former SEC Chairman, June 28, 2012).

- To what extent are audit committees sufficiently accountable and independent of management?

Audit Firm Rotation: Views on Ways to Scope and Scale a Rotation Requirement

- ❑ Limit the scope of a rotation requirement (e.g., to those issuers that have the most impact on the market, where audit fees are very high or based on PCAOB inspection findings).
- ❑ Consider rotation terms of 10 years or greater and allowing for some flexibility in the timing of a rotation in certain circumstances.
- ❑ Phase in a rotation requirement over a period of time.
- ❑ Develop standards to codify best practices to mitigate initial year audit risk.
- ❑ Further limit provision of non-audit services, require “audit-only” firms or institute a cooling-off period before a predecessor auditor may sell non-audit services.
- ❑ Couple a rotation requirement with some form of tenure protection to further bolster the auditor’s independence and allow the audit firm to price the engagement appropriately.

Academic Literature Relevant to Audit Firm Rotation

- ❑ The comment letter process and the public meetings have identified a large body of academic research that commenters believe to be important to the subject matter.
- ❑ Studies on the Relationship Between Auditor Tenure and Audit Quality:
 - Most tend to support the view that engagements with short tenure are relatively riskier.
 - But just how relevant are these studies to mandatory audit firm rotation?
 - Voluntary rotation may be associated with auditor-issuer disagreements, other financial reporting issues, or economic issues.
 - Short-tenured engagements may arise because the company is newly public - earnings quality could be lower than for more established companies.
 - Difficult in identifying suitable proxies for “audit quality”.
- ❑ Results of studies on actual experience with mandatory audit firm rotation or that experimentally model rotation, provide comparatively more support for the concept.

Views on Other Approaches – Mandatory Retendering

- ❑ Some audit committee members, preparers, investors, former regulators and audit firms have expressed support for mandatory retendering, although other representatives of these same groups have expressed opposition.
- ❑ Specific suggestions on ways to structure such a requirement have included:
 - A requirement to “retender or explain”
 - A requirement to “retender and explain”.
 - Multi-year engagement of auditors followed by a mandatory proposal process.

Views on Other Approaches – Mandatory Retendering (cont.)

- ❑ Proponents of retendering have suggested that such a requirement might facilitate the audit committee's oversight of the auditor, reinforce the primacy of the audit committee over management in the eyes of the auditor, reduce perceptions of a familiarity threat and be less costly than audit firm rotation.
- ❑ Opponents have suggested that mandatory retendering approaches could have the opposite effect to what is intended – that is: result in the incumbent auditor being more willing to accede to management's views in order to secure a renewal of the engagement.
- ❑ Limited academic research directly on mandatory retendering.

Views on Other Approaches – Strengthening the Audit Committee

- ❑ Many audit committee members, preparers and auditors have expressed support for further strengthening the audit committee.
- ❑ Others, including some former regulators, investors and academics (while not disputing that further strengthening the audit committee might be beneficial) have asserted that more fundamental reform is necessary to appropriately address deficiencies in professional skepticism.
- ❑ Specific recommendations for strengthening the audit committee:
 - Enhancing the Independence, Education and Expertise of Audit Committee Members.
 - Improving Audit Committee Policies and Procedures and Communication of Such Policies and Procedures to Shareholders.
 - Enhancing PCAOB Communications with Audit Committees.
 - Enhancing Audit Firm Communications with Audit Committees.
- ❑ Recent release on approaches an audit committee might consider for initiating or enhancing inspection-related discussions with an audit firm was informed, at least in part, by discussions at recent public meetings.

Views on Other Approaches – Enhancing Audit Firm Culture and Systems of Quality Control

- ❑ Some auditors, audit committee members and issuers have suggested that auditor independence might be improved by making certain improvements to audit firm culture and systems of quality control.
- ❑ Some suggestions are based on existing “best practices”.
- ❑ Common suggestions have included:
 - Emphasizing messages regarding auditor independence, ethical responsibilities and the profession’s role as a public watchdog to audit firm personnel.
 - Improving auditor training on independence, objectivity and professional skepticism.
 - Explicitly including independence, objectivity and professional skepticism in goal-setting and evaluation processes.
 - Linking compensation systems to the application of effective professional skepticism.
 - Improving engagement performance and monitoring processes (e.g., by enhancing audit firm internal reviews and/or consultation requirements).
- ❑ Ideas such as these will help inform the Board’s current standard setting initiative to explore potential improvements to the existing quality control standards.

Views on Other Approaches – Strengthen Existing Independence Requirements

- ❑ Some comment letters and have expressed support for enhancing existing independence rules and auditing standards.
- ❑ Suggestions have included:
 - Further limiting the provision of non-audit services or requiring “audit-only” firms.
 - Strengthening existing prohibitions on auditors taking jobs with clients.
 - Extending partner rotation requirements to managers and senior managers.
 - Further strengthening the engagement quality review process (e.g., by requiring more frequent rotation of the engagement quality reviewer or by requiring the engagement quality reviewer to come from a different firm).
 - Requiring a periodic forensic audit on a portion of the financial statements (potentially performed by another audit firm).

Views on Other Approaches – PCAOB Inspection and Enforcement Activities

- ❑ A number of audit committee members, preparers and auditors have suggested that, instead of requiring audit firm rotation, the Board either expand or modify its inspection activities to place more focus on identifying lapses in professional skepticism and the extent to which firms develop and train their staff in this skill.
- ❑ A variety of commenters have supported enforcing stiffer penalties on firms and audit partners that foster a culture of tolerance for a lack of independence, objectivity and professional skepticism or when audit failures occur.
 - Some have expressed support for making public the Board's enforcement investigations and proceedings.
 - Others have suggested that the PCAOB require rotation of the audit firm in instances where the Board is able to demonstrate a lack of insufficient auditor skepticism.

International Exploration of and Experience with Audit Firm Rotation – European Commission

- ❑ On November 30, 2011, the European Commission adopted proposals that are intended to strengthen the independence of auditors and introduce greater diversity into the audit market.
- ❑ The Commission's proposals regarding the audit of public-interest entities ("PIEs") include (among other things) mandatory rotation of audit firms:
 - PIE audit firms would be required to rotate after a maximum engagement period of 6 years though the period could be extended by two years on a case by case basis by a company's national regulator.
 - A cooling off period of 4 years is applicable before the audit firm can be engaged again by the same client.
 - The period before which rotation is obligatory can be extended to 9 years if joint audits are performed. Joint audits are not made obligatory but are thus encouraged.
 - Other reforms included in the Commission's proposals also include audit-only firms, expanded requirements for the auditor's report, enhancements to audit committee oversight, a strengthened and more coordinated approach to the supervision of auditors across the EU and prohibition of Big 4-only contractual clauses.
- ❑ The European Commission proposals are now formally before the European Parliament for consideration.

International Exploration of Audit Firm Rotation – United Kingdom

- In September 2012, the UK's Financial Reporting Council announced changes to the UK Corporate Governance Code:
 - FTSE 350 companies are to put the external audit contract out to tender at least every ten years with the aim of ensuring a high quality and effective audit, whether from the incumbent auditor or from a different firm.
 - Audit Committees are to provide to shareholders information on how they have carried out their responsibilities, including how they have assessed the effectiveness of the external audit process.
 - The Code will continue to apply on a “comply or explain” basis.

International Exploration of Audit Firm Rotation – United Kingdom (cont.)

- In 2011, the UK House of Lords issued a highly critical report after an inquiry concluded that complacency of bank auditors during the financial crisis contributed to the need for government bailouts of UK banks:
 - Several recommendations for improvement (including mandatory retendering).
 - Called for the Office of Fair Trading, the UK's consumer and competition authority, to launch an inquiry.
 - OFT decided that competition problems in the UK audit market met the test for referral to the Competition Commission, an independent public body that conducts inquiries into mergers, markets, and regulation of major industries.
- UK Competition Commission's Survey of Finance Directors and Audit Committee Chairs:
 - 41% said the audit fee was lower in the first and following year; 21% said switching had no material impact on audit fees; 59% said switching had no material impact on internal costs.
 - 80 companies said that switching resulted in a change in quality, with 70 saying the change was positive and 10 saying the change was negative at least in the first year.

International Experience with Audit Firm Rotation

- ❑ The staff is aware of 27 countries that have some form of audit firm rotation requirement.
- ❑ Italy, Brazil and China represent the largest of these 27 countries by GDP.
 - Italy has required mandatory audit firm rotation of listed companies since 1975. In Italy the audit engagement may be retendered every 3 years and the same public accounting firm may serve as the auditor of record for a maximum of 9 years. In addition, there is a minimum time lag or cooling-off period of 3 years before the predecessor auditor can return.
 - Brazil enacted a mandatory audit firm rotation requirement in May 1999 with a 5 year maximum term and minimum time lag of 3 years before the predecessor auditor could return. The measure was suspended in 2008 so that the market could focus on shifting to International Financial Reporting Standards but, in November 2011, the Brazilian regulator adopted Instruction No. 509, which reinstituted a mandatory audit firm rotation requirement. The new requirement extended the maximum term for which an independent auditor may be engaged from 5 years to 10 years, so long as the company has an audit committee in place which meets certain requirements focused on independence, including being composed of a majority of independent members, and also meets certain operational requirements, such as holding a minimum number of meetings per month.

IESBA's Consideration of Strengthening Safeguards Against Familiarity Threats

- ❑ The Weight of Evidence Suggests that this Topic Needs to be Studied:
 - Regulators around the world continue to raise significant concerns over professional skepticism.
 - A very small number of the largest auditor-client relationships change hands.
 - Familiarity and self-interest threats, the impact of tenure on audit quality and mandatory rotation continues to be the subject of extensive academic research.
 - The issue is under active consideration in many jurisdictions around the world, including the U.S.A. and Europe.
 - Twenty-seven countries already have a rotation requirement, others are in the process of passing (or have passed) legislation to require rotation or retendering.
 - Strong view of the CAG that IESBA should add a project to its agenda.

Questions?

