Center for Financial and Accounting Literacy

Investor Confidence in Audits:
What More Can Be Done?

Last updated: February 15, 2010

Seemingly sudden bank failures and massive undetected investment swindles have fueled fresh criticism of the value of independent audits as a way to protect investors. Much has been done since the Enron meltdown and other accounting scandals to preserve the integrity and effectiveness of audits of public companies. Yet there is still room for improvement, and regulators are considering a number of additional steps designed to further strengthen audits and restore investor confidence. This Special Report summarizes the basics of auditing, describes the events and trends that are likely to affect future audits of public companies, and provides links to additional information.

Current Audit Practices

Public companies listed on US capital markets must obtain independent audits of their published historical financial statements. Key points to keep in mind:

- *The requirements for audited financial statements.* The US Securities and Exchange Commission (SEC) requires that companies that are listed on US capital markets file certain reports, including an annual report with audited financial statements.
- *The objective of an audit of financial statements.* The objective of an audit of financial statements is to determine whether the financial statements are stated in accordance with specified criteria. For US public companies traded on US capital markets, the criteria are US generally accepted accounting principles (US GAAP).
- *Auditors and CPAs.* The term "auditor" typically refers to a firm of certified public accountants (CPAs). The use of the title CPA is regulated in the US by state laws.
- *The role of the PCAOB.* To perform an audit of the financial statements of a public company, an independent auditor must be registered with the US Public Company Accounting Oversight Board (PCAOB). The PCAOB sets the standards for audits of public companies and inspects audit firms to determine if their audits comply with the standards.
- *The auditor's role.* The auditor's basic role is to gather sufficient evidence to determine whether the financial statements contain material errors or other misstatements and to communicate the findings of audits to shareholders and others in a written audit report that indicates whether the financial statements are in material conformity with GAAP.
- *Integrated audits.* Under an integrated approach to auditing, the auditor considers both the risk of misstatements and the operating controls put in place by a

company's management to prevent misstatements. Where applicable, the auditor must attest to management's report on the effectiveness of internal control over financial reporting.

- *The auditor's responsibility to investors.* The CPA firm that issues an opinion on the financial statements of a public company is hired and compensated by the company's audit committee. The firm has a responsibility to act in the public interest because it owes its ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.

Recent Improvements and Recommendations

In August 2009, the SEC approved a new set of reporting requirements for all firms registered with the PCAOB. The new rules require that these firms file annual reports containing certain required disclosures and that the firms issue special reports when certain events occur. The added disclosures are designed to help investors and regulators better assess the risks associated with audit firms and their audit opinions.

In addition, the following additional steps were discussed in a report from a high-level advisory committee:

- *Require that the partner responsible for the audit sign the audit report.* On July 28, 2009, the PCAOB requested comments on a controversial Concept Release. The purpose of the release is to consider the pros and cons of requiring the engagement partner who oversees the audit work to sign the audit report. Currently, practice varies around the world. The US practice is that the report bears the signature of only the CPA firm. In Europe and in the approach discussed in the Concept Release, the report must contain the signature of the engagement partner in addition to the firm's signature.
- *Require that US audit firms provide investors with annual reports*. Another area in which US practice differs from European practice is in the level of information about audit firms that is made available directly to investors. For example, UK audit firms are required to publish audited financial statements, but US firms are not required to do so. The final report of the US Treasury Advisory Committee on the Auditing Profession, also known as the Paulson Committee, contained several suggestions in this regard. The Committee's co-chairs suggested that at least the largest firms should be required to make audited financial statements available to audit committees and the investing public.
- *Establish a formal system for monitoring sources of catastrophic risk to audit firms*. Another recommendation in the Paulson Committee's report is that the PCAOB should monitor sources of catastrophic risk to audit firms. A key concern is that global networks of accounting firms could create new areas of risk and gaps in regulatory oversight. In the new regulatory environment that is emerging in the wake of the financial crisis of 2008 and 2009, there is a concern that some accounting firms, like some banks and other institutions, may be growing too big to fail or may need an international super-regulator.
- *Morph toward an expanded plain-English audit report.* Investors might find audit reports more useful if the reports contained more explanations of the audit process and more findings. For example, the report might clarify the auditor's responsibility to detect fraud. Or it might highlight some of the important judgments and estimates that a company makes in putting together its financial statements.

- *Other possible steps.* Other steps being discussed now include creation of a national center for the prevention and detection of financial fraud, appointment of independent members to serve on advisory boards to audit firms, and a study to identify ways to remove barriers to growth by smaller auditing firms.

Importantly, PCAOB board member Steven Harris has said publicly that he believes all these areas should be given serious consideration by the SEC and PCAOB.

Other PCAOB Priorities

Additional PCAOB priorities relating to investor protection include a standard-setting initiative to address supervision of audit work and a project to provide enhanced reporting of the Board's own activities for the benefit of investors and other interested parties. Going forward, Harris expressed strong support for more participation by investors in discussions about ways to improve audit quality, both at the PCAOB and at the International Forum of Independent Audit Regulators (IFIAR), of which the PCAOB is a member.

Answers to Frequently Asked Questions (FAQs)

What is controversial about requiring audit firm engagement partners to sign audit reports?

The controversy is rooted mainly in different views of whether this step is necessary or sufficient to improve audit quality and/or make auditors more accountable to investors.

Proponents (mostly investors) see the following benefits:

- The added visibility of the engagement partner's name will help investors assess risks associated with audits, make auditor ratification decisions, and communicate with auditors (in ways supplemental to questions raised at annual shareholders meetings). Most notably, it will enable research on track records of individual partners and facilitate questions about their past affiliation with clients having troublesome matters, e.g., restatements.
- It will also help to improve audits. The signature requirement will fix accountability (similar to the way the Sarbanes Oxley Act requires that corporate officers certify to the accuracy of financial statements). In effect, this exposure will force the individual to take greater ownership of the opinion.

Opponents (mostly auditors) argue that:

- Added transparency can be achieved through proxy disclosures (rather than additional signatures on reports).
- Informal communications with investors are limited by restrictions on revealing confidential information or selectively disclosing information to investors.
- The added signatures will not improve audits because the requirement may embolden practitioners to circumvent consultations and procedures that are needed to adapt to US liability practices under which the audit opinion is backed by the assets of the entire firm (not just the individual audit partner's).

Could required signatures by audit partners have unintended consequences?

This is an open question in the PCAOB's Concept Release. Concerns about possible consequences have ranged from increased audit fees to the need for issuers of financial statements to explain the reasons for any change in the engagement partner assigned to the company.

How would standards on supervision of audit work help?

The PCAOB's Inspection Division has identified "inadequate supervision and review" as an important factor that has allowed audit deficiencies to occur in recent years. Among the areas in which weaknesses were noted are internal inspection programs and oversight of work performed by audit firms' foreign affiliates.

What types of additional information might the PCAOB make available to investors?

The PCAOB may soon make available more information about:

- Audit firms that fail to remediate deficiencies in their quality control systems.
- The identities of firms that the Board has not yet inspected.
- The number of international inspections that have been deferred and the reasons for the deferrals.

Helpful Links

Insights into PCAOB Auditor Reporting Requirements
http://www.fincenter.org/PCAOB_Auditor_Reporting.htm

PCAOB Concept Release on requiring the engagement partner to sign the audit report
http://pcaobus.org/Rules/Rulemaking/Docket029/2009-07-28_Release_No_2009-005.pdf

PCAOB RuleMaking Docket on Concept Release
http://pcaobus.org/Rules/Rulemaking/Pages/Docket029.aspx

Speech by PCAOB Board member Steven Harris at Ernst & Young Accounting and Public Policy Symposium, June 3, 2009,
http://pcaobus.org/News/Speech/Pages/07282009_StatementHarrisEPS.aspx

Sarbanes-Oxley Act of 2002
http://banking.senate.gov/pss/acctrfm/conf_rpt.pdf