September 9, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C.  20006-2803

Via email to comments@pcaobus.org

RE:  PCAOB Rulemaking Docket Matter No. 029: Concept Release on Requiring the Engagement Partner to Sign the Audit Report

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the PCAOB Rulemaking Docket Matter No. 029: Concept Release on Requiring the Engagement Partner to Sign the Audit Report. We appreciate the opportunity to provide input.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist in developing revisions to the PCAOB’s standard on partner signature. If the Board has any questions about our input, please feel free to contact our committee chair for additional follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Commenting Committee Members:
Chair, James L. Bierstaker, Villanova University, phone: (610) 519-6101, email: james.bierstaker@villanova.edu
Past Chair – Randal J. Elder, Syracuse University
Paul Caster, Fairfield University
Brad J. Reed, Southern Illinois University Edwardsville
Lawrence Abbott, University of Memphis
Susan Parker, Santa Clara University
Steven Firer, Monash University – South Africa
General Comments

The Committee commends the PCAOB (“the Board”) for addressing the issue of including partner signatures on the audit report. The following section presents a number of specific comments or suggestions, organized along the lines of the questions posed by the Board in the concept release.

Here are comments to selected specific questions in the concept release:

1. *Would requiring the engagement partner to sign the audit report enhance audit quality and investor protection?*

   Based on the existing research, it is unclear whether the signature of the engagement partner will improve audit quality. The requirement is largely based on the assumption of increased partner accountability, but this implies that existing partner accountability to the firm and SEC is insufficient. Further, it assumes that the benefits of increased personal responsibility by the engagement partner exceed any potential loss in accountability by the firm.

   Nevertheless, existing research does suggest that accountability reduces auditors’ information biases, and enhances consensus, effort, and perhaps the quality of audit documentation (Johnson and Kaplan 1991; Kennedy 1993; Brazel et al. 2004; DeZoort et al. 2006). Since it seems likely that the signature requirement would enhance partner perceptions regarding personal accountability, there is a variety of research in auditing contexts that suggests there are benefits that may result from requiring the engagement partner to sign the audit report.

2. *Would such a requirement improve the engagement partners’ focus on his or her existing responsibilities? The Board is particularly interested in any empirical data or other research that commenters can provide.*

   As stated above, there is no research that pertains directly to this issue. However, based on the existing research, including that cited above, it is clear that accountability does focus attention, and could result in elevated levels of audit quality. On the other hand, new standards that provide additional clarity on partners’ responsibilities, or enhanced accountability structures, might be another, and perhaps more direct approach to achieving enhanced audit quality.

3. *Would disclosure of the engagement partner’s name in the report serve the same purpose as a signature requirement, or is the act of signing itself important to promote accountability?*

   It is likely that disclosure would provide transparency, but accountability to a lesser extent than a signature requirement. Another alternative would be a concurring partner signature in the proxy or 10-K. However, one could certainly draw an analogy between
the SOX Section 302 requirement that the CEO and CFO certify the financial statements, and requiring the audit partner to sign the audit report. Lobo and Zhou (2006) document an increase in conservatism in financial reporting following the requirement by the SEC that financial statements be certified by firms’ CEOs and CFOs. Lobo and Zhou (2006) find that firms engage in less income-increasing earnings management in the year of certification by their CEO/CFOs than in the immediately preceding year. They also find that firms incorporate losses more quickly than gains when they report income in the certification year than in the year preceding certification. This, at least on the face, provides empirical, archival support for the notion that - even in a high litigation securities market - signing requirements may increase accountability amongst signing parties. On the other hand, CEO’s and CFO’s may have more control over the financial reporting process than audit partners, who engage in a consultative process with many other members of the audit firm.

4. **Would increased transparency about the identity of the engagement partner be useful to investors, audit committee members, and others?**

   It is likely that the identity of the engagement partner is already known to the audit committee. Knowledge of the identity of the engagement partner may be potentially helpful to investors, although we are not aware of research that directly addresses this issue. Research suggests that information about audit firm size and industry specialization is used by market participants (Eichenseher et al. 1989; Menon and Williams 1993; Teoh and Wong 1993;) so it is certainly plausible that knowledge of the identity of the audit partner could provide a meaningful signal regarding audit quality. Additionally, research indicates that there is a change in audit quality surrounding a change in the auditing firm (DeFond and Subramanyam 1998).

   A study using Taiwan data (Chi, Omer, Myers and Xie 2008) provides some evidence that characteristics of the audit partner can be used to deduce audit quality. This paper uses audit partner ‘pre-client’ experience (i.e. the number of years in which the audit partner signed the audit opinions of other clients before becoming a signing partner for the current client) and ‘client-specific’ experience (i.e. the number of years in which (s)he has served as a signing partner for the current client). These authors find a modest effect of pre-client experience on reducing extreme negative discretionary accruals. These authors also find that audit partner pre-client experience is negatively related to bank loan pricing – suggesting that some financial statement users find such information about the individual partner useful, although much additional research is needed on this issue. A starting point may be sole practitioners or smaller audit firms who in essence “sign” their reports already.

5. **Would such information allow users of audit reports to better evaluate or predict the quality of a particular audit? Could increased transparency lead to inaccurate conclusions about audit quality under some circumstances? We are particularly interested in any empirical data or other research that commenters can provide.**
As noted above, there is some evidence to suggest that knowledge of the individual partner can be used to infer audit quality. However, because lead engagement partners are generally not involved with an extensive number of engagements, it is quite possible that incorrect inferences could be drawn about the quality of audits associated with an individual partner due to the small number of audits associated with individual partners, and the existence of other factors that impact audit and financial reporting quality.

6. *Are there potential unintended consequences of requiring the engagement partner to sign the audit report that the Board should be aware of?*

As previously noted, the requirement could actually have an adverse effect on audit quality if it diminishes firm accountability. Also, if the requirement increases individual partner liability, this could have an adverse effect on top talent remaining in the profession and could potentially discourage new entrants into the profession.

Engagement partners may also engage in defensive auditing that increases the costs of audits. In addition, certain partners may find it more appealing to 'shed' more aggressive clients and higher risk clients as a means of maintaining their 'audit quality profile'. This avoidance of risky clients is analogous to the under-investment problem when CEOs are evaluated solely on ROA; the CEO may forgo positive NPV projects because it brings down their overall ROA. Consequently, more senior partners may be unwilling to be the lead partner on a particular client, when, in fact, it is precisely that type of client who needs better audit quality.

7. *The EU’s Eighth Directive requires a natural person to sign the audit report, but provides that “[i]n exceptional circumstances, Member States may provide that this signature does not need to be disclosed to the public if such disclosure could lead to an imminent, significant threat to the security of the person.” If the Board adopts an engagement partner signature requirement, is a similar exception necessary? If so, under what circumstances should it be available?*

Although it seems likely that situations of imminent threats are rare, we favor taking measures to protect the personal security of the audit partner when there is credible evidence of potential harm from disclosure of the partner’s identity. It is also possible that investors may want to contact partners or interact with them in ways that are not productive or appropriate. It is also worth noting that the legal environment in the EU is quite different from that of the United States.

8. *What effect, if any, would a signature requirement have on an engagement partner’s potential liability in private litigation? Would it lead to an unwarranted increase in private liability? Would it affect an engagement partner’s potential liability under provisions of the federal securities laws other than Section 10(b) of the Securities Exchange Act, such as Section 11 of the Securities Act of 1933? Would it affect an engagement partner’s potential liability under state law?*
We are not experts in this area. However, it seems likely that partners could be named in civil litigation, potentially triggering other, potentially unintended, negative consequences including privacy and security issues.

9. & 10. *Are there steps the Board could or should take to mitigate the likelihood of increasing the audit partner’s potential liability in private litigation?* (Question 10 not included).

Again, we are not experts on this. However, the committee is supportive of a safe harbor type provision to help limit liability and other potentially unintended consequences for the partner.

11. *Would other audit standards need to be modified?*

Not that we are aware of.

12. *Should the Board only require the engagement partner’s signature as it relates to the current year audit? If so, how should the Board do so? For example, should firms be permitted to add an explanatory paragraph in the report that states that the engagement partner’s signature relates only to the current year?*

This question speaks to the practical problems that could result from a partner signature requirement. If a partner signature is required, it is one additional factor that suggests that the partner signature should be included in the proxy statement. We would not favor an explanatory paragraph that the engagement partner’s signature relates only to the current year as it would unnecessarily complicate the audit report.

13. *If a signature requirement is adopted, should a principal auditor that makes reference to another auditor also be required to make reference to the other engagement partner? Would an engagement partner be less willing to assume responsibility for work performed by another audit firm under AU sec. 543?*

Although the committee was not unanimous on this issue, the majority believed that the other auditor engagement partner should be referred to. However, as a result of a partner signature requirement, the majority of the committee also believes it is likely that audit firms will be more likely to refer to other auditors. We note that under existing standards references to other auditors do not even contain the name of the other audit firm, which we believe should be included as part of the reference to other auditors.

14. *Should partners sign reviews of interim financial information?*

The committee believes this is unnecessary, and the signature requirement should only apply to audits.

15. *Would other changes to the audit report be necessary?*
There are some situations that could require other changes to the audit report. As noted in Q12, requiring the engagement partner to sign the audit report could be problematic when multiple years are covered with different audit engagement partners. In these circumstances, the audit report may require modifications. It is also worth noting that restatements may also create complications regarding partner signature requirements.

16. If the Board adopts a signature requirement, should it specify a form of the engagement partner’s signature? For example, should the engagement partner sign on behalf of the firm and then “by” the engagement partner?

If a signature requirement is adopted, having the engagement partner sign the audit report should not in any way change the existing firm signature requirement.
References


