



**ICGN**

International Corporate Governance Network

## **ICGN Annual Conference San Francisco 2016**

### **The Role of the PCAOB in Investor Protection:**

#### **Steven B. Harris, PCAOB Board Member**

I want to thank the ICGN for inviting me to speak today. I am grateful to you and your many members for, among other things, commenting on our rule making projects and serving on the Public Company Accounting Oversight Board's ("PCAOB") two advisory groups. I also want to thank CalPERS and CalSTRS for sponsoring this conference.

At the outset, I must state that the views I express are my own and do not necessarily reflect the views of the Board, any other Board member, or the staff of the PCAOB.

I have been asked to address the role of the PCAOB in investor protection and to highlight a few issues that the Board is considering. Your input on these issues is extremely important.

#### **Role of the Independent Auditor**

The independent auditor serves a vital role in our capital markets by providing an objective third party opinion on the integrity of financial statements that investors rely upon for investment decisions. Accurate and reliable financial statements are critical for companies to raise capital and for investors to make informed decisions.

The auditor has been given a unique franchise under our federal securities laws. All companies wishing to access the U.S. capital markets must obtain an audit. That franchise, however, carries certain responsibilities.

The Supreme Court, in *United States v. Arthur Young*, described the auditor's role as a "public watchdog function" that demands "total independence from the client at all times and requires complete fidelity to the public trust."<sup>1</sup> This means that auditors must work on behalf of investors and the public interest.



## Why the PCAOB is Important to Investors

The PCAOB is the regulator with responsibility for ensuring that auditors of public companies and brokers-dealers are faithfully carrying out their duties on behalf of investors.

Although the seeds of reform were planted long before,<sup>2</sup> it was the audit failures at Enron and WorldCom, and the phony earnings, accounting gimmickry and restatements at numerous other companies in the late 1990s and early 2000s—which cost investors over \$7 trillion in wealth—that led to the passage of the Sarbanes-Oxley Act in 2002, the creation of the PCAOB, and the end of the era of self-regulation by the audit profession in the United States.<sup>3</sup>

The PCAOB's role in investor protection is clearly laid out in the Act. Its first words are “[t]o protect investors by improving the accuracy and reliability of corporate disclosures.” Section 101 of the Act states that the PCAOB oversees the audits of public companies “in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and *independent* audit reports.” (Emphasis added.)

A core part of the PCAOB's mission is investor protection. This is why our work should be important to you.

## Emerging Threat to Auditor Independence

I stress the word "independent" in the context of "independent audit report" because of the inherent conflicts of interest in the current issuer pay model where the company pays for its own audit. This is particularly important as investor protection is still not in the DNA of the auditor. Further, while our efforts have led to improvements in audit quality, more work needs to be done.<sup>4</sup>

Accordingly, I believe investors should be concerned about the emerging threats to auditor independence from the evolving firm business model.

### Rise in Consulting and Advisory Services

The Big Four global network firms are actively growing their consulting and advisory practices either internally or through acquisitions. For example, in the past five years, they have acquired over 160 consulting businesses, including over 50 in 2015 alone. As a result, the Big Four in the U.S. now dominate the consulting market.<sup>5</sup>

These acquisitions have enabled the firms to expand their service offerings. For example, a U.K. affiliate of one of these firms is now aiming to become a global top-20 legal service provider.<sup>6</sup> A U.S. Big Four firm recently acquired an advertising firm.<sup>7</sup>



Today, we see firms providing services not generally associated with accounting firms, such as investment banking, asset management, personnel recruitment, and marketing campaigns, just to name a few.

The audit practice is no longer the centerpiece of the Big Four firms' practice areas. For several years now the assurance practice has generated less than half of total revenues at each of the global firms. Domestically, revenue from consulting and advisory services collectively exceeds audit revenue for these firms.

### Need For Focus on Independence

This trend is important because the last time this occurred was prior to the adoption of the SEC independence rules and passage of the Sarbanes-Oxley Act. At that time, as some of you will recall, firms unsuccessfully tried to serve two roles – one as a supposed objective third party examining management's assertions and another as management's consultant, partner or advocate.

The regulatory landscape changed to prevent that from happening again by prohibiting the firms from providing certain consulting and advisory services to audit clients. Firms implemented safeguards to comply with those requirements. Yet, nearly 16 years after the adoption of those rules, we continue to see auditor independence violations.

For example, over the past two years all of the global network firms or their affiliates have either settled enforcement actions related to independence violations or resigned from an engagement because they provided prohibited services to a client or its affiliates. Our inspectors also continue to identify independence issues.

Regulators around the world are raising similar concerns. The U.K. regulator has noted a need for improvement in monitoring independence compliance in four of the most recent inspection reports it issued for the top six firms.<sup>8</sup> Also, just this month, it announced an investigation of one of the Big Four firms for possible independence violations related to non-audit services provided to an audit client.<sup>9</sup>

These continued independence violations call into question the effectiveness of the firms' controls and protocols to prevent the cross-selling and marketing of prohibited services to audit clients that was so prevalent prior to the passage of the Sarbanes-Oxley Act.

The expansion of consulting and advisory services and the profession's continued use of terms such as "strategic partners" or "trusted advisor" in describing its relationships with clients raises red flags for some. Questions are now being posed about whether the amount and types of non-prohibited services that firms provide to audit clients are appropriate. For example, some question if the auditor is truly independent when it is paid more for non-audit services than for the audit. Others have



expressed concerns when firms perform certain compliance work or advise on and implement certain tax structures for their audit clients.<sup>10</sup>

At the same time, some members of the profession are calling for “modernizing” the independence rules.

So, as you can see, while things have changed since the passage of the Sarbanes-Oxley Act, it appears that new threats to auditor independence have emerged, and that others have reappeared. The events that preceded the enactment of the Sarbanes-Oxley Act demonstrated the perils investors and our capital markets face when auditor independence is compromised by auditors becoming too cozy with management.

The Board is analyzing the business model of the firms with a focus on responding to potential risks to auditor independence and audit quality. We have and will continue to discuss this topic with firm leaders. Regulators around the world are similarly monitoring the evolution of the firms’ business model. I would encourage you to pay close attention as well given that increased focus on consulting and advisory services by the major firms is likely to reduce their focus on audit quality and hence, investor protection.

### **Board’s Standard Setting Initiatives**

While the Board has a number of tools that it can use to mitigate risks to audit quality and auditor independence, I would like to address specifically the Board’s standard setting activities. We have an active standard-setting agenda but for today’s purposes I will focus on two: expanding the auditor’s report and the auditor’s going concern assessment.

#### **Transparency**

But first, I would like to note a significant achievement on behalf of investors – the name of the engagement partner—the person most directly responsible for the audit—and other firms who worked on the audit will soon be public in the United States.

Last December the Board adopted a rule which for the first time will require firms to disclose such information on a new Form AP (the AP standing for Audit Participants). It is anticipated that the first Form APs will be filed in early 2017.

This rule involved a multi-year effort and several proposals. I would like to thank those of you who commented on this project throughout the process. Your comments, including pointing out the precedents in other jurisdictions, helped the Board’s deliberations.



While the final transparency rule was a compromise from the original proposal of having the engagement partner sign the audit report, I nonetheless believe that investors will benefit from what was ultimately adopted. For example, you will soon be able to:

- Evaluate and compare the performance of individual engagement partners over time;
- Determine whether an engagement partner has been associated with adverse audit outcomes or sanctioned by the PCAOB or SEC; and
- Discover how much of the audit was performed by the firm issuing the report and by other firms.

This information is also aimed to help in your decision whether or not to ratify a company's independent auditor.

I believe that audit quality will improve from the public identification of the engagement partner as it will heighten his or her sense of accountability, one of the tenets of the Sarbanes-Oxley Act.

#### Auditor's Reporting Model

Another tenet of the Act was more transparency. This brings me to the Board's current project on expanding the auditor's report, which has not changed substantially for over 70 years.

Similar to our transparency project, this project is intended to incentivize the auditor to change his or her behavior in ways that enhance audit quality by making the audit report more informative and hence, more relevant.

The Board's May 2016 reproposal retains the existing pass/fail model but calls for additional information to be provided in the report, such as new disclosure about auditor independence, auditor tenure, and critical audit matters. The discussion of critical audit matters is designed to inform investors as to how the auditor responded to material issues that arose during the audit that involved especially challenging, subjective, or complex auditor judgment and could cover such areas as significant management estimates and judgments or unusual transactions.

This is one of the Board's most important investor initiatives. I strongly encourage you to comment on the Board's latest re-proposal so this standard is finalized and adopted by the end of the year.

As many of you know, much of the rest of the world has already taken steps to address this matter, including the United Kingdom,<sup>11</sup> the European Union (EU),<sup>12</sup> and the International Auditing and Assurance Standards Board.<sup>13</sup> Reaction from U.K.



investors has generally been positive with the expanded report being credited for improving audit quality.<sup>14</sup> Given the current state of affairs, I believe U.S. investors deserve reports that are just as informative as those now being provided abroad.

### Going concern

The PCAOB is also contemplating revisions to another standard which I believe warrants your attention: the auditor's going concern determination and reporting.

Under the federal securities laws, as part of the audit, auditors must evaluate whether there is substantial doubt about the ability of a company to continue as a going concern during the ensuing fiscal year.<sup>15</sup> The original intention of this requirement was that auditors would give investors an "early warning" before a company's financial difficulties become severe.<sup>16</sup>

As we all know, investors did not receive such information with respect to the failures that led to the passage of the Sarbanes-Oxley Act and perhaps more importantly, during the recent financial crisis. Meanwhile, short sellers and members of the financial press have often already reported what many believe the auditor should have disclosed.

The PCAOB's work in this area is especially important to you because the Financial Accounting Standards Board (FASB) recently established new requirements for management to disclose going concern matters.<sup>17</sup> If the FASB's disclosure threshold was applied for the audit, you should know that even fewer going concern opinions would be issued in the future than during the past crises.<sup>18</sup>

This is another transparency issue that I believe it is important for you to focus on.

### **Need for Investor Involvement**

I bring these initiatives to your attention because I believe we share a common interest in promoting high quality audits. This is why your input in the Board's deliberative process is so important.

I stress this because the accounting firms and their associations annually spend millions of dollars commenting and lobbying on matters related to accounting and auditing. For example, with respect to our proposal on related parties, approximately 80 percent of the comment letters we received came from auditors and companies while only 8 percent came from investors or investor groups.

Given that the PCAOB was created to protect the interest of investors, I believe it is extremely important that you should be similarly aggressive in commenting to the



Board. Your active involvement in the Board's agenda is essential for the PCAOB to evolve the audit in the manner that best benefits investors.

## **Emerging Issues**

I would like to conclude by addressing a few issues I believe we share a common interest in promoting: the need for greater diversity in the audit profession, independent board representation on the firms' governance boards, and an enhanced focus on sustainability reporting.

### Diversity

There is growing recognition of the importance of diversity. We now know that a diverse board of directors improves shareholder value.<sup>19</sup> Similarly, diverse audit engagement teams result in better audits.<sup>20</sup>

All the major accounting firms have been actively focused on increasing diversity in the profession for a number of years and are hiring more minorities out of colleges and graduate schools.<sup>21</sup>

According to the 2012 U.S. Census Bureau Report, by 2043 there will be no single ethnic or racial majority group in the United States as the share of non-Hispanic whites falls below 50 percent.

To remain relevant, the accounting profession needs to reflect the general population. I believe we all must encourage the profession to continue their efforts to attract and retain talented minorities. Diversity must no longer be viewed as just a business imperative but as a business opportunity.

### Audit Firm Governance

I also believe that the major accounting firms should increase their board governance diversity. In this context, I am referring to the need for the major accounting firms to have independent individuals serve on the managing boards of the global firm.

Many believe that independent board members will provide an independent perspective which will assist the firms in maintaining a focus on improving audit quality and preventing potential conflicts of interest as well as the independence issues I have previously mentioned.

### Sustainability Reporting

Finally, I would like to briefly address the issue of sustainability reporting. I applaud the ICGN for focusing on this topic during this conference.



From my perspective, environmental, social, and governance (ESG) matters are increasingly playing a significant role in investors' voting and investment decisions. According to a recent report, 89 percent of global investors state that non-financial performance factors, such as ESG matters, are integral to their investment decision making.<sup>22</sup> A 2015 CFA Institute survey found that 73 percent of respondents take ESG issues into account in their investment analysis and decisions.<sup>23</sup>

This is the heart of what makes ESG information material from a disclosure perspective.

We are seeing sustainability reporting gain prominence globally and public policy is adapting accordingly. As of 2014, approximately 31 countries and 18 stock exchanges require or encourage some form of ESG reporting.<sup>24</sup> Notably, in September 2014, the EU adopted an amendment requiring large, publicly listed companies to disclose in their management report relevant and material information on environmental and other matters.

In the U.S., sustainability reports are prepared on a voluntary basis, though public companies must disclose material impacts of climate related changes. But in both the reports and filings, the information is often presented in boilerplate manner, with limited comparability, and inconsistently.

I was pleased to see that in April the SEC issued a concept release on disclosure reform which includes 11 pages of discussion on sustainability.<sup>25</sup> I think this is an essential first step in addressing some extremely serious issues of concern to investors.

Given the needs of investors and the momentum created by so many other countries throughout the rest of the world, I think more comprehensive, higher quality ESG disclosures in the U.S. is inevitable – particularly as they relate to the mandatory disclosures of the material impacts of environmental and climate related changes. With that comes the question of whether such information should be subject to independent verification. I note that 69 percent of the respondents to the CFA Institute survey think it should.<sup>26</sup>

I would like to see investors work with all the relevant parties in the United States, namely the SEC, the FASB, and the PCAOB, to address the sustainability issues you have so forcefully brought up and discussed during this conference, including whether such information should be subject to independent verification.

## **Conclusion**



In conclusion, the PCAOB protects investors by holding auditors accountable to the highest standards of independence, objectivity and professional skepticism. But, while audit quality has improved, more needs to be done.

The PCAOB continues to focus on addressing threats to auditor independence from the firm business model. But your input and active involvement relating to all the Board's activities is essential. Otherwise, as George Santayana, the renowned Spanish philosopher, once proclaimed "[t]hose who cannot remember the past are condemned to repeat it."

Thank you.

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<sup>1</sup> *United States v. Arthur Young*, 465 U.S. 805, 818 (1984).

<sup>2</sup> See, e.g., Staff of Subcomm. on Reports, Accounting and Management of the S. Comm. on Government Operations, 95th Cong., *The Accounting Establishment* iii (Comm. Print 1977) and *The Commission on Auditors' Responsibilities, Report, Conclusions, and Recommendations* xi (1978). See also, [The New York Times: Auditors Face U.S. Scrutiny](#), Gary Klott (Feb. 18, 1985).

<sup>3</sup> See [Rebuilding Investor Confidence, Protecting U.S. Capital Markets: The Sarbanes-Oxley Act: The First Year](#), House Committee on Financial Services, Michael G. Oxley, Chairman, at 8.

<sup>4</sup> This was acknowledged by the leadership of the profession in a recent release following the 2015 Inspection Findings of the International Forum of Independent Audit Regulators where the six largest network firms agreed to work towards reducing the number of deficient audits by 25 percent over the next four years. See [International Audit Regulators Say Pace of Audit Quality Improvement Too Slow; Call for Measurable Improvement By 2019](#), press release (March 3, 2016).

<sup>5</sup> See [Accounting Today: Big Four Firms Dominate U.S. Consulting Market](#), by Michael Cohn (June 9, 2016).

<sup>6</sup> See [The Lawyer: PwC Legal chief: we can be a top 20 global legal services business in five years](#), By Yun Kriegler (March 18, 2014).

<sup>7</sup> See [The Wall Street Journal: Deloitte Digital Buys Creative Agency Heat](#), By Suzanne Vranica (Feb. 29, 2016).

<sup>8</sup> See [Accountancy Age: Firm by firm: The FRC's audit quality inspections](#), By Calum Fuller (May 23, 2016).

<sup>9</sup> See [Financial Times: KPMG Probed Over Non-Audit Services to Ted Baker](#), by John Murray Brown (June 6, 2016).

<sup>11</sup> See paragraphs 19A–B of [ISA \(UK and Ireland\) 700](#) (Revised June 2013), *The Independent Auditor's Report on Financial Statements*. The requirements became effective for audits of financial statements for periods beginning on or after October 1, 2012 and were applicable to audits of companies that apply the United Kingdom Corporate Governance Code.



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<sup>12</sup> See [Reforming EU audit services to restore investors' confidence](#), Press Release (April 3, 2014).

<sup>13</sup> See [IAASB Issues Final Standards to Improve Auditor's Report](#), Press Release (Jan. 15, 2015).

<sup>14</sup> See [Extended Auditor's Reports, A Further Review of Experience](#), Financial Reporting Council (Jan. 2016).

<sup>15</sup> Section 10A(a)(3) of the Securities Exchange Act of 1934 provides that each audit required under the Exchange Act of an issuer by a registered public accounting firm must include an "evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year." Pub. L. No. 104-67, title III, § 301(a), 109 Stat. 737, 762 (Dec. 22, 1995).

<sup>16</sup> From 1985 through 1989, more than 25 hearings were held in the U.S. House of Representatives regarding auditor and financial reporting that arose out of issues posed, in large part, by the savings and loan crisis. During those hearings, certain members of Congress expressed concern regarding the absence of "early warnings" regarding a company's potential failure or financial difficulties. See, e.g., *Financial Fraud Detection: Hearing on H.R. 574 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Energy and Commerce*, 103rd Cong. 1 (1993) 11 (Statement of Rep. Ronald L. Wyden) ("Whether it relates to the disasters at the savings and loans, defense contracting fraud, health care fraud, a variety of financial fiascos over the years, shortly on the heels of a clean audit one of these companies goes belly up and the system has not produced the kind of early warning lights and bells that is necessary to ensure that regulators who have the responsibility to deal with these things can get there in a prompt fashion.")

For a discussion of the ten major topics debated at the Congressional hearings, including the absence of auditor "early warnings" regarding company financial failures, see [CPA Audit Quality—Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies](#), United States General Accounting Office (March 1989), GAO/AFMD-89-38.

<sup>17</sup> See Financial Accounting Foundation, [Financial Accounting Series, Accounting Standards Update No. 2014-15: Presentation of Financial Statements—Going Concern \(Subtopic 205-40\), Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern](#) (FASB ASC amendments), FASB (August 2014).

<sup>18</sup> As noted by FASB Board member Lawrence W. Smith in dissenting to the FASB ASC Amendments, FASB's increased threshold "will result in a decrease in the number of going concern disclosures as compared with current practice." FASB ASC amendments at 17.

<sup>19</sup> See Credit Suisse Research Institute, ["Gender diversity and corporate performance,"](#) (Aug. 2012), (reporting that from 2005-2011 companies with women on the board had higher average returns on equity and higher net income growth).

<sup>20</sup> See [Global Review 2013](#), EY (2013) ("We know from experience and research that our best-performing teams are made up of highly engaged individuals from a diverse range of backgrounds. They out-perform all norms in terms of revenue-per-person and brand favorability. Put simply, diverse teams made up of highly engaged employees deliver exceptional client service.").

<sup>21</sup> See [2015 Trends in the Supply of Accounting Graduates and the Demand for Public Accounting Recruits](#), AICPA.

<sup>22</sup> See ["Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges"](#), by Initiative for Responsible Investment, Harvard Kennedy School, The Hauser Institute for Civil Society



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at the Center for Public Leadership, citing “RI ESG Briefing, April 3: New EU Audit Rules OK’d by European Parliament”, *Responsible-Investor*. Responsible-investor.com, (April 3, 2014).

<sup>23</sup> See [Environmental Social and Governance \(ESG\) Survey Report](#), CFA Institute (June 2015) (CFA Institute ESG Survey Report).

<sup>24</sup> See [Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges](#), Initiative for Responsible Investment- Harvard Kennedy School (2014). For example, French companies are required to include ESG information in their annual reports, and companies listed on the Johannesburg Stock Exchange must describe financial, social and environmental factors. Numerous countries, including Japan, The Netherlands, and even China, require companies to publish their environmental records or activities. Many more countries and exchanges have similar policies or guidance encouraging such disclosure.

<sup>25</sup> See [Securities Act Release No. 10064](#), pgs. 204-214 (April 13, 2016).

<sup>26</sup> See [CFA Institute ESG Survey Report](#).