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## Audit Firm Practice and Transparency

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WHAT AREA OF AUDIT FIRM PRACTICE AND TRANSPARENCY WOULD IMPROVE AUDITOR PROFESSIONAL SKEPTICISM AND, MORE BROADLY, AUDIT QUALITY?

## Working Group Focus

- Measurement of audit quality and performance
- Audit partner compensation

## Summary of Recommendations

Support issuance of concept release on disclosure of key indicators of audit quality

Support creation of Audit Fraud Center

Split on SEC revision of Rule 2-01(c)(8) and specialized inspections of audit partner compensation

## Measurement—Background

- 2008—U.S. Department of the Treasury Advisory Committee on the Auditing Profession recommended:
  - PCAOB should “determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators”
  - The SEC and Congress, as appropriate, should provide for the creation by the PCAOB of a national center to facilitate auditing firms’ and other market participants’ sharing of fraud prevention and detection experiences and other information
- 2010—PCAOB created a new position, the Director of the Financial Reporting Fraud Resource Center
- 2011-2015 PCAOB Strategic Plan—creates the PCAOB Center for Excellence

## Potential Areas of Further Study

- Should the PCAOB issue a concept release for public comment requesting input on one or more approaches to requiring audit firms to publicly disclose key indicators of audit quality?
- Should the PCAOB complete the creation of a national center addressing audit fraud?

## Concept release

### Pros:

- Basis for measuring and improving audit quality and enhancing auditor training and development
- Disclosure may enhance:
  - quality of audits;
  - the ability of smaller audit firms to compete with larger audit firms;
  - the audit committee's auditor selection process;
  - shareholder decision-making related to ratification of auditor selection; and
  - PCAOB oversight of registered auditing firms.

### Cons:

- No common definition of audit quality
- Audit quality indicators differ substantially depending upon:
  - the audit engagement complexity and size;
  - the auditing firm's size, ownership structure; and
  - client portfolio.

## Audit Fraud Center

### Pros:

- Understanding audit failures may assist with auditor training/development and development of audit quality indicators

### Cons:

- Audit failures already considered by the PCAOB, so a center would be a poor use of resources

## Working Group Recommendations

### Concept release on disclosure of key indicators of audit quality:

- Most support issuance of concept release
- Concern with using predetermined metrics to evaluate audit quality and their possible unintended consequences

### Audit Fraud Center:

- Most support creation of Audit Fraud Center
- Concern over redundancy given PCOAB existing work

## Compensation- Background

- Regulators increasingly examining incentive compensation of regulated entities
- Sarbanes-Oxley prohibits certain types of non-audit services (Section 201) and requires audit committee approval of other non-audit services (Section 202)
- Today many audit committees prohibit or closely monitor non-audit services
- Use of audit firms to perform non-audit services is trending upward

S&P 500	2007	2008	2009	2010
Auditors performing non-audit services (#)	186	199	202	230
Value non-audit services	\$26.1 million	\$31.9 million	\$40 million	\$64.6 million

- SEC rules prohibit audit partner's compensation on sale of non-audit services to audit clients (Rule 2-01(c)(8))
- However, footnote to SEC rules indicates that audit partner could be *indirectly* compensated for selling non-audit services and evaluated on the overall client relationship, *including the provision of non-audit services*

## Potential Areas of Further Study

- Should the PCAOB recommend that the SEC explicitly prohibit audit partner compensation from considering non-audit services provided for audit clients?
- Should the PCAOB complete specialized inspections of audit partner compensation with a view toward how compensation practices may impact audit quality?
- Should the PCAOB publicly report findings on audit partner compensation trends and practices, including whether and how adverse audit findings in PCAOB inspections or internal quality reviews are factored into lead engagement partner compensation?

## SEC revision of Rule 2-01(c)(8)

### Pros:

- Consistent with intent of Sections 201 and 202 of SOX
- Addresses one reason why auditors may not be exercising sufficient professional skepticism

### Cons:

- Sections 201 and 202 of SOX are adequate
- Inappropriate because Congress did not intend to prohibit auditors from performing all non-audit services
- Unnecessary because audit committees currently robustly consider provision of non-audit services along with audit quality

## Specialized inspections

### Pros:

- Consistent with an increased focus by regulators on compensation matters
- Compensation may motivate behavior that may harm audit quality, so more robust evaluations are appropriate
- Public disclosure would benefit audit committees and the investing public by providing transparency to an important issue that may impact audit quality

### Cons:

- Unnecessary because audit committees currently robustly consider issues that may impact audit quality
- Complex issue and not an area of expertise for the PCAOB or its inspectors, and as a result, poor use of PCAOB resources
- Public disclosure of PCAOB inspection results is inappropriate because audit firms are private partnerships

## Working Group Recommendations

### SEC revision of Rule 2-01(c)(8)

- Evenly split

### Specialized inspections of audit partner compensation

- Evenly split

## Other Potential Issues

- Should the PCAOB enable or require the appointment of independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms?
- Should the PCAOB promptly issue a final rule mandating the disclosure of the engagement partner's name on the auditor's report?
- Should the PCAOB require the larger auditing firms to produce a public annual report incorporating (a) information required by the EU's Eight Directive, Article 40 Transparency Report, (b) key indicators of audit quality and effectiveness (see above discussion) and (c) audited financial statements?
- Should the PCAOB initiate a study or issue a Concept Release on the issue of whether Global Networks impact audit quality?