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Report from the Working Group on Audit Firm Business Model and Incentives

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Report from the Working Group on Audit Firm Business Model and Incentives

- The International Landscape
- Consulting Creep
- Auditor Transparency
- Who Pays for the Audit

Audit Firm Business Model and Incentives

Audit Regulatory Initiatives – U.S. / International Comparison

Audit Firm Business Model and Incentives

Audit Regulatory Initiatives – U.S. / International Comparison

Items to be covered:

- Audit engagement partner signature
- Expanded audit report
- Independent non-executives on firm governing boards
- Preparation of transparency reports
- Audit firm rotation

Audit Firm Business Model and Incentives

Audit Engagement Partner Signature

- Been in place in much of the developed world for years
  - European Union, Australia, Taiwan, and China

- Evidence of the effect of the partner signature requirement:
  - Audit quality improves and audit fees increase after the adoption of a signature requirement (Carcello and Li 2013 TAR)
  - Aggressive or conservative reporting is a systematic partner characteristic that persists over time and extend to the partners' other clients (Knechel et al. Forthcoming CAR)

Audit Firm Business Model and Incentives

Audit Engagement Partner Signature

- Challenge to implementation – Consents needed in registration statement and partner may have left firm
  - Solution: SEC to designate consents as “evergreen” unless financial statements or nature of audit report has changed – generally a rare occurrence
- ACAP recommended that the PCAOB require the engagement partner’s signature on the audit report (Recommendation #6, Firm Structure and Finance)

Audit Firm Business Model and Incentives

Expanded Audit Report

- An expanded audit report has been in place in the United Kingdom since fall, 2013
  - “I am certain that the quality of the audit was improved as a consequence of the changes brought in by the FRC.”- ***Philip R. Johnson,*** Chairman of the Audit Committee, Yorkshire Building Society
  - “The reaction from the audit firms, essentially the Big Six, has been positive, constructive and very supportive…it appears to be enhancing their position with management and the audit committee, and giving them a chance to demonstrate their depth of thinking and management challenge…initial reaction from investors has been very positive. It’s given them some insight into the auditor’s world, and disclosure around scope materiality has begun to generate discussions amongst stakeholders.” - ***Nick Land,*** Chairman, Audit and Assurance Council, UK FRC

Audit Firm Business Model and Incentives

Expanded Audit Report

- Challenge to implementation – New information may be communicated in the audit report
  - Solution – New information is what creates value; providing value to users should be the goal of the audit report
- IAASB's proposal related to an expanded audit report is progressing more rapidly than a similar PCAOB proposal
  - IAASB intends to finalize audit reporting standards at its September 15-19th meeting
  - Implementation of the reporting standards are also being planned
- ACAP recommended that the PCAOB undertake a standard-setting initiative to consider improvements to the standard audit report (Recommendation #5, Firm Structure and Finance)

Audit Firm Business Model and Incentives

Independent Non-Executives on Firm Governing Boards

- Been in place in the UK since 2010 (as part of the Audit Firm Governance Code)
  - Although subjective, we have generally received positive feedback from FRC and ICAEW representatives as to the benefits associated with INEs
- Different firms have implemented the use of INEs differently, some:
  - Globally – EY – chaired by Mark Olson
  - Throughout Europe
  - Only in the U.K.

Audit Firm Business Model and Incentives

Independent Non-Executives on Firm Governing Boards

- Deloitte has established a similar advisory committee composed of INEs in the U.S. – chaired by Dan Goelzer
- Challenge to implementation – Disclosure of proprietary firm information
  - Solution – Confidentiality agreements, similar to agreements between independent board members and public companies
- ACAP recommended that firms appoint independent members with full voting rights to firm boards and/or advisory boards (Recommendation #3, Firm Structure and Finance)

Audit Firm Business Model and Incentives

Preparation of Transparency Reports

- Required in the European Union for a few years (under the EU's Eighth Directive, Article 40)
- Challenge to implementation – Disclosure of proprietary information
  - Solution – Certain aspects of the transparency reports could be included only in a confidential filing to the PCAOB
- ACAP recommended that firms be required to produce a public transparency report (Recommendation #7, Firm Structure and Finance)

Audit Firm Business Model and Incentives

Audit Firm Rotation

- EU implementing a form of mandatory firm rotation
  - Public interest entities required to change auditors after 10 years
  - Tenure can be extended to 20 years if the audit is put out for bid or 24 years if joint audit conducted
  - Application begins on June 17, 2016
- Italy has required audit firm rotation every 9 years since the mid 1970s

Audit Firm Business Model and Incentives

Audit Firm Rotation

- Mandatory rotation existed in Spain from 1989 to 1995
- South Korea has required auditor rotation every 6 years since 2006
- Brazil revised its mandatory rotation rule from 5 years to 10 years in 2011 for companies that have a statutory audit committee
- Challenge – Loss of issuer-specific knowledge
  - Solution – Regulators need to assess whether any increase in auditor objectivity outweighs the loss of issuer-specific knowledge

Audit Firm Business Model and Incentives

Consulting Creep

Audit Firm Business Model and Incentives

Consulting Creep

- Today, most jurisdictions across the globe as well as professional codes of ethics permit auditors to provide non-audit services to companies they audit for services that do not conflict with the auditor’s independence.

  - History of Consulting within the Big Four.
  - Why Policy Changes Should be Considered.
  - What Policy Changes Should be Considered.

Audit Firm Business Model and Incentives

The Enron Effect

Consultancy Build Up

- In 1999, U.S. consulting revenue for the Big Five firms totaled more than $15 billion, accounting for roughly half of total revenue.[1] In 1981, consulting revenues constituted just 13% of total revenue.
  - The number of restatements due to accounting irregularities for the period of January 1997 through June 2002 grew significantly, about 145%.[2]

1. See Table 1 in Appendix B. The underlying data are reported in "Special Supplement: Annual Survey of National Accounting Firms - 2000," Public Accounting Report (Mar. 31, 2000).
2. GAO Report: Financial Statements Restatements, October 2002, http://www.gao.gov/new.items/d03138.pdf

Audit Firm Business Model and Incentives

The Enron Effect

Pull Back of Consultancy

- In February 2000, Ernst & Young Consulting was sold to Cap Gemini.
- In February 2001, KPMG Consulting (later BearingPoint, Inc.) was floated with an IPO.
- In July 2001, Accenture (known as Andersen Consulting before its split from Arthur Andersen) went through an IPO.
- In October 2002, PricewaterhouseCoopers Consulting was sold to IBM.

Audit Firm Business Model and Incentives

Post Enron

- Since 2002, we've seen the following changes in the environment:
  - The industry now has a regulator that is setting standards, auditing engagement performance and taking action against audit failures;
  - Sarbanes-Oxley didn't previously exist;
  - Audit Committees are far more engaged in oversight than previously;
  - Independence rules are better and more services are prohibited than in 2002;
  - The industry has seen a Big Firm fail;
  - Firms must consider audit quality when compensating audit partners; and
  - Audit firms must now disclose the fees they earn by major category.
- Are these changes sufficient to prevent a repeat of history or are more reforms needed?

Audit Firm Business Model and Incentives

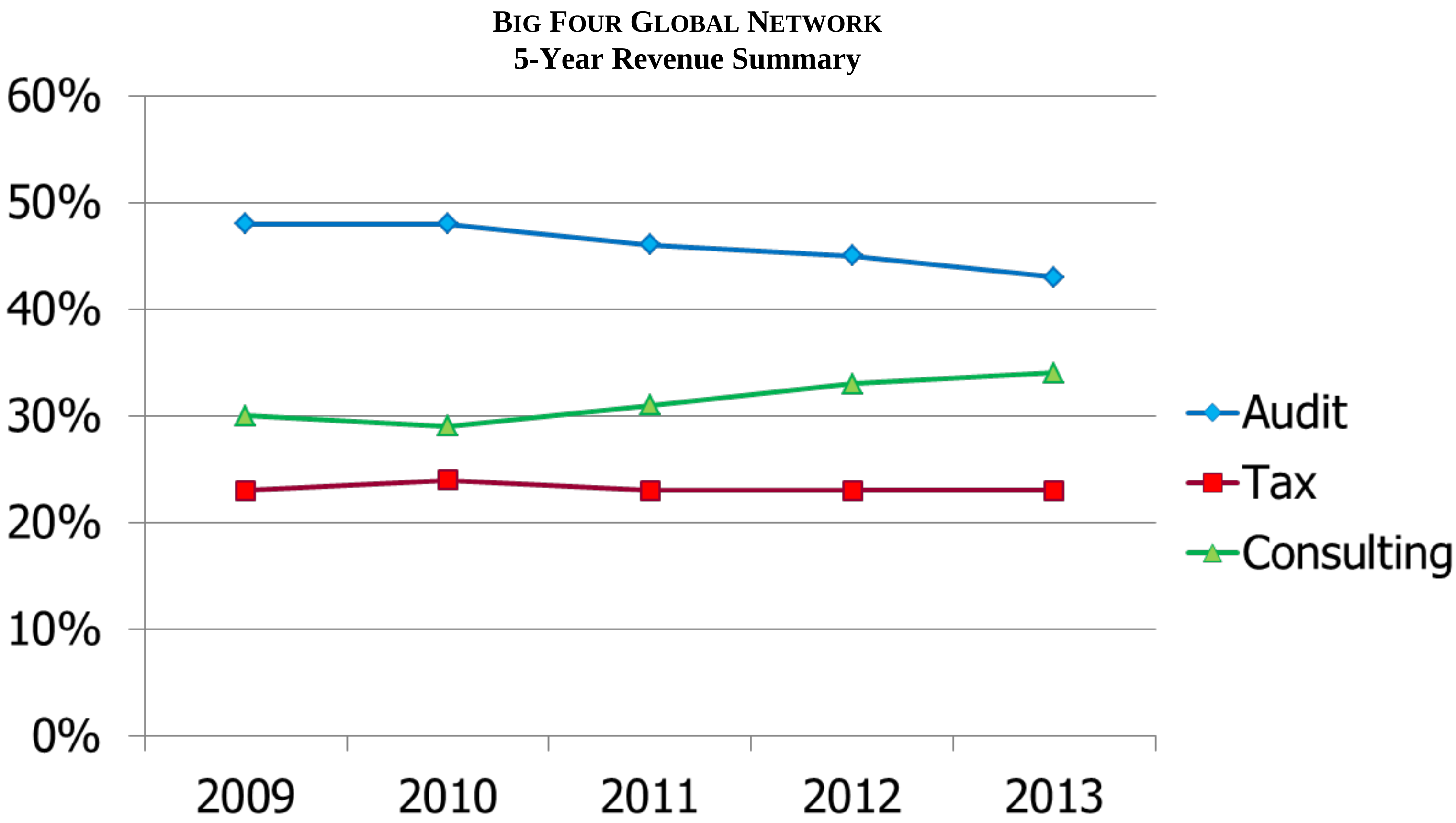
The Crawl Back to Consulting

- Today, the Big Four have made their way back to non-advisory services under U.S. regulations that permit these services for companies other than audit clients, and audit clients outside the U.S.
- Global non-audit advisory services of the Big Four firms, including tax services, increased to $64.73 billion in fiscal year 2013, a 5.47% increase over 2012.[3]
  - In 2012, the advisory revenue (excluding tax) for the Big Four surged at a rate four times the gains in audit fees.[4]
- In recent years, the Big Four have acquired numerous consulting firms.
  - For example, PwC purchased management-consulting firm Booz & Co. in December 2013.

3. Monadnock Research, Big Four Fiscal 2013 Advisory Practice Rankings and Conflict Risk Metrics, www.monadnockresearch.net
4. ibid.

Audit Firm Business Model and Incentives

The Crawl Back to Consulting

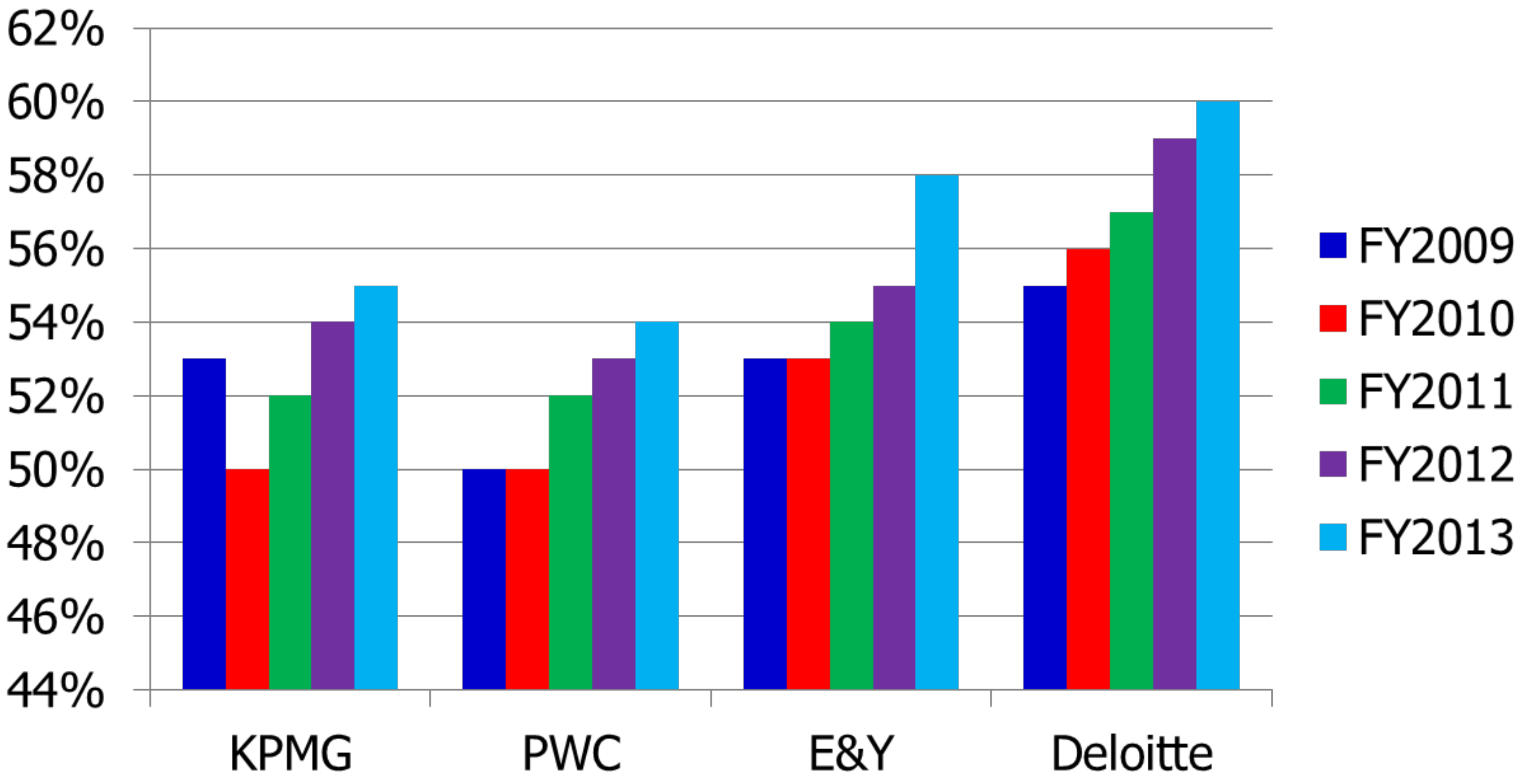


Source: Transparency Reports of KPMG, Ernst & Young, Deloitte, PwC.

Audit Firm Business Model and Incentives

The Crawl Back to Consulting

BIG FOUR GLOBAL NETWORK
5-Year Revenue for Consulting and Other Non-Audit Services by Firm



Source: Transparency Reports of KPMG, Ernst & Young, Deloitte, PwC.

Audit Firm Business Model and Incentives

Why Should Policy Changes be Considered?

- Talent Management
  - Misallocation of talent, with the best minds going to consulting at the expense of audit expertise and competence; decreased desirability of audit partnership.
- Governance
  - Audit leadership playing a less significant role in the governance of the firm resulting in decreased emphasis on needs of audit line/audit quality.

Audit Firm Business Model and Incentives

Why Should Policy Changes be Considered?

- Partnership model/profitability
  - Partnership model being ineffective in incentivizing long term investment in the audit business line/profession; cross subsidization between different business lines; is the pyramid structure effective when over 70% of the audit work is performed by individuals with less than 3 years of experience.
- Market risk
  - A firm may decide to exit the audit services market, further reducing competition; a large audit firm fails, thus reducing competition.

Audit Firm Business Model and Incentives

Why Should Policy Changes be Considered?

- Public interest
  - Partners inadequately incentivized and protected to perform a high quality audit; core audit service provided does not meet the key needs of stakeholders; growing audit-advisory imbalance creating moral hazard for audit professionals; unsuccessful management of independence and objectivity requirements for audit engagements given emphasis on consulting.

Audit Firm Business Model and Incentives

What Policy Changes Should be Considered?

- Non-Audit Services Cap
  - Limit the amount of non-audit services an auditor would be permitted to provide to audit clients.
- “White List” of Non-Audit Services
  - Specific services an auditor would be permitted to provide to audit clients.
- Strengthening Audit Committees
  - Education or guidance on prohibited services and non-audit advisory services engagement.
- Mandating Audit-Only Firms
  - Eliminate the ability of audit firms to provide non-audit services to any client.

Audit Firm Business Model and Incentives

Auditor Transparency

Audit Firm Business Model and Incentives

Recommendations of Advisory Committee on the Auditing Profession (2008)

- Require large auditors to file confidential audited financial statements with PCAOB
- Adopt EU Directive requiring website disclosure of:
  - Legal and Governance Structure
  - Ownership Description
  - Financial Information (inc. audit fees, tax advisory fees, and consulting fees, and partner remuneration policies)

Audit Firm Business Model and Incentives

Current Auditor Transparency Requirements

- Mandatory annual reporting to the PCAOB of (see Form 2):

  Fees received for audit services, tax services, non-accounting services and non-audit services (as a percentage of fees billed to audit clients)

Audit Firm Business Model and Incentives

Current Auditor Transparency Requirements

ITEM 3.2 - FEES BILLED TO *ISSUER AUDIT* CLIENTS			
The option to request confidential treatment for information provided in Item 3.2 is available only to *foreign registered public accounting firms.*			
a. Of the total fees billed by the Firm to all clients for services that were rendered in the reporting period, state the percentage (which may be rounded, but no less specifically than to the nearest five percent) attributable to fees billed to *issuer audit* clients for–			
1. *Audit services*	CA ☐ CR ☐	2. *Other accounting services*	CA ☐ CR ☐
25		5	
3. *Tax services*	CA ☐ CR ☐	4. *Non-audit services*	CA ☐ CR ☐
5		0	

FEES BILLED BY ERNST & YOUNG

The following table presents fees billed for professional audit services rendered by Ernst & Young for the audit of Groupon's annual financial statements for the years ended December 31, 2013 and 2012, and fees billed for other services rendered by Ernst & Young during those periods.

	Year Ended December 31, 2013	Year Ended December 31, 2012
Audit Fees	$ 6,928,000	$ 8,193,000(1)
Tax Fees	$ 1,817,000	$ 1,621,000
Other Fees	$ 2,000	$ 3,990
Total	$ 8,747,000	$ 9,817,990

(1) This amount represents a $423,500 increase from the amount the Company reported in its 2013 proxy statement, as billing for the services had not been finalized at the time of filing.

Audit Firm Business Model and Incentives

UK Auditor Transparency Report
(effective 2010)

- Mandatory website disclosure of:
  - Legal and Governance Structure
  - Ownership Description
  - Financial Information (including significance of statutory audit work and basis for remuneration of partners)

Audit Firm Business Model and Incentives

Who Should Pay for the Audit

Audit Firm Business Model and Incentives

Previous Reform Initiatives

- Quality Control Standards were adopted by the auditing profession, its Auditing Standards Board (ASB) and audit firms beginning in approximately 1979.

- In 1978, the SEC adopted a new proxy disclosure requirement requiring companies to disclose the percentage of the overall fees an audit firm billed, that were for management advisory and audit services. This requirement was dropped in the early 1980's.

Audit Firm Business Model and Incentives

Previous Initiatives (cont.)

- In the late 1990’s, the SEC proposed new auditor independence rules that prohibited audit firms from providing certain services to companies they audited. After a difficult fight with the auditing profession, the SEC adopted final rules in 2000 that were not as proscriptive as originally proposed.
- Congress adopted the Sarbanes-Oxley Act of 2002 (SOX), which adopted the original independence rules the SEC had proposed, and which were more proscriptive. In addition, Congress (1) created the PCAOB and gave it powers to perform inspections of audit firms that audited public companies, write auditing and quality control standards, and take enforcement and disciplinary actions against auditing firms.

Audit Firm Business Model and Incentives

Previous Initiatives (cont.)

- SOX also made it the responsibility of corporate board audit committees to hire and fire the independent auditors, although the evidence may suggest this function often is done by management, with loose oversight by the audit committee.

- US Treasury Secretary Henry Paulson appointed the US Advisory Committee on the Auditing Profession. In October, 2008, the Committee issued a report with 18 recommendations. Some of these recommendations, such as urging a fraud center be established, improved reporting by auditors with respect to fraud, and enhanced transparency and competition among audit firms have never been acted upon.

Audit Firm Business Model and Incentives

Potential Reform Proposals

- Eliminate the requirement in the Federal Securities Laws mandating an independent audit be performed.
- Replace the government mandate with a requirement that companies submit a vote on whether or not to require an audit to their stockholders every 3-5 years. This would leave this important decision up to investors, a market driven approach.
- Investors would vote annually on the appointment of auditors. Prior to the vote at the annual shareholders meeting, investors would be provided disclosure of audit quality indicators for their specific audit.

Audit Firm Business Model and Incentives

Potential Reform Proposals

- Annually, the Audit Committee would negotiate the audit fee with the independent auditors. It would be the obligation and responsibility of the Audit Committee to negotiate the fee, not management.
- The PCAOB would collect a fee from each company, as they do now, that would cover the expected audit costs. From the pool of audit fees collected, the PCAOB would pay the audit firm for the audit services.
- The PCAOB could require a change in an auditor when as a result of an inspection, it found the auditor had not followed generally accepted auditing standards in the performance of the audit.

Audit Firm Business Model and Incentives

Questions