PCAOB
Public Company Accounting Oversight Board

Protecting Investors through Independent, High Quality Audits

DATE: Oct. 14, 2012

SPEAKER: Jeanette M. Franzel, Board Member

EVENT: NACD 2012 Board Leadership Conference

LOCATION: National Harbor, MD

RELATED INFORMATION

- Event Details and Documents

I am honored to be here today at this important conference to explore issues of mutual interest to audit committees and the Public Company Accounting Oversight Board.

Before I get started, I must tell you that the views I express today are my personal views and do not necessarily reflect the views of the Board, any other Board member, or the staff of the PCAOB.

I want to commend the NACD on its mission to "advance exemplary board leadership" and on the extensive training and resources devoted to leading practices for board members, including audit committees and other specialized board committees.

The principal elements of the Sarbanes-Oxley Act — strengthening the role of audit committees, establishing the PCAOB to oversee auditors, and enhancing auditor independence and corporate accountability -- aligned the interests of the PCAOB and audit committees. We both focus on auditor oversight to help ensure independent, high quality, and reliable audits to protect investors.

Recent questions about financial reporting and auditing, as well as related regulatory initiatives in the U.S. and around the world, highlight the benefits of and need for greater communications between regulators and audit committees.

Today, following the recent financial crisis, we find ourselves once again evaluating how best to protect investors through high quality financial reporting and reliable audits.

As you know, in pursuing our core mission of protecting investors through audit oversight, the Board has a number of initiatives to consider improvements in major areas of audit practice. I'd like to provide an update on several of the Board's key initiatives that have a direct impact on audit committees, including our concept release on auditor independence and audit firm rotation, the new auditing standard on communications with audit committees, and our recent informational release that deals with communications with audit committees about PCAOB inspection results.

Auditor Independence and Audit Firm Rotation

One of the Board's initiatives that has received an abundance of attention is its concept release and ongoing exploration of ways to enhance auditor independence, objectivity, and professional skepticism, including through mandatory rotation, or term limits, for audit firms.

On August 16, 2011, the Board issued PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation,* which notes the critical importance of auditor independence, objectivity, and professional skepticism to the viability of auditing as a profession and highlights the risk of bias arising from the "client-pay" model.

Throughout the history of the auditing profession, the inherent conflicts in the "client-pay" model have been debated. [1] The outcome of these debates in the U.S. generally has been an ongoing willingness of stakeholders to accept the "client-pay" model, together with safeguards to minimize the occurrence of potential negative outcomes from the inherent conflict.

Mandatory audit firm rotation is one idea that has been debated over the years as a potential way to mitigate risks that arise from the arrangement whereby the audited entity hires and pays its independent audit firm. As the U.S. Supreme Court has said, "the independent auditor assumes a *public* responsibility transcending any employment relationship with the client." [2]

In 2002, as part of the debates leading up to the Sarbanes-Oxley Act, Congress considered requiring audit firms to rotate off an audit engagement after a set number of years. Instead, Congress decided that the idea required further examination and directed the General Accounting Office (GAO) (now called the Government Accountability Office) to study the matter.

The GAO issued its report [3] the following year, which concluded that more experience needed to be gained with the Act's requirements and that "it will take at least several years for the SEC and the PCAOB to gain sufficient experience with the effectiveness of the Act in order to adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed to further protect the public interest and to restore investor confidence." [4]

The GAO went on to say that some of the reforms embedded in the Sarbanes-Oxley Act, when implemented, may provide some of the intended benefits of mandatory audit firm rotation. Specifically, the Act contained significant reforms aimed at enhancing auditor independence through audit partner rotation and restrictions on non-audit services, which reinforced restrictions adopted by the SEC two years earlier. The Act also strengthened the role of audit committees with increased responsibilities for enhancing auditor independence and audit quality, which was intended to eliminate the dynamic of the auditor being hired and retained by company management and generally answering to management.

The GAO report also pointed out the importance of audit committees being vigilant in the oversight of the auditor and in considering when a "fresh look" (e.g. new auditor) is needed, stating that "…if audit committees regularly evaluated whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, many of the benefits of audit firm rotation could be realized at the initiative of the audit committees rather than through a mandatory rotation requirement." [5]

In the interest of full disclosure, I must tell you that prior to joining the PCAOB as a board member in March 2012, I had worked at the GAO for almost 23 years most recently in the position of managing director. And in my previous position as GAO director, I was charged with conducting GAO's required study on mandatory audit firm rotation. As you probably know, in 2003, GAO recommended against mandatory audit firm rotation and suggested that more time was needed to evaluate the impact of the Sarbanes-Oxley Act reforms.

I find it a bit ironic that I am now at the PCAOB, involved in a follow-up examination of the subject. People frequently ask about my views on mandatory audit firm rotation given the GAO report's conclusions. My response is that it is too early to conclude for this current round. The PCAOB's efforts represent a new examination of auditor independence issues, representing a different scope, in a new timeframe, and additional information, data, and experience. We are still in the information gathering and analysis phases of the project.

Certainly, we are, once again, in a period of re-examination of the role, relevance, and reliability of financial audits in protecting investors and the public interest. And at the heart of the current debate, which is happening around the world, are issues involving auditor independence, professional skepticism and objectivity; audit quality; and the role of audit committees, among other issues.

We've had many stakeholders and members of the profession tell us that they believe that auditor independence and audit quality have been strengthened since the passage of the Sarbanes-Oxley Act, and we also believe that audit quality has improved. We've also heard from audit committee members that they believe that the financial reporting and auditing processes have been strengthened.

However, more work needs to be done. The PCAOB continues to find a disturbingly high number of instances through its inspections where auditors do not approach important aspects of their audit work with the required independence, objectivity, and professional skepticism.

THE BOARD'S CONCEPT RELEASE AND RELATED PUBLIC MEETINGS

In its August 2011 concept release, the Board sought to solicit public comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced, including through consideration of auditor term limits. The Board has also held two public meetings on the issue (March 21-22 in Washington, DC; and June 28 in San Francisco), and will host a third public meeting later this week in Houston.

With each public meeting, the Board has re-opened the comment period on the concept release. In total, the Board has received more than 670 comment letters on this issue and has heard from 77 panelists at the first two public meetings, including investors and investor advocates, audit committee chairs and senior executives of major corporations, CEOs of audit firms, academicians and others.

It is certainly public knowledge that the majority of the commenters were opposed to a requirement for mandatory audit firm rotation for a variety of reasons. At the same time, commenters acknowledged the fundamental importance of auditor independence as the underpinning of confidence in the auditing profession.

In addition, the majority of commenters expressed support for the Board's efforts to ensure or enhance the auditor's independence, objectivity, and professional skepticism, although suggestions for how this might be achieved varied widely. The comment letters also provided rich feedback on the complex issues that impact auditor independence and audit quality, as well as a range of suggestions for potential actions that could be taken to address independence and audit quality issues.

The same pattern emerged from our public meetings-- a large majority of the panelists supported the Board's focus in auditor independence, objectivity, and professional skepticism, but expressed a wide variety of views about what should be done to improve them.

Panelists generally agreed that the Sarbanes-Oxley Act reforms have improved audit quality and auditor independence. They also generally agreed that audit committees have been more active in discharging their responsibilities and recognized the benefits that arise from a strong audit committee. However, others asserted that audit committees would not be able to address the issues of lack of professional judgments, skepticism, and bias on the part of the auditor. Some also pointed out that in some cases, audit committees are still very close to management.

A strong, effective, and competent audit committee is an important part of the "ecosystem" for an independent, high quality audit. Achieving audit committee effectiveness on a broad and consistent basis is a key element of effectively implementing the Sarbanes-Oxley Act reforms and achieving the intended benefits of the Act for investors and the public interest.

STATUS OF THE BOARDS EFFORTS ON AUDITOR INDEPENDENCE

So where are the Board's current efforts on auditor independence leading? As I mentioned, we are having our third public meeting on the subject this week, on Thursday, Oct. 18, at the Jones Graduate School of Business at Rice University in Houston. It will be open to the public, and also available via webcast on the PCAOB website. At the meeting, the Board hopes to expand on the themes from the first two meetings.

As I'm sure you are aware, the concept release and our related public meetings are creating a substantive debate among the full range of stakeholders. We are currently conducting analyses of the feedback we have received, as well as additional research by the PCAOB and others.

We are seeing major themes in the comment letters and panelist feedback, including the following suggestions:

- implementing pilot programs of auditor rotation;
- limiting a rotation requirement to certain audits and certain circumstances;
- requiring joint audits in some circumstances;

- using mandatory "retendering" of the audit and/or a formal re-evaluation of the auditor's tenure at given intervals;
- the use of tenure protection for the auditor if a rotation requirement is put in place;
- potentially further restricting the provision of non-audit services by the auditor;
- strengthening audit committees, in terms of their financial expertise, increased independence from management, and enhanced and increased interaction and communications with investors, auditors, and the PCAOB;
- increasing the transparency surrounding PCAOB inspection results, as well as making public the PCAOB's enforcement investigations and proceedings;
- expanding PCAOB inspections in certain circumstances;
- increasing the root cause analyses by the PCAOB and the firms on the causes of audit deficiencies; and
- increasing emphasis on professional skepticism in standards and education for auditors, as well as in the firms' culture and systems of quality control.

Additionally, during the normal course of inspections and other oversight activities, the Board continues to engage in constructive dialogue with the firms in order to encourage effective root cause analysis and remediation efforts across areas of deficiencies. Specifically we are dealing with improvements in professional skepticism, firm culture and tone at the top. I am encouraged that we have seen most firms take their responsibilities for remediation efforts very seriously.

In terms of moving forward from the Board's concept release and related public meetings, the Board will consider next steps and priorities related to this project during 2013.

In the meantime, the conversation and engagement with a full range of stakeholders on these very important issues is providing immense value to the entire system for an independent, high quality audit.

RELATED IMPLEMENTATION ISSUES FOR AUDIT COMMITTEES

A two-fold theme emerged from our public meetings and comment letters on auditor independence and audit firm rotation. First, there seems to be a common understanding and agreement that improvements are still needed to the current audit model in order to make financial statement audits more credible and relevant for investor protection.

And the second theme is an agreement about the importance of audit committees in overseeing the auditor and the audit process. The feedback regarding audit committees is that when they have the right people and the right resources, they have a tremendous, positive impact on the independence and quality of the financial audit.

We heard from many panelists and audit committee members that the audit committee oversight process was effective and working well in their organizations. However, we also heard that "not all audit committees are created equal" and that there appears to be significant variability in quality of practice.

PCAOB does not have oversight over the activities of audit committees. During our outreach, however, PCAOB has received feedback on ways that audit committee performance can be enhanced and strengthened, including audit committee expertise, education, and communications.

Regarding expertise, some suggested that the criteria and requirements for financial expertise on the audit committee should be strengthened. In addition, we received recommendations and suggestions dealing with the ongoing education for audit committees, including dissemination of information about audit committee "best practices," and that such actions would be especially helpful to smaller companies. We also received a recommendation for increased interaction among the PCAOB, the Securities and Exchange Commission, the stock exchanges, and audit committees to gather information about current strengths and weaknesses in audit committee practice.

The PCAOB has authority to set standards and regulate the auditor side of the relationship with audit committees. During our process of exploring auditor independence and audit firm rotation, some commenters emphasized the point that the PCAOB does not have authority to regulate audit committees. That is true. But we should not overlook the tremendous value in coordinating and leveraging our efforts; avoiding duplication and/or fragmentation; and providing for a seamless system of effective governance and audit oversight.

It is in the best interests of investors if the various organizations and groups charged with protecting investors, the public interest, and the integrity of the U.S. capital markets can work together effectively to achieve these goals.

I want to acknowledge and commend the collaborative efforts undertaken by the NACD, along with the Financial Executives International (FEI), the Institute of Internal Auditors (IIA), and the Center for Audit quality (CAQ), on a variety of projects to promote the deterrence and detection of financial reporting fraud through efforts aimed at increasing the effectiveness of participants across the supply chain. These types of efforts across networks and organizations get at the types of actions being called for in terms of providing education and resources for audit committees.

Recent PCAOB Initiatives Related to Audit Committee Communications

The PCAOB has taken steps recently to reach out to and support the work of audit committees. In August 2012, the Board issued both an informational release and a new standard dealing with audit committee communications. Both of the initiatives deal with topics that commenters and panelists have suggested would help strengthen communications between auditors and audit committees, including information about the audit, as well as the PCAOB inspection processes and results. As you know, healthy communications between auditors and audit committees are an important part of the audit committee's role of overseeing audit effectiveness, quality, and independence.

INSPECTION INFORMATION FOR AUDIT COMMITTEES

On August 1, 2012, the Board issued its release, *Information for Audit Committees about the PCAOB Inspection Process,* [6] to help audit committees understand the information provided in public PCAOB inspection reports and to alert audit committees to the nature of the nonpublic inspection information that they may find useful to explore with their auditor.

The Board has been told that audit committees want to hear more about our inspection reports and what they may be saying about the companies the audit committees oversee. We have also heard audit committee members express concern regarding a lack of information about PCAOB inspections of their audit firm, and we've been asked about how to understand what their auditors say about their inspection results.

The Board's release describes the contents of the inspection reports, including the public and non-public portions, and also describes the inspection process. The release also contains possible questions that audit committees may wish to ask their audit firms about PCAOB inspections, including:

1. *Was the company's audit selected for PCAOB inspection?* Audit committees may want real time updates about whether their audit has been selected for inspection and, if so, what is being looked at and whether the PCAOB identified any deficiencies in the company's audit.
2. *Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit*? Audit committees may want to understand whether similar deficiencies could occur in the company's audit, and what the firm is doing to prevent such deficiencies.
3. *What were the audit firm's responses to the PCAOB findings?* The PCAOB is aware of certain audit firm responses that should be viewed with skepticism, such as: *"It was just a documentation problem"* or *"There was a difference in professional judgment."* The release contains additional information about how to interpret such responses.
4. *What topics are included in Part II findings? A*udit committees may want to ask for certain information about the findings and the firm's efforts and actions to address any quality control deficiencies. Audit committees may also want to inquire about the status of the PCAOB's evaluation of the firm's progress on remediation.

AUDITOR COMMUNICATIONS WITH AUDIT COMMITTEES

The Board's other development dealing with auditor communications with audit committees is Auditing Standard (AS) No. 16, [7] which updates the information that auditors are required to share with audit committees. The objective of the standard is to increase the relevance and effectiveness of communications between the auditor and the audit committee and emphasize the importance of effective, two-way communications. In practice, many of the proposed communications were already taking place between many auditor and audit committees. The new standard should help ensure that these practices will be more consistently applied across audits.

The standard requires the auditor to communicate key issues about the overall audit strategy, timing, and significant risks, as well as audit results surrounding critical accounting policies and estimates, an evaluation of the quality of the company's financial reporting, difficult and contentious issues encountered during the audit, among other areas. In addition, AS No. 16 requires the auditor to inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not limited to, violations of laws or regulations. These auditor inquiries will supplement and enhance the current requirements under AS No. 12 — identifying and assessing the risks of material misstatement — for the auditor to inquire about the audit committee's knowledge of the risks of material misstatement, including fraud risks.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports.

The standard was approved by the Board on August 15, 2012, and is currently with the SEC. The standard will become effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

Concluding Remarks

It should be clear from my remarks today that I highly value the very important role that audit committees play in helping to ensure independent, high quality, and reliable audits. As a PCAOB board member, I welcome the opportunity to engage with the director and audit committee community to explore ways for the entire system to function effectively to produce reliable financial reporting with independent and credible audits.

Together we are in the position to provide powerful incentives and support for auditors and preparers to do the right thing, as well as adequate transparency to provide reasonable assurance that people will do the right thing, and appropriate accountability when issues need to be addressed.

The Board is currently exploring ways to have increased engagement with audit committee members. I look forward to working with the audit committee community on issues of mutual interest as we continue to advance the independence and reliability of financial auditing for the protection of investors and the effective and efficient functioning of our capital markets.

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[1] See, for example, the discussion by the Securities and Exchange Commission of the "self-serving bias" that auditors are inclined to experience in the Commission's release accompanying its 2000 amendments to its auditor independence rules, SEC Release No. 33-7919, Nov. 21, 2000.

[2] *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817 (1984) (emphasis in original).

[3] United States General Accounting Office, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, November 2003 (GAO-04-216).

[4] GAO-04-216, p. 8

[5] GAO-04-216, p. 9.

[6] ***Information for Audit Committees about the PCAOB Inspection Process***, PCAOB Release No. 2012-003, August 1, 2012.

[7] ***Auditing Standard No. 16 — Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU sec. 380***, PCAOB Release No. 2012-004, August 15, 2012.