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Report from the Working Group on How to Improve Audit Quality and the Relevancy of the Audit

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Recommendations

- Implement an expanded audit report that provides meaningful, incremental information to investors
- Require the audit report to include the name or signature of the lead engagement partner
- Implement a rebuttable presumption that the auditor of an issuer will be inspected if audit fees decline by X% and/or if size- and industry-adjusted audit fees are more than two standard deviations away from the mean
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Recommendations

- Enhance audit firm governance by requiring independent directors (with full voting powers) and/or advisory boards with meaningful governance responsibilities
- Heighten the existing auditing standard regarding the auditor’s going concern evaluation
- Allow shareholder proposals to address auditor issues, including auditor ratification and the audit report
Implement an Expanded Audit Report

Audit quality will improve because if the client’s accounting is pushing the bounds of acceptability the auditor can highlight such in the report.

- As a result, client is likely to temper accounting that is “too close to the line”

Including meaningful, incremental information in the report would make the report more relevant for both investment and stewardship purposes, by helping investors better evaluate and price risk.

Such expanded auditor reporting exists in the UK and appears to be working well.

- Example: Rolls Royce

An expanded audit report was recommended by the Advisory Committee on the Auditing Profession (ACAP)
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Require the Signature or Identification of the Engagement Partner

- Audit quality will improve because personal identification, which fosters enhanced personal accountability, makes individuals more careful and diligent.
- Audits are done by teams of individuals – the partner is the team leader – market (and ACs) would have better information for auditor selection since the engagement partner’s industry-experience and prior performance history would now be transparent.
- Growing body of research finds a number of salutary benefits associated with audit partner identification (e.g., Carcello and Li 2013 TAR; Knechel et al. Forthcoming CAR).
- Partner signature or identification was recommended by ACAP.
Implement a Rebuttable Presumption that Abnormally Low Audit Fees will Result in Inspection

- Audit quality is inversely correlated with audit hours, and prior research finds a strong positive relation between fees and hours: higher fees, more audit work – no evidence of rent seeking (e.g., Eshleman and Guo 2014 AJ PT; Blankley et al. 2012 AJ PT)
- If issuers know that abnormally low fees will result in their auditor and engagement being inspected, such low-balling behavior will be mitigated
- A reduction in low-balling behavior will increase audit quality in the short run
- A more profitable profession will attract better entrants, improving audit quality in the long run
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**Auditor Switches and Audit Fee Changes**

Analysis below based on Audit Analytics data from 2010 to 2013:

<table>
<thead>
<tr>
<th>From</th>
<th>To</th>
<th>N</th>
<th>Average Change in Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms 1-3</td>
<td>Firms 4-6</td>
<td>130</td>
<td>(14.2%)</td>
</tr>
<tr>
<td>Firms 4-6</td>
<td>Firms 1-3</td>
<td>85</td>
<td>6.5%</td>
</tr>
<tr>
<td>Firms 1-3</td>
<td>Firm 4</td>
<td>85</td>
<td>(7.3%)</td>
</tr>
<tr>
<td>Firm 4</td>
<td>Firms 1-3</td>
<td>67</td>
<td>6.4%</td>
</tr>
<tr>
<td>Firms 5-6</td>
<td>Firm 4</td>
<td>11</td>
<td>26.6%</td>
</tr>
<tr>
<td>Firm 4</td>
<td>Firms 5-6</td>
<td>15</td>
<td>(18.3%)</td>
</tr>
</tbody>
</table>
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Enhance Audit Firm Governance by Requiring Independent Directors on Firm Governing and/or Advisory Boards

- Audit quality will improve because independent directors will be an advocate for the public interest and will act as a disciplining mechanism on firm decisions and actions
  - The salutary benefits of effective corporate governance are well documented in the corporate community
- A greater diversity of thought usually increases the quality of decisions
- Independent non-executives (INEs) have been required for firms in the UK for a number of years and individuals in the UK are generally quite positive as to their effects (both at the FRC and ICAEW)
- INEs on firm governing boards was recommended by ACAP
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**Heighten Auditor Going Concern Reporting**

- Audit quality is better if investors are provided with an early warning of impending firm failure.
- Investors are particularly concerned with fraud and bankruptcy given the large dollar losses typically triggered.
- Need for improvement – very few financial institutions received GC reports before the financial crisis.
- Any reduction in auditor GC reporting would clearly reduce the information set received by investors.
- Some have expressed concerns of impact of new FASB standard on related auditing standards.
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Allow Shareholder Proposals on Auditor Issues

- We recognize that this is an SEC issue, not a PCAOB issue
- Nevertheless, substantial, enthusiastic support for this recommendation among the sub-committee
- Audit quality would improve by more closely aligning the auditor’s incentives with those of users of the audit services, investors
  - We expect more informative audit reports, produced by higher quality auditors, fairly compensated
  - In many ways, this one recommendation, particularly if mutual funds were required to attend to, addresses a number of the other issues in our presentation
- Enables private ordering, rather than one-size-fits-all regulations, which has the benefit of greater tailoring to individual issuer-auditor circumstances
- Provides investor feedback to regulators
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Questions