

Comments on Governance, Professional Skepticism, and Auditor Independence

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I appreciate the opportunity to participate in this important conversation regarding professional skepticism and auditor independence. I commend the PCAOB for its work in addressing these important issues and building on the knowledge base developed from its inspection process. In my view, these issues are at the heart of what is needed for the profession to meet public expectations while dealing with an ever changing business environment. Auditing is a difficult task that should not be underestimated. The audit environment is characterized by increased risk taking by organizations, complex transactions where the economic benefits may be difficult to ascertain, highly technical accounting standards, increased dependence on information technology and related data repositories, increased globalization of commerce, and the speed of change.

I have been asked to comment on three specific issues:

1. The role of audit committees in enhancing auditor independence and professional skepticism,
2. The independence and composition of audit committees i.e. are audit committees capable of executing the important task that they are asked to perform, and

3. Reaction to recent comments regarding AS 16, previous board testimony regarding empowering audit committees, ability of audit committees to evaluate the professional skepticism of the audit firm (particularly audit partners), and various recommendations regarding the role of the audit committee.

My presentation is organized around these main thoughts starting with a few comments on (a) professional skepticism and related research; (b) comments on what I believe a well-constituted audit committee (AC) can do to enhance professional skepticism and auditor independence, and (c) comments on issues that the Board might consider in enhancing auditor independence and professional skepticism.

Selected Research on Professional Skepticism

Professional skepticism is individualistic and partially shaped by experiences accumulated over time. I briefly cite two research projects that illustrate this concept and its relevance to the questions posed. Research conducted by two colleagues and myself 25 years ago¹ asked a fundamental question: “does professional skepticism change over time, and if yes, how does it change?”. In that research, we performed a cross sectional analysis of professional skepticism at four times in a career: (1) last year of school, (2) audit senior, (3) audit manager, and (4) audit partner. We found that professional skepticism was very high when students left college. However, skepticism decreased over time as the individuals moved from staff auditors

¹ “An Investigation of the Impact of Economic and Organizational Factors on Auditor Independence,” *Auditing: A Journal of Practice and Theory*, Fall 1987, pp. 1-14 (with Tim Farmer and Greg Trompeter)

to audit managers. An interesting finding was that partners exhibited approximately the same amount of professional skepticism as did the college seniors and graduate students. We hypothesized that those individuals who exhibited the higher levels of professional skepticism were more likely to become partner. Of course, that research is somewhat dated by the nature of the profession during that time period. The pressure to sell services was not as heavy as what was later experienced in the 90's, but, in my opinion, it was similar to the current environment.

More recent research by Adam Vitalis² used an economics laboratory setting to investigate subject reaction to risk cues that emulated experience effects similar to that of auditors. In his experiment, student subjects (accounting seniors and graduate students) received cue information that signaled a high or low risk situation. Subjects could purchase additional risk information to help them maximize income over a period of time. One pattern of cues was designed such that risk cues were available, but subjects experienced a long series of results without a high-risk situation. He found that after some period of time, (around 25 periods) a significant number of subjects no longer purchased risk information, and were then unable to identify that the series changed to a high-risk situation. This would be analogous to an auditor seeing a high risk situation and investigating it (often at different clients) over time and never finding a problem. That experience changes behavior. On a positive vein, Vitalis found that when he primed the subject that each period was a separate, unique event, the subjects were less influenced by their previous experience, i.e. they remained more skeptical.

² Vitalis, Adam, "Experimental Tests of Experience and Costly Risk Cues on Risk Assessment Decisions", unpublished working paper, July 2012, Georgia Institute of Technology, based on his dissertation work at the University of Wisconsin-Madison.

Further, he found that individual traits also made a difference, i.e. those who scored higher on a skepticism scale continued to select more risk cues than those that were not initially as skeptical.

What does this mean for audit committees and professional skepticism? First, it is important that audit partners continue to show high levels of skepticism. As an audit partner put it to me:

“As a partner, an important part of my job is to keep my teams focused and challenged on their conclusions at all times. Said another way, if an individual does the same audit step 30 times and never finds an issue, the degree of focus on the 31st time may not be as robust. But, the 31st time may be where the issue is at. My job is to make sure they see the unique importance of doing that step every time.”

Second, it relates to training of students and auditors to understand the uniqueness in every situation³. Third, if an auditor understands a client’s business and its business strategy, then the auditor understands the uniqueness of each company. That uniqueness should translate into higher levels of skepticism on the audit engagement than would otherwise be attained.

Finally, developing that understanding of the business takes time and effort and argues against mandatory audit firm rotation.

Can the Audit Committee Enhance Professional Skepticism and Auditor Independence?

³ I will address additional issues related to university education later as I believe professional skepticism needs to start with our universities and the need to involve our students in more analysis and less rule memorization.

The answer to this question must be unequivocally yes. If not, then the audit committee, as conceived in recent regulation and in research, is not meeting one of its important mandates. In my view, there are a number of things the audit committee can do to enhance auditor independence and professional skepticism. They include:

1. ***Require Audit Expertise on the Audit Committee.*** I have always been intrigued that the Sarbanes-Oxley Act requires financial expertise (in at least one member), but does not require auditing expertise. I find that non-auditors are great committee members because they bring an objective, independent approach to asking questions. I am not advocating replacing that expertise. I am advocating that we recognize the need for audit knowledge with sufficient depth to independently assess the auditor's choices on audit risk, audit approaches, or ascertaining the importance of PCAOB inspection reports. Further, there needs to be an understanding of the extra cost of audits that require more detailed testing. In my view, expanding the auditing knowledge requirement for audit committees would be effective in supporting both the skepticism and the independence of the external auditor, and assessing the quality of audits we are receiving. As an example, I had the experience of taking over as audit committee chair and finding out that our audit had been cited in an inspection finding. Because of my audit experience, I felt comfortable in going to our audit firm's office and reviewing their working papers, the audit issue, the PCAOB position, the firm's position, and other relevant facts. I wanted to be able to answer any question about the PCAOB's findings if

such questions were raised in the shareholder's annual meeting, or in our audit committee, or in our board meeting. Further, I felt it necessary to report not only the PCAOB findings, but my analysis of those findings to the audit committee and the board. Finally, the audit knowledge helped us perform an independent assessment of whether the findings were such that we should consider replacing the audit firm or the audit partner.⁴

- 2. *Knowledge of the Business by the Audit Team is Important, and it can be assessed by the Audit Committee.*** In my view, this is extremely important. First, as noted above, it helps establish that each business, its strategies, its risks, and its processes are unique. Reminding auditors of the uniqueness of each audit finding has been shown to help maintain skepticism. Second, most of the larger "financial reporting" problems historically could have been identified earlier if the auditor had better known the client's business, its strategies, operations, and the successes (challenges) of its competitors (more on this later). Third, the audit committee (or the AC Chair) can evaluate the auditor's knowledge of the business, its strategies, its risks, pressures on managers, and audit risks through discussion with the audit partner and audit manager. Audit committee members are first and foremost board members. Thus, they have a working knowledge of business issues and can decipher whether the audit is properly adjusted to fit the organization's strategies, its risk and related accounting and/or audit issues.

⁴ The issues were important, but not sufficient to change either the audit partner or the audit firm. Further, our audit committee developed a better understanding of the audit approach utilized by the audit firm.

3. ***The Audit Committee Should Gain an Overall Understanding of the Planned Audit***

Approach. AS 16 helps in this regard. I believe that most Audit Committees set aside time to review the overall audit plan built on the auditor's risk assessment. However, time is limited in AC meetings as many other issues are covered including important compliance and regulatory issues, financial reports, and internal audit reports. In my view, there should be standing meetings where the AC Chair sits down with the audit partner and audit managers to discuss the overall audit approach. I am pleased that our audit firm has been proactive in seeking knowledge of business strategies, risks, and potential pressures on individual managers. How the auditor reacts to these factors can assist the audit committee in evaluating the professional skepticism of the audit team.

4. ***Be Proactive in Consulting with Management and the Audit Team on Potentially***

Controversial Accounting Issues. Most accounting issues do not arise overnight, but arise more gradually as a company's business strategy unfolds. The audit committee becomes aware of these issues in board meetings and should be proactive in discussing such issues with both financial management of the enterprise and with the audit team.

The audit firm ought to have a documented, systematic process in reviewing such transactions that includes:

- a. Understanding the economics of the proposed transaction or contract,
- b. Identifying the relevant facts,
- c. Reviewing the relevant literature
- d. Developing alternatives and recommend a preferred approach, along with the rationale as to why such an approach is best. In this approach, I want to see a

“best solution” and the rationale for such by both management and the audit team, not just an acceptable approach.

As an aside, I have always been influenced by the Cohen Commission’s⁵ recommendation in 1978 that the auditors look at the cumulative effect of transactions to determine if they adequately portray the economic substance of what is taking place in the company, and they should communicate that assessment to the audit committee. I am aware of the arguments on both sides of the ‘preferability issue’. However, a required discussion of the cumulative effect of accounting choices on the overall presentation of the financial statements would be a positive contributor to the dialogue with the audit committee and thus benefit the investor community.⁶ Finally, I believe the audit committee should be supportive of the need for the audit partner to consult with the national office on important issues. At the same time, the AC Chair, the local audit partner, and management need to be involved in the conversations.

5. ***Encourage Fair Compensation for Audits.*** This may be a heretical statement as most people believe the free market can sufficiently address this issue. My concern is that audits are increasingly complex and that we need to retain individuals in the audit profession who would otherwise be very successful in the public company sector. To do so, audit partners and staff must be fairly compensated. Thus, while I have been at professional conferences where I have heard audit committee chairs talk about ‘having

⁵ AICPA, The Commission on Auditor’s Responsibilities: Report, Conclusions, and Recommendations; New York, AICPA, 1978, p. 21.

⁶ The fundamental problem that arises is that many standards, including accounting standards, are often written to stifle the most egregious misuse of accounting techniques. At times, the standards can be so confined that they potentially obfuscate the fundamental economics of the issue. That said, I believe the audit committee and the board want to know where the auditor identifies applicable GAAP even if the prescribed accounting might seem to be at odds with the board and management’s perceived economics of the situation.

conversations' with auditor about their fees (and keeping them in line), I personally believe there should be more conversation on what kind of fees are needed to retain 'great people' in the profession. As an example, one question that was asked by our audit committee when we changed auditors a few years ago was whether the fees were sufficient for that marketplace. Further, one audit firm that had fees well below the others was eliminated because of a concern about whether they could bring the right resources to perform the kind of audit we believed was needed for a growing international company. As noted earlier, I believe the audit committee has to develop a sense of what it might cost for the audit firm to perform additional work where the profession has not be consistently meeting existing standards. I am not talking about opening up a carte-blanche checkbook for auditing; rather, I am advocating an understanding of the economics of the audit firm and the importance of the task performed. Finally, to fully understand auditor independence, the Audit Committee should develop an understanding of criteria used by the audit firm to compensate audit partners.

6. ***Monitor Rotation of Non-Partner Personnel.*** There is a need to thoroughly understand a business. Thus, during a period of time when audit partners are required to be rotated off an engagement every five years (I personally would increase this to 6 years because of the start-up and hand-off costs associated with partner rotation), it makes sense that there should be some continuity in staff personnel to make sure someone knows the client pretty well. However, there may be a tension between how much time is needed to retain sufficient business knowledge in the audit team balanced with over-

familiarity with a client by those “on the ground” performing an audit. I have heard of instances where an audit manager had served a client for 15 years, starting as a junior auditor and progressing through the staff to a senior manager position. That seems too long to me. My point is that the total staffing should be managed by the firm and the audit committee should have some knowledge of how the firm staffs its audit engagement, including knowledge of the concurring partner who can also constructively contribute to the maintenance of professional skepticism.

7. ***Executive Sessions and Individual Meetings with AC Chairs are Essential.*** Many commentators in your previous hearings have made this point. I simply want to reiterate the importance of such meetings and add a couple of other thoughts. First, there needs to be a detailed follow up by the AC Chair on important issues that are not resolved. Second, although I have not done so yet, I am planning on holding the Executive Session where we review the audit plan at the start of the AC meeting. This may not seem like much, but it addresses the “fatigue issue” that can arise with executive sessions are always held at the end of the AC meeting. Third, I am familiar with some auditors having executive sessions with the full board. We have not tried that yet, but I find it intriguing. It was used successfully while I was on the audit committee at Petro China.

8. ***Incorporate Active Review of Audit Inspections into the Audit Committee Cycle.*** I believe the AC has an obligation to understand what the firms are doing in relationship to the PCAOB’s inspection process, as well as internal inspections that involve the audit client. The audit firms should be “out-front” in letting the AC know if the client firm has

an audit that is being inspected by the PCAOB or internal inspectors. I believe they should report the results of all PCAOB inspections of their audits to each audit committee where such an inspection was performed⁷. As noted earlier, I believe it is a both a “best practice” as well as a “necessary practice” for the AC and its Chair to review the specifics of the PCAOB’s comments on any deficiencies found in the audit.

Individual audit expertise on the AC will assist in evaluating the Inspection Report findings. Such discussion also can enhance the independence of the audit firm because they know that the audit committee considers inspection findings to be important.

9. ***Proactively Monitor Other Services Provided by Audit Firm.*** The independence standards are pretty clear. However, there appears to be more pressure to extend work performed by each firm, e.g. more tax services offered by the firm. These should be monitored and assessed for possible effect on auditor independence. Thus far, I don’t believe this is an issue, but it can develop into an issue. Further, and somewhat related to one of my previous points, if an audit firm is pushing other services, it may reflect mis-pricing of the audit.

10. ***Continue to Reinforce that the Audit Committee is the Client.*** The audit committee and its chair should be proactive in communicating with the audit firm and management about important issues and the ultimate decision of the audit committee in retaining or changing audit firms. A good working relationship with management is important and should be considered by the audit committee in its decision to retain or change audit

⁷ I believe the reporting on internal inspections by the firm can remain optional. The purpose of all inspections, including internal inspections, is to improve the audit process. I do not want to turn “internal inspections” into an audit committee analysis as it would likely impede the openness of client-auditor relationship and may dampen the nature of the internal inspections.

firms or audit partners, but the ultimate decision rests with the audit committee. The same pertains to appointing a new audit partner when mandatory rotation of the existing audit partner is required. To summarize, the audit committee is a very important part of governance and oversight. It must continue to do its job.

Reporting on the Audit Committee's Assessment of Auditor Independence and Professional Skepticism

One of the previous presenters,⁸ suggested that the audit committee formally evaluate the external audit firm every few years (he suggested five) using various criteria that could be articulated by either the audit committee or the PCAOB. The audit committee would then publicly report on the criteria utilized and the decision made by the audit committee. I do not support such a suggestion. Essentially, if the audit committee is doing its job, it is making these decisions every year. Further, I worry about public reporting of such activities (especially in our litigious society) because:

- The audit committee has an oversight responsibility and that responsibility should not be confused with attesting to the financial statements,
- Development of criteria would likely become 'checklist oriented' and defensive in nature.

⁸ See Harvey Pitt's presentation, especially pages 23 - 24

- The unintended consequence could be more emphasis on issues that do not directly relate to the quality of the audit.

Most audit committees informally evaluate their external auditor on a continuous basis. I believe that this existing process can be improved upon in the following ways:

- Putting a formal evaluation of the external auditor on the 'meeting planner' for the audit committee each year, and
- Requiring a formal report from the audit firm on important accounting, reporting, and audit issues addressed during the year such as required in AS 16. I would add a request that the audit firm specifically comment on how they exhibited professional skepticism and independence in the conduct of the audit.
- Finally, the audit committee should have a meaningful and documented process that could be adequately described in its public report.

Issues for the PCAOB to Consider in Supporting Professional Skepticism and Auditor Independence

The PCAOB has done an outstanding job in raising our awareness of 'professional skepticism' issues. There are a few additional things that I believe the PCAOB could do to further enhance the effectiveness of audits and enhance auditor independence and professional skepticism. These include:

1. ***Expand the Audit Standards Relating to Business Knowledge.*** I made the point on the importance of understanding the business earlier, but I want to expand on it here. Many of the major financial frauds were discovered by “short-sellers” before they were found by the audit firm. We have to ask “why”. It isn’t always that the short sellers have more information, or that they have better analysis. It is because they do the industry analysis and ask the “why” question. For example, many short sellers looked at gross margins of selected companies and asked “why” did a company have a significantly larger gross margin than its competitors, and could it be sustained? These types of questions apply to frauds as old as Equity Funding to WorldCom or Medicis Pharmaceuticals. While there may be problems in identifying industries, my belief is that the larger public accounting firms have the ability to perform such an analysis for their public clients. It also changes the nature of auditing away from a checklist of transaction testing to a detailed analysis of their clients. It reflects much of what is constructively done by good financial analysts. Second, it would be useful for the auditors to be aware of what financial analysts are saying about their audit clients. Finally, an easy thing to do is to monitor the “short” stock positions of their clients on a periodic basis to determine if significant changes in the overall position could possibly be indicative of risks that the audit firm has not considered.
2. ***Facilitate Analysis being built into the Accounting Curricula.*** At the University of Wisconsin, we have been a strong advocate that no more than half of the courses during our graduate year can be in accounting. Rather, we want students to better understand what their finance, real estate, marketing, and management colleagues in

their MBA programs are learning about managing companies. Further, many of the accounting courses emphasize analysis rather than rule memorization of rules and standards. The PCAOB could facilitate further development in this area by making public the details of its analysis from its inspections as well as the research supporting its analysis. I understand that the Board is working with the audit section of the AAA on this issue and I endorse moving forward as it will facilitate development of the next generation of auditors who have better analytical skills and professional skepticism. I believe the PCAOB can play an important and constructive role in facilitating the future of audit education and research.

3. ***Address Extent of Testing in Providing Future Guidance.*** In my conversation with many professionals, it seems that there is a divergence between the Inspection teams and many in the audit profession on the extent of detailed testing that needs to be done, and in particular, the extent and conditions in which the audit team can rely on analytical procedures. My own personal experience in reviewing the issues around an inspection report focused on the basic issue related to the extent to which the audit team can rely on internal controls and analytical procedures. These procedures are not designed to replace all detailed testing, but to reduce detailed testing to an amount that is sufficient to corroborate, or not corroborate, the results of the analytical procedures⁹. There is a need to understand that professional judgment that can differ among auditors, and between individual auditors and individual inspectors. In my view, the Inspection Reports point to the need for more guidance. However, providing

⁹ If the results do not corroborate expectations, then the Standards are clear that the auditor has to do more detailed tests to determine if there is a potential material misstatement in an account balance or balances.

more guidance is a difficult issue because the role of professional judgment must be maintained while providing more guidance on extent of testing. In developing additional guidance, it is important that the Board consider two potentially unintended consequences of more guidance: (a) it will likely increase the cost of auditing because of the greater emphasis on detailed testing; and (b) it may shift the audit away from the “business analysis” approach that I have suggested earlier.

4. ***Evaluating and Placing Reliance on Internal Control.*** My observation is that the inspection reports do not focus very much on auditor reports on internal control over financial reporting and whether sufficient audit work has been performed to support the auditor’s conclusions on internal control over financial reporting. I have spent a great deal of the latter part of my career working in the broad area internal control and risk management. In my view, if controls are strong and the auditor has appropriate evidence that the controls are well designed and implemented, then much of the audit can focus on developing evidence that either corroborates or does not corroborate the expectations founded on strong internal controls. More PCAOB analysis in this area could better guide practicing auditors as well as contributing to the development of curricula for the next generation of auditors. In my role as audit committee chair, I am encouraging our company to place more emphasis on continuous monitoring of controls built into our IT systems and changing the nature of internal audit reports to move away from detailed testing of controls to reporting on whether or not the monitoring processes are robust and working. The detailed tests are then designed to provide corroboration as to whether such processes are working.

Summary

There is much that an audit committee can do to support the independence and professional skepticism of the audit profession. It starts with greater audit expertise on audit committees and a process that focuses on better understanding of the business and less on pre-formed audit programs that become somewhat mechanical in approach. In my view, some of the changes will require the PCAOB to re-think some of its guidance regarding integrating business-knowledge into the conduct of an audit.

I appreciate the opportunity to contribute to this important dialogue.