

Audit Quality and Investor Protection: The Need for Ongoing Vigilance

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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.

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 certain provisions of the Sarbanes-Oxley Act, the rules of the PCAOB and the Securities and Exchange Commission, and other laws, rules, and PCAOB standards governing the audits of issuers, brokers, and dealers.

The PCAOB's responsibilities extend to registered public accounting firms that are located in the United States and in other jurisdictions around the world, regardless of the location of the audit work.

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 800 firms report that they audit 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.

PCAOB Inspections: Common Findings

□ **Common Audit Deficiency Areas**

- Revenue Recognition
- Fair Value of Financial Instruments
- Testing and Evaluating Internal Controls
- Related Party Transactions
- Fraud Risk
- Equity Financing Instruments

□ **Common Audit Firm Quality Control Deficiency Areas**

- 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

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:
 - 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)

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%

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)

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

Audit Standard No. 16

Communications with Audit Committees

- On August 15, 2012, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*, and related amendments.
 - AS No. 16 is effective for audits of fiscal years beginning on or after December 15, 2012.
- AS No. 16 requires communications with the audit committee to be made in a timely manner and prior to the issuance of the audit report.
- Auditing Standard No. 16:
 - Provides a definition of audit committee;
 - Retains or enhances existing communication requirements;
 - Incorporates certain SEC auditor communication requirements to audit committees; and
 - Adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

Audits and Attestations --Brokers and Dealers

- ❑ On July 30, 2013, the SEC adopted new rules to amend the broker-dealer reporting rule (Rule 17a-5) under the Securities Exchange Act of 1934:
 - PCAOB standards are applicable for audits of years ending on or after June 1, 2014.
 - Generally, a broker-dealer that **has** custody of the customers' assets must file a compliance report with the SEC to verify they are adhering to broker-dealer capital requirements, protecting customer assets they hold.
 - Generally, a broker-dealer that **does not have** custody of its customers' assets must file an "exemption report" with the SEC citing its exemption from requirements applicable to carrying broker-dealers.

Recently Adopted PCAOB Standards for Brokers-Dealer Auditors

- ❑ Attestation Standard No. 1 – *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*
- ❑ Attestation Standard No. 2 – *Review Engagements Regarding Exemption Reports of Brokers and Dealers*
- ❑ Auditing Standard No. 17 – *Auditing Supplemental Information Accompanying Audited Financial Statements*

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%

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

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

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.

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.

Related Parties Reproposal

- On May 7, 2013, the Board repropoed for comment an auditing standard on related parties and related amendments, including amendments regarding significant unusual transactions.
 - An original proposal was issued for public comment on February 28, 2012. The Board received 37 comment letters and discussed the proposal at the May 17, 2012 SAG meeting.
- The repropoed standard and amendments address:
 - Evaluating a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.
 - Identifying and evaluating a company's significant unusual transactions.
 - Obtaining an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment process.
- The repropoed standard and amendments are designed to improve audit quality in areas that pose significant risks of material misstatement, including misstatement arising from fraud.
- The comment period closed on July 8, 2013. The staff is analyzing 24 comment letters received.

Audit Transparency: Identification of the Engagement Partner and Other Public Accounting Firms or Persons That Are Not Employed by the Auditor but Participate in the Audit

- ❑ On October 11, 2011, the Board issued for public comment proposed amendments to its auditing standards and annual reporting form.
- ❑ The proposed amendments would improve transparency of audits by requiring the disclosure of the engagement partner and disclosure of other accounting firms and other persons that took part in the audit.
- ❑ The proposed amendments were discussed at the November 2011 and May 2013 SAG meetings.
- ❑ The PCAOB plans to re-propose amendments before the end of 2013.

Reorganization of PCAOB Auditing Standards

“Interim” Standards

AU
110

AU
161

AU
210

Etc.

**Reorganized
Standards
(AS Sections)**

Board-Issued Standards

AS No.
1

AS No.
3

AS No.
4

Etc.

Reorganization of PCAOB Auditing Standards (cont'd)

- **Categories in the proposed framework for the reorganization:**
 - AS 1000 General Auditing Standards
 - AS 2000 Audit Procedures
 - AS 3000 Auditor Reporting
 - AS 4000 Matters Relating to Filings under Federal Securities Laws
 - AS 6000 Other Matters Associated with Audits

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

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

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

Audit Quality Indicator Project

- ❑ 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

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.

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, in order to better understand audit quality in firms and better inform the PCAOB's standard-setting and other regulatory activities;
- 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.

Standing Advisory Group Meeting

Nov. 13-14, 2013

- ❑ **Fraud Task Force:** Potential objectives of a Fraud Task Force, as well as a panel discussion related to fraud considerations. Fraud was last discussed with the SAG at the November 2012 meeting.
- ❑ **Audit Quality Indicators:** An update on the development of audit quality indicators since the SAG last discussed the issue at its May 2013 meeting.
- ❑ **Auditor's Reporting Model:** Proposed auditing standards on the auditor's report and the auditor's responsibilities regarding other information in an annual report.

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