Statement of Joseph V. Carcello
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University of Tennessee
Before the PCAOB Investor Advisory Group
May 4, 2010
Washington, D.C.

In advance of the inaugural meeting of the PCAOB's Investor Advisory Group, I have been asked to list the five items that I believe should be the PCAOB's top priorities. These items and my reasoning are listed below.

<u>Item #1</u> -- Prioritize inspections of foreign registered firms, particularly for those firms performing substantial portions of the audits of U.S. multinationals or, where legal obstacles remain, implement and rely on firm-based inspections of such foreign affiliates which are subject to detailed PCAOB inspection.

I believe that the top priority of the PCAOB should be to complete inspections of all registered foreign firms that audit one or more foreign issuers or that play a substantial role in the audit of a U.S. multinational company. I suggest that the Board focus its efforts on inspecting those foreign accounting firms that audit large foreign issuers or that play a substantial role in auditing U.S. multinationals, especially where the foreign subsidiaries of the U.S. multinational audited by the registered foreign firm are material to the consolidated financial statements of the U.S. multinational.

Foreign registrants audited by foreign accounting firms represent a non-trivial portion of total U.S. stock market capitalization (more detail will be provided in our presentation at the IAG meeting). To the extent that these firms have not been inspected, U.S. investors are potentially exposed to sub-standard audit quality.

This issue is exacerbated because redress to the U.S. court system by investors in foreign registrants in the case of financial reporting and auditing failures, either against the foreign registrant or against the foreign accounting firm, is likely to be more difficult.

In addition, a substantial portion of consolidated revenues, income, and assets of U.S. multinationals pertain to foreign subsidiaries (more detail will be provided in our presentation at the IAG meeting). U.S. accounting firms typically outsource the auditing of foreign subsidiaries to a foreign affiliate of the U.S. firm. To the extent that these foreign affiliated accounting firms have not been inspected, U.S. investors are potentially exposed to sub-standard audit quality.

The importance of inspecting large foreign accounting firms is accentuated by the fact that the Board's ability to inspect registered firms in a number of foreign countries – in particular, in China, Germany, France, the United Kingdom, and Italy have been blocked. These countries have the 3rd, 4th, 5th, 6th, and 7th largest gross domestic products in the world so foreign registrants domiciled in these countries are likely to be large, and subsidiaries of U.S. multinationals located in these countries are likely to be large. Therefore, the exposure of U.S. investors to sub-standard audit quality may be significant.

Finally, fraudulent financial reporting is a strategic act. That is, management reacts to actions taken by auditors and regulators to prevent and detect fraud. To the extent that audit quality has improved in the U.S. as a result of PCAOB inspections, and to the extent that accounting firms auditing foreign subsidiaries are not being inspected, a rational, self-interested, manager who is committing fraud should be expected to seed the fraud in those subsidiaries where audit work is not being examined. This likely behavioral consequence of the Board's inability to inspect certain foreign accounting firms only exacerbates the risk to U.S. investors. And there is some evidence that U.S. multinationals have seeded fraud in their foreign subsidiaries (e.g., see WorldCom and Lehman Brothers).

I recognize that the Board faces a difficult challenge in this area because inspections of certain foreign accounting firms are being blocked by foreign governments. Nonetheless, I suggest that the Board redouble its efforts to get access to these foreign accounting firms through political and diplomatic negotiations. In the interim, the Board should not only disclose the registered foreign accounting firms that have not been inspected, but also disclose: (1) the names of foreign registrants whose auditor has not been inspected, and (2) the names of U.S. multinationals if material foreign subsidiaries have been audited by a non-U.S. firm that has not been inspected. In addition, for foreign subsidiaries of U.S. multinationals audited by foreign affiliates of U.S.-based accounting firms, the Board should require the U.S.-based accounting firm to conduct detailed internal inspections of foreign affiliates subject to PCAOB review.

<u>Item #2</u> -- Require registered firms (at least the 6 largest) to have independent members on firm governing boards and/or implement more rigorous PCAOB examination of the audit firm's culture.

The importance of accounting firm's culture to audit quality has been documented by "blue ribbon" commissions in the past. For example, the Panel on Audit Effectiveness concluded "[t]he "tone at the top" of an audit firm is a major influence on its culture. It determines, for example, whether the culture is quality-oriented or sales-oriented, and whether top management extols the important role audits play in the capital markets or acts as if audits are little more than minimum-value commodities" (2000, p. 99).

I believe that independent members on firm governing boards can act to improve audit quality by helping to ensure that the focus of the firm remains primarily on the public interest. Therefore, I suggest that the PCAOB encourage the largest accounting firms to add independent members to firm governing boards – individuals of competence and integrity who have a demonstrated interest in public company auditing and a commitment to the needs of investors. If firms are unresponsive to such encouragement, I believe the PCAOB, working in conjunction with the SEC, should require firms to include independent members on firm governing boards.

A number of prominent outside groups recognize the potential benefits of placing independent members on firm governing boards. For example, the U.S. Treasury Advisory Committee on the Auditing Profession recommended that "the PCAOB and SEC … analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting powers to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms" (Treasury Advisory Committee 2008, VII:8). Unfortunately, although the PCAOB has discussed this recommendation, it has not taken any action (PCAOB Standing Advisory Group Meeting white paper, April 2010). In addition, the United Kingdom has recently adopted a new Audit Firm Governance Code (ICAEW, January 2010). Under this U.K. Code, independent members will be added to audit firm governing boards.

<u>Item #3</u> -- Create a national fraud center under the auspices of the PCAOB.

Fraudulent financial reporting, although having declined from its incidence pre-SOX, continues to exist and, if anything, the consequences of fraud have become larger in more recent years. A forthcoming study funded by COSO finds that fraud has become slightly more prevalent between 1998 and 2007 than between 1987 and 1997, and that the magnitudes of the frauds have become much larger (Beasley, Carcello, Hermanson, and Neal 2010).

The U.S. Treasury Advisory Committee recommended that the PCAOB create a national fraud center (Treasury Advisory Committee 2008, VII:1). The PCAOB has decided to create this Center and is in the progress of searching for an executive director (PCAOB Standing Advisory Group Meeting white paper, April 2010). Although this decision by the PCAOB is encouraging, the proposed scope of the Center is limited to: (1) being a repository of information related to financial reporting fraud, and (2) producing reports related to the risks of financial reporting and fraud. These are worthwhile activities, but to some extent these activities are already being performed by other organizations (e.g., see AICPA, ACFE, CAQ, COSO, Deloitte Forensic Center, and academic research, among others).

I would encourage the PCAOB to be more ambitious in developing the fraud center. Working with the SEC, the PCAOB should model the National Fraud Center after the National Transportation Safety Board. As such, a detailed forensic examination would be performed after major instances of fraudulent financial reporting to understand: (1) the motivations behind the fraud, (2) how the fraud was perpetrated, including how controls were overridden, (3) the failure of governance mechanisms in preventing and detecting the fraud, including the failure of the external auditor to detect the fraud. This knowledge would then inform future rulemaking, standard setting, and inspection policy, affecting both public companies and their auditors and contributing to the effective discharge of both the SEC's and PCAOB's investor protection missions.

<u>Item #4</u> -- Develop, measure, and report on a listing of audit quality indicators.

The PCAOB's mission is to "…protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports." Improving audit quality is the major way the PCAOB can accomplish its mission. By creating incentives for accounting firms to compete on audit quality, such quality is likely to improve. Recognizing this fact, the Treasury Advisory Committee recommended that the PCAOB "determine the feasibility of developing key indicators of audit quality and effectiveness and require auditing firms to publicly disclose these indicators" (Treasury Advisory Committee 2008, VIII:14).

The PCAOB has discussed the issue of developing audit quality indicators with its Standing Advisory Group, and it is monitoring activities in this area by other groups (e.g., IOSCO, IAASB) (PCAOB Standing Advisory Group Meeting white paper, April 2010). Although these initiatives are appropriate, they do not go far enough. Since audit quality indicators have already been developed in the United Kingdom and in continental Europe, the development of audit quality indicators is clearly feasible.

I encourage the PCAOB to promptly develop a panel of audit quality indicators and require firms to publicly disclose these indicators, subject to PCAOB inspection. In addition, I believe that the Board should primarily focus on output measures of audit quality rather than focusing exclusively on input measures of quality.

<u>Item #5</u> -- Require the audit partner to sign the audit report.

Audit reports are currently signed in the name of the audit firm. The Treasury Advisory Committee recommended that the PCAOB "…undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report" (Treasury Advisory Committee 2008, VII:19). The PCAOB has issued a concept release to solicit comments on whether the Board should require the audit partner to sign the engagement report (PCAOB Standing Advisory Group Meeting white paper, April 2010). Such a requirement already exists in much of Europe as well as in certain other countries around the world.

I believe that the requiring the engagement partner to sign the audit report in his or her own name would increase a sense of personal accountability, particularly at the margin, and would also increase the transparency around the audit process. My comment letter (jointly with Audrey Gramling, Todd DeZoort, and Dana Hermanson) to the PCAOB outlining these arguments in greater detail is attached. I encourage the Board to move forward with a standard setting agenda to require the engagement partner to sign the audit report.

August 13, 2009

Mr. J. Gordon Seymour
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket No. 029 – Engagement Partner Signature on the Audit Report

Dear Mr. Seymour:

We are members of the Auditing Section of the American Accounting Association, and are writing to commend the PCAOB for formally considering requiring the engagement partner's signature on the audit report. As you are aware, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession recommended that the PCAOB undertake a standard-setting initiative mandating the engagement partner's signature on the auditor's report. We believe that such a requirement is likely to have a number of positive effects, including a change in partner behavior that would positively influence audit quality, and an increase in transparency for audit and financial statement users. We are not advocating any specific requirements of the partner sign-off (e.g., which partners should be required to provide signatures); rather, we want to highlight why having one or more individuals provide a personal signature on the audit report has strong potential merit (addressing Questions 1-3 of the July 28th Concept Release). Below we describe the basis for our belief, including references to relevant research. This letter represents our views, which are not necessarily the views of our universities, the American Accounting Association, or the Auditing Section of the American Accounting Association.

While the academic literature does not directly address the issue of partner sign-off, research (e.g., DeZoort, Harrison, and Taylor 2006; Johnson and Kaplan 1991; Kennedy 1993) shows that accountability (which would likely result from having to provide a personal signature on the audit report) reduces auditors' biases in information processing and enhances auditors' consensus and effort. We believe that there is a persuasive body of evidence suggesting accountability effects are robust across a variety of groups representing different ages, professional interests, and hierarchical levels. Further, the psychology literature (Schlenker, Britt, Pennington, Murphy, and Doherty 1994) highlights that individual sense of responsibility for performance "flows" from accountability. We also find it very interesting that a recent research study (Cohen, Krishnamoorthy, and Wright 2009) reports that 68% of practicing auditors interviewed believe that the SOX Section 302 requirements for CEO and CFO certification have had a positive effect on the integrity of financial reporting. Reasoning would suggest that certification by an audit partner, in the form of a personal signature, would have a similar positive effect on the performance of the audit. We also refer you to Carcello, Bedard, and Hermanson (2009), who expressed strong support for audit partner signatures on the audit report.

We acknowledge that the current research does not definitively settle the issue of partner sign-off, and we recognize that researchers may learn about other effects of partner sign-off with additional research. However, we believe that currently there is a strong basis for anticipating that partners, and hence audit quality, would be affected by the accountability pressure resulting from providing a personal signature.

Thank you for your work on this very important initiative and your continued focus on the public interest.

Sincerely,

Audrey Gramling, President, Auditing Section of the American Accounting Association, Kennesaw State University

Joseph Carcello, Ernst & Young Professor and Director of Research – Corporate Governance Center, University of Tennessee

Todd DeZoort, Professor of Accounting and Accounting Advisory Board Fellow, The University of Alabama

Dana Hermanson, Dinos Eminent Scholar Chair and Professor of Accounting, Kennesaw State University

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