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# Report from the Working Group on the Investor Survey

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- With thanks to Patrick Whalen for research assistance.

# Investor Survey

## Sampling Framework and Response Profile

- Survey was developed initially by Carcello and Yerger, and then substantially revised based on feedback from other members of the working group
- Survey was sent to the membership base of the Council of Institutional Investors, with follow-up
- Survey was sent to a database of institutional investors developed by Carcello (three mailings)
  - Approximately 500 entries
  - Mutual funds, Public and union pension funds, Endowments and foundations, Hedge funds, Private equity

# Investor Survey

## Why a Survey?

- ❑ The SEC has been described as “We are the investor’s advocate”
- ❑ The PCAOB’s website says: “Protecting investors through audit oversight”
- ❑ Suggests that the missions of these two agencies should be heavily influenced by the needs of investors
- ❑ Survey designed to get high-level views of investors on issues affecting audit oversight

# Investor Survey

## Respondents – Organizational Type

□ N=51

Respondent type	Number of respondents	Percentage
Company sponsored pension fund	2	4%
Endowment	13	25%
Hedge fund	2	4%
Insurance company	2	4%
Mutual fund	10	20%
Private equity fund	2	4%
Public pension fund	9	18%
Union pension fund	2	4%
Asset / investment management	7	14%
Other	2	4%

# Investor Survey

## Respondents – Organizational Type

Assets under management	Number of respondents	Percentage
Less than \$1 billion	1	2%
\$1 billion - \$10 billion	14	27%
\$10 billion - \$100 billion	10	20%
\$100 billion - \$500 billion	10	20%
\$500 billion - \$1 trillion	6	12%
More than \$1 trillion	6	12%
N/A	4	8%

# Investor Survey

## Respondents – AUM

- The cumulative assets under management (AUM) of the organizations that responded to the survey are approximately **\$13.4 trillion**

# Investor Survey

## Respondents – Job Position

Job position	Number of respondents	Percentage
Chief investment officer	9	18%
Governance officer	9	18%
Portfolio manager	5	10%
Senior analyst	10	20%
Director of investment operations	2	4%
Investment relations officer	2	4%
Chief financial officer	5	10%
Accounting / auditing / treasury / operating officers	8	15%
Not provided	1	2%

# Investor Survey

## Knowledge about External Audits and Audit Process

Knowledge level	Number of respondents	Percentage
Very high	17	33%
High	12	24%
Moderate	18	35%
Low	3	6%
Very low	1	2%

# Investor Survey

## Reliance on Audit Opinion – FS GAAP Compliant

Reliance on FS audit opinion	Number of respondents	Percentage
Extensively	24	47%
A good bit	24	47%
A little	3	6%
Not at all	0	0%

# Investor Survey

## Reliance on Audit Opinion – FS GAAP Compliant

- Supportive:
  - “Financial statements would be worthless without GAAP compliance.” (Governance officer, Union pension fund)
  - “The financial system is built largely on trust. The only way investors can rely on financial statements is if there is an independent observer seeing what we cannot see to help establish that the trust is reasonable.” (Senior analyst, Mutual fund)
  - “I think the audit profession has done a good job overall in ensuring companies adhere to GAAP – this is a situation that is best answered in reverse – it matters a lot when an auditor qualifies a report as it is a powerful signaling device.” (Portfolio manager, Mutual fund)

# Investor Survey

## Reliance on Audit Opinion – FS GAAP Compliant

- Less Supportive:
  - “Audit opinion is very important to investors; however, we use other sources such as sell-side research, primary research, and corporate governance vendors.” (Portfolio manager, Public pension fund)
  - “You can’t necessarily trust the statements with an auditor sign off, but you certainly can’t trust them without one.” (Portfolio manager, Mutual fund)

# Investor Survey

## Reliance on Audit Opinion – ICFR

Reliance on ICFR audit opinion	Number of respondents	Percentage
Extensively	18	35%
A good bit	19	37%
A little	14	27%
Not at all	0	0%

# Investor Survey

## Reliance on Audit Opinion – ICFR

- Supportive:
  - “This is a huge red flag.” (Portfolio manager, Mutual fund)
  - “I cover financial institutions. This has been an excellent innovation, as it forces companies to invest more in risk management & compliance systems that are the lifeblood of an FI.” (Senior analyst, Mutual fund)
- Less Supportive:
  - “Experience shows that most red flags are discovered ex-post.” (Portfolio manager, Mutual fund)
  - “A surprising number of firms have auditor identified material weaknesses in internal controls; however, most such weaknesses that I have encountered do not appear to imply significant risk. As a result, this opinion is important but not necessarily a driver of investment.” (Senior analyst, Mutual fund)

# Investor Survey

## Reliance on Audit Opinion – ICFR

- Differences between investor group (n=38) and management group (n=13):
  - All but one of the management group respondents relied on the ICFR opinion either “a good bit” or “extensively”
  - Investor group responses were evenly split between “extensively” (34%), “a good bit” (32%), and “a little” (34%)

# Investor Survey

## Effect on Confidence – Elimination of Mandatory FS Auditing

Effect on confidence if mandatory FS auditing eliminated	Number of respondents	Percentage
Substantially reduced	41	80%
Reduced a good bit	7	14%
Reduced a little	1	2%
Not reduced at all	2	4%

# Investor Survey

## Effect on Confidence – Elimination of Mandatory FS Auditing

- Supportive:
  - “We would not invest in companies that didn’t have their financial statements audited.” (Governance officer, Public pension fund)
  - “The financial system cannot work without sound audits. Some management teams would use the lack of financial statement audits to defraud investors. Also, short sellers would have a greater opportunity to make audacious claims that cannot be put down by an independent party.” (Senior analyst, Mutual fund)
  - “The increased risk of fraud would be exponential and lead to a stock market collapse.” (Governance officer, Union pension fund)
  - “While most firms would uphold high standards, some wouldn’t and it would taint the entire market. Classic “problem of lemons” from economic literature. (Senior analyst, Mutual fund)

# Investor Survey

## Effect on Confidence – Elimination of Mandatory FS Auditing

- Supportive (con't):
  - “GAAP is increasingly complex and frequently not intuitive, so easy for companies to make an error and without an audit could also increase the opportunity for error. Although non-GAAP results are often more relevant, the non-GAAP is anchored in the GAAP results.” (Governance officer, Private equity fund)
- Less Supportive:
  - “I think that the market would self regulate by applying a discount to public companies that didn’t have audited financials. It is the footnotes and MD&A where much of the accounting policies and their impact are disclosed and of value to investors.” (CFO, Endowment)

# Investor Survey

## Assess Regulatory Safeguards – Audit Firm Independence – Non-Audit Services

Adequate regulatory safeguards – non-audit services	Number of respondents	Percentage
Strongly agree	6	12%
Agree	12	24%
Neutral	21	41%
Disagree	8	16%
Strongly disagree	4	8%

# Investor Survey

## Assess Regulatory Safeguards – Audit Firm Independence – Non-Audit Services

- Differences between investor group (n=38) and management group (n=13):
  - 29% of investor respondents either “disagree” or “strongly disagree” that adequate regulatory safeguards exist
  - Only 8% of management respondents feel this way

# Investor Survey

## Do You Have the Information Needed to Make the Previous Assessment?

Information needed to assess audit firm independence – non-audit services	Number of respondents	Percentage
All of the information needed	7	14%
Most of the information needed	17	33%
Some of the information needed	21	41%
None of the information needed	6	12%

# Investor Survey

## Sufficient Information Needed to Assess Audit Firm Independence – Free Response

- Agree:
  - “Existing fee disclosures are sufficiently robust.” (Governance officer, Private equity fund)
- Don't Agree:
  - “The disclosure on non audit work is not sufficiently granular for us to understand where independence may be impaired.” (Portfolio manager, Public pension fund)
  - “I would like better disclosure of auditing firms’ conflicts policy and also detailed financial statements including profit earned by division (tax, consulting, and audit) (Portfolio manager, Public pension fund)
  - “Audit firm tenure and the name of the lead audit partner should be disclosed.” (Governance officer, Union pension fund)

# Investor Survey

## Sufficient Information Needed to Assess Audit Firm Independence – Differences

- Difference between investor group (n=38) and management group (n=13):
  - The modal response from investor group respondents was “I have some of the information I need” (47%)
  - The modal response from the management group respondents was “I have most of the information I need” (46%)

# Investor Survey

## Assess the Scope of the Standard Independent Audit

Adequate scope of external audit	Number of respondents	Percentage
Expand audit scope	12	24%
Audit scope about right	38	74%
Reduce audit scope	1	2%

# Investor Survey

## Assess the Scope of the Standard Independent Audit – Free Response

- Sufficient:
  - “In my opinion, the scope of those audits I’ve observed is balanced.” (CIO, Operating fund)
  - “I think it’s about right. If anything it should be reduced. You currently have the situation where management is signing rep letters that limit auditor scope and responsibility anyway.” (CFO, Endowment)

# Investor Survey

## Assess the Scope of the Standard Independent Audit – Free Response

- Not Sufficient:
  - “We should get more than pass/fail given the money that is spent on audits.” (Governance officer, Public pension fund)
  - “I think it would be useful if audits were expanded to include more tests for fraud.” (Senior analyst, Mutual fund)
  - “I think management and their typically self-selected board of directors should not hire the auditors. I am not as worried about the scope, as I am on auditors focusing on what matters to investors, that is where material misstatements are more likely to happen.” (Portfolio manager, Public pension fund)

# Investor Survey

## Assess the Scope of the Standard Independent Audit – Differences

- Difference between investor group (n=38) and management group (n=13):
  - All but one of the 11 responses claiming “the scope of the external audit should be expanded” fell in the investor group
  - 29% of investors thought the scope of the audit should be expanded; only 8% of the management group felt this way

# Investor Survey

## Have Enough Information to Assess the Quality of the External Audit

Adequate information to evaluate audit quality	Number of respondents	Percentage
All of the information needed	5	10%
Most of the information needed	23	45%
Some of the information needed	18	35%
None of the information needed	5	10%

# Investor Survey

## Sufficient Information to Assess the Quality of the External Audit – Free Response

- Agree:
  - “It’s hard to audit the auditor, but I believe the processes, if followed, are adequate.” (Portfolio manager, Mutual fund)
  - “As a PE firm we either sit on the board or control the company and therefore have sufficient information regarding the auditor.” (Governance officer, Private equity fund)

# Investor Survey

## Sufficient Information to Assess the Quality of the External Audit – Free Response

- Don't Agree:
  - “Greater transparency into audit quality through the use of audit quality indicators would give investors more information to evaluate the quality of the external auditor.” (Governance officer, Public pension fund)
  - “Need to know the name of the partner and for how much work other firms were used especially in other countries like China.” (Senior analyst, Mutual fund)
  - “The audits are pass/fail. That provides little information, so there is a reliance on auditor reputation.” (Governance officer, Public pension fund)
  - “Maybe it would be help to see a scorecard of what % of the auditor’s audits turned out to be materially wrong over time.” (Portfolio manager, Mutual fund)

# Investor Survey

## Sufficient Information to Assess the Quality of the External Audit – Differences

- Differences between the investor group (n=38) and management group (n=13):
  - 85% of management group respondents felt that either had “all of the information needed” or “most of the information needed”
  - Only 45% of investor group respondents felt this way

# Investor Survey

## Assess Importance of Potential AQIs

<b>AQI</b>	<b>Very important</b>	<b>Somewhat important</b>	<b>Not important</b>	<b>Uncertain</b>	<b>Average</b>
Partner workload	39%	53%	0%	8%	2.43
Staff workload	59%	29%	0%	12%	2.67
Audit team turnover	67%	24%	2%	8%	2.70
Partner professional experience	75%	20%	0%	6%	2.79
Staff professional experience	51%	43%	0%	6%	2.54
Partner industry experience	76%	20%	0%	4%	2.80
Staff industry experience	49%	47%	0%	4%	2.51

# Investor Survey

## Assess Importance of Potential AQIs

<b>AQI</b>	<b>Very important</b>	<b>Somewhat important</b>	<b>Not important</b>	<b>Uncertain</b>	<b>Average</b>
Supervision and review	69%	27%	0%	4%	2.71
Firm tone at the top	65%	22%	2%	12%	2.71
Firm investment in tools, technologies	49%	41%	4%	6%	2.48
Focus on audit quality in evals and comp	55%	37%	0%	8%	2.60
PCAOB inspection findings	49%	37%	8%	6%	2.44
Litigation against auditor	57%	37%	4%	2%	2.54

# Investor Survey

## Assess Importance of Potential AQIs

<b>AQI</b>	<b>Very important</b>	<b>Somewhat important</b>	<b>Not important</b>	<b>Unsure</b>	<b>Average</b>
Restatements – audit by current firm	71%	24%	2%	4%	2.71
Frauds – audit by current firm	84%	14%	0%	2%	2.86
Clean report before bankruptcy	57%	35%	4%	4%	2.55
Clean report before MW	57%	33%	4%	6%	2.56

# Investor Survey

## Confidence that Audit Committees Adequately Represent the Interest of Investors

<b>Confidence that audit committees adequately represent interests of investors</b>	<b>Number of respondents</b>	<b>Percentage</b>
Completely	4	8%
A good bit	29	57%
A little	16	31%
Not at all	2	4%

# Investor Survey

## Audit Committees Adequately Represent the Interest of Investors – Free Response

- Agree:
  - “I believe they act independently to review external auditors.” (Assistant treasurer, Mutual fund)
  - “The Sarbanes-Oxley Act strengthened the independence and expertise of audit committees.” (Governance officer, Union pension fund)
- Don't Agree:
  - “Hard to determine since these committees are not very transparent.” (CFO, Endowment)
  - “Audit committees are often nominated by management. We believe directors on the audit committee should only be allowed to be nominated by investors.” (Portfolio manager, Public pension fund)

# Investor Survey

## Audit Committees Adequately Represent the Interest of Investors – Free Response

- Don't Agree (con't):
  - “Audit committees tend to defer to management when negotiating audit fees.” (Senior analyst, Mutual fund)
  - “Corporate boards in general are weak. Directors are chosen based on relationships and reputation. Rarely do they have deep industry expertise, let alone functional expertise. Most directors are conscientious and have good intentions. But they do not have deep industry/subject expertise and thus are not in a position to challenge management.” (Senior analyst, Mutual fund)

# Investor Survey

## Audit Committees Adequately Represent the Interest of Investors – Differences

- Differences between investor group responses (n=38) and management group responses (n=13):
  - 77% of the management group are either “a good bit” or “completely” confident that audit committees adequately represent the interests of investors
  - 61% of investor group respondents felt this way

# Investor Survey

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## Questions



# Investor Survey

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## **Open Discussion**