

## Dialogue with PCAOB board member Jeanette Franzel

On October 24 and 25, 2013, members of the North American Audit Committee Leadership Network (ACLN) met in New York for their 27<sup>th</sup> stand-alone meeting.<sup>1</sup> One session was a dialogue with Jeanette Franzel, a member of the Public Company Accounting Oversight Board (PCAOB) since 2012.<sup>2</sup> *Ms. Franzel's biography is included in Appendix 1 on page 15.*

This document summarizes the key points that Ms. Franzel and members raised in the discussion, along with background information and perspectives that members shared before the meeting.<sup>3</sup> *For further information about the network, see "About this document" on page 16. For a list of participants, see Appendix 2 on page 16.*

### Executive summary

Ms. Franzel and the ACLN members discussed a number of topics on the PCAOB's agenda, delving into details of PCAOB oversight programs as well as the PCAOB's efforts to engage with audit committees on these issues. The key items discussed are summarized below and described in more detail on the following pages:

- **Enhanced auditor reporting is one element of a holistic approach to transparency and improving the informational value of audits** (*page 4*)

The PCAOB's proposed new standards on the auditor's reporting model would expand disclosures by the auditor on such issues as "critical audit matters." The proposal would also expand the auditor's responsibilities for evaluating other information in the annual report, such as the management discussion and analysis (MD&A), for any material misstatements of fact or material inconsistencies with the financial statements and communicating the results of that evaluation in the audit report. Ms. Franzel welcomed the opportunity for a broad discussion of the auditor's report. The ACLN members discussed with Ms. Franzel the potential value of such disclosures for investors and potential drawbacks, such as longer and more confusing reports, increased legal liability for the audit firms, and increased costs for issuers. They also addressed other ways of providing more transparency to investors, such as enhanced audit committee or management reporting. Ms. Franzel underscored the benefits of a holistic approach to transparent reporting.

- **Audit quality indicators may provide for better evaluation of audits** (*page 9*)

Ms. Franzel and the members touched on the PCAOB's efforts to develop audit quality indicators that would allow for a more expansive evaluation of audit quality by different stakeholders that would potentially meet their unique needs. They discussed how PCAOB's inspection process is not intended to provide an overall view of a firm's audit quality but can provide an indicator of audit quality relative to

<sup>1</sup> In the other session, members discussed ethics and compliance. See Audit Committee Leadership Network, "[Ethics and compliance](#)," *ViewPoints*, December 4, 2013.

<sup>2</sup> Ms. Franzel's views do not necessarily reflect the views of the PCAOB, any other PCAOB member, or the staff of the PCAOB.

<sup>3</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

compliance with existing auditing standards. The thinking about what could be measured and how the audit quality metrics would serve different stakeholders is in the early stages, but Ms. Franzel and the members agreed on the value of pursuing this effort while also coordinating with organizations such as the International Auditing and Assurance Standards Board (IAASB) and the Center for Audit Quality (CAQ) to avoid a multiplicity of competing indicators.

- **The PCAOB is looking to improve clarity of inspections process and subsequent reporting** *(page 10)*

The PCAOB is responding to concerns about the timeliness and usability of inspection reports, and it has published guidance for audit committees about the inspection process, including suggested questions to ask their audit firm (see page 12). Ms. Franzel explained that PCAOB uses risk-based criteria to select audits for inspection, and she explained some of the issues identified in PCAOB's inspections of audits of internal controls over financial reporting. When discussing audit deficiencies identified by the PCAOB, Ms. Franzel acknowledged conflicting perspectives on use of the term "audit failure," suggesting that an approach based on "gradations of severity" for the deficiencies presented in the public portion of inspection reports may be more helpful to audit firms and audit committees. Ms. Franzel also welcomed the introduction of verbal feedback on good practices to the audit firms by inspectors in the 2013 inspections.

- **The PCAOB and audit committees have complementary objectives** *(page 13)*

Ms. Franzel identified the promotion of audit quality and auditor independence as two objectives common to the PCAOB and audit committees. Ms. Franzel emphasized the importance of audit committee input for the PCAOB's policy-making and standard setting. The PCAOB's Standing Advisory Group (SAG) has discussed a range of outreach approaches, including town hall meetings and roundtables specifically for audit committees, and improvements to the agency's website. Ms. Franzel expressed her willingness to visit individual audit committees from both large and small companies to have a structured dialogue on key issues.

## Background on the PCAOB

The PCAOB was established in 2002 by the Sarbanes-Oxley Act. Until then, the accounting profession had been self-regulated, but financial and accounting scandals prompted a number of reform initiatives, one of which was to establish independent external oversight of the public company auditing profession.<sup>4</sup> The mission of the PCAOB is to

oversee 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. The

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<sup>4</sup> In 2010, the Dodd-Frank Act expanded the PCAOB's authority to include oversight of the auditors of brokers and dealers. The Sarbanes-Oxley Act required auditors of brokers and dealers to register with the PCAOB. Dodd-Frank gave the PCAOB authority to set standards, conduct inspections, and take disciplinary action with regard to broker-dealer audits. See Public Company Accounting Oversight Board, "[PCAOB Statement upon Signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)," news release, July 21, 2010.

PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.<sup>5</sup>

More specifically, the PCAOB carries out four oversight tasks: it registers public accounting firms that audit public companies or broker-dealers; it inspects those firms and their audits; it investigates and enforces audit firms' compliance with applicable laws, rules, and standards; and it establishes auditing and other professional standards.<sup>6</sup>

The Sarbanes-Oxley Act assigned oversight of the PCAOB to the Securities and Exchange Commission (SEC), which appoints the PCAOB's five board members to staggered five-year terms and also approves the PCAOB's rules, standards, and budget.<sup>7</sup> The PCAOB's funding comes primarily from annual fees assessed on public companies based on their market capitalization and on broker-dealers based on their net capital.<sup>8</sup> The 2013 fiscal year budget is approximately \$245.6 million, an increase of \$17.9 million (8%) over the 2012 budget.<sup>9</sup> The PCAOB's 2013 budget estimates that total staff by the end of the year will number 839. More than 60% of the staff is employed in the Division of Registration and Inspections.<sup>10</sup>

The PCAOB has also established a number of advisory and working groups, including the Standing Advisory Group (SAG), which consists of auditors, investors, public company executives, and others,<sup>11</sup> and the Investor Advisory Group (IAG), which was established to deepen the involvement of the investor community.<sup>12</sup>

In its strategic plan for 2012 to 2016, the PCAOB laid out a number of near-term priorities:<sup>13</sup>

- Improving the timeliness, content and readability of inspection reports, including through outreach designed to improve usefulness of reports;
- Improving the timeliness of remediation determinations and providing additional information on the PCAOB's remediation process;
- Initiating a project to identify audit quality measures, with a longer-term goal of tracking such measures with respect to domestic global network firms and reporting collective measures over time;

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<sup>5</sup> Public Company Accounting Oversight Board, "[Mission, Structure & History.](#)"

<sup>6</sup> Jeanette M. Franzel, "[Accountability: Protecting Investors, the Public Interest and Prosperity](#)" (speech at the Association of Government Accountants 62nd Annual PDC, Dallas, TX, July 17, 2013).

<sup>7</sup> Public Company Accounting Oversight Board, "[About the PCAOB.](#)"

<sup>8</sup> [Ibid.](#)

<sup>9</sup> Public Company Accounting Oversight Board, "[PCAOB Approves 2013 Budget and 2012-2016 Strategic Plan.](#)" news release, November 28, 2012.

<sup>10</sup> [Ibid.](#)

<sup>11</sup> Public Company Accounting Oversight Board, "[Standard Advisory Group.](#)"

<sup>12</sup> Public Company Accounting Oversight Board, "[Investor Advisory Group.](#)"

<sup>13</sup> Public Company Accounting Oversight Board, "[Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2012-2016](#)" (Washington, DC: Public Company Accounting Oversight Board, 2012), 5.

- Enhancing the PCAOB’s processes and systems to improve analysis and usefulness of PCAOB inspections findings, including comparative analysis across firms over time, in order to better understand audit quality in firms and better inform the PCAOB’s standard-setting and its other regulatory activities;
- Enhancing the framework for the PCAOB’s standard-setting process in order to improve the effectiveness of the process as well as the standard-setting project tracking information provided to the investing public; and
- Enhancing the PCAOB’s outreach to and interaction with audit committees to constructively engage in areas of common interest, including auditor independence and audit quality.

### **Enhanced auditor reporting is one element of a holistic approach to transparency and improving the informational value of audits**

Ms. Franzel said the original impetus for change in the auditor’s reporting model was a recommendation in the 2008 report from the US Treasury Department’s Advisory Committee on the Auditing Profession (ACAP).<sup>14</sup> Following consultation on the auditor’s reporting model, on August 13, 2013, the PCAOB proposed two new standards intended to expand and improve the information in the auditor’s report.<sup>15</sup> Ms. Franzel noted in her public statement about the proposed standards that they are a response to stakeholders who want auditors “to convey more clearly the auditor’s responsibilities, the nature of the work performed, the level of assurance provided by the audit, and additional information about significant matters in the financial statements or audit.”<sup>16</sup>

The PCAOB is not alone in its efforts to improve the auditor’s report. International standards bodies and some European regulators also have related projects underway. The International Auditing and Assurance Standards Board (IAASB), for example, released an exposure draft in July 2013 that consisted of a new proposed international standard on auditing (ISA 701), *Communicating Key Audit Matters in the Independent Auditor’s Report*, plus proposed revisions to other standards, including a standard on handling other information in documents containing audited financial statements.<sup>17</sup> Meanwhile, the Financial Reporting Council in the United Kingdom has revised some auditing standards to enhance the transparency of the auditor’s report.<sup>18</sup> This international push has led some observers in the United States to suggest that change to the auditor’s report is coming.

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<sup>14</sup> Advisory Committee on the Auditing Profession, *Final Report of the Advisory Committee on the Auditing Profession to the Treasury Department* (Washington, DC: United States Treasury Department, 2008).

<sup>15</sup> Public Company Accounting Oversight Board, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion ... and Related Amendments to PCAOB Standards* (Washington, DC: Public Company Accounting Oversight Board, 2013).

<sup>16</sup> Jeanette Franzel, “[Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information](#)” (speech at a PCAOB open board meeting, Washington, DC, August 13, 2013).

<sup>17</sup> International Auditing and Assurance Standards Board, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)* (New York: International Federation of Accountants, 2013).

<sup>18</sup> Financial Reporting Council, “[FRC Issues Revised Auditing Standard: Making Auditors’ Work More Transparent to Investors](#),” news release, June 4, 2013.

## Key requirements

The PCAOB's proposed standards contain several key requirements:<sup>19</sup>

- **Disclosure of “critical audit matters.”** The first proposed standard says that the auditor must determine and communicate in the auditor's report “critical audit matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.”<sup>20</sup> It explains that “critical audit matters ... are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three.”<sup>21</sup> It also notes that “it is expected that in most audits, the auditor would determine that there are critical audit matters,” and it lays out factors that determine whether a matter is critical or not.<sup>22</sup>
- **Information about auditor independence and tenure.** The first standard would also require the auditor to provide a “statement regarding the auditor's existing requirements to be independent of the company,”<sup>23</sup> and it requires the auditor to disclose the year the auditor began serving as the company's auditor, thereby providing information about the length of the relationship between the auditor and the company.
- **Evaluation of “other information” in the annual report.** The second proposed standard would require the auditor to perform procedures to identify any material inconsistencies between the company's financial statements and other information included in a 10-K filing, such as the MD&A. The auditor must also evaluate whether this other information contains material misstatements of fact, and it must communicate in the auditor's report whether it found material inconsistencies or misstatements. The auditor must evaluate not only quantitative amounts that relate to amounts in the financial statements, but also qualitative statements both related and not directly related to the financial statements.<sup>24</sup>

## Discussion

Comment letters are due on December 11, 2013, and the PCAOB is considering a public roundtable on the proposal in 2014.<sup>25</sup> The proposed standards, if adopted, would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2015. However, it is unclear when any final standard might be adopted by the PCAOB, and SEC approval would also be required before such standards could take effect. The materials accompanying the standards in the release contain extensive discussion of issues associated with the proposals and numerous questions on which the PCAOB would like feedback, including

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<sup>19</sup> For more detail on the standards, see the PCAOB fact sheet included in the meeting book.

<sup>20</sup> Public Company Accounting Oversight Board, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion ... and Related Amendments to PCAOB Standards*, A1-8.

<sup>21</sup> *Ibid.*, A1-6–A1-7.

<sup>22</sup> *Ibid.*, A1-6.

<sup>23</sup> *Ibid.*, 18.

<sup>24</sup> *Ibid.*, A2-3.

<sup>25</sup> Comments can be submitted on [the PCAOB website](#).

questions about the economic considerations related to the standards.<sup>26</sup> An EY partner remarked that this proposal is “significant and requires the thoughtful review and input of audit committees.”

In their statements on the proposed standards, members of PCAOB board highlighted some of the issues the board will continue to discuss, several of which were also raised by audit chairs in pre-meeting conversations and at the meeting itself.

#### Will the added information be valuable?

Ms. Franzel posed several questions in her public statement: “How would investors and other stakeholders use such information? Also, would this type of information help to alleviate the information asymmetry that exists between company management and investors?”<sup>27</sup> Another board member, Steven Harris, suggested that the proposals might not go far enough and asked whether the proposal regarding other information should apply to registration statements as well as annual reports.<sup>28</sup>

Some audit chairs were skeptical of the value of expanding the auditor’s report. In a pre-meeting conversation, one member asked, *“What does the auditor’s reporting model proposal do to a document that is already beyond people’s comprehension? How does it provide value to a sophisticated investor? Are sophisticated investors going to pay attention, given that they have their own models? Will a retail investor read it?”* At the meeting, another audit chair noted: *“When I think of the complexity you have, for example, in banking, I wonder how you would do this without confusing investors.”*

Several audit chairs brought up concerns about increasing the length of the auditor’s report. In a pre-meeting conversation, one audit chair spelled out the implications if an audit were to yield six or more critical audit matters: *“If each of those took close to a page to cover in the report, we’re talking about a six- to 10-page addition to the auditor’s report. The document becomes so long it’s difficult for readers to read.”*

At the meeting, Ms. Franzel acknowledged these concerns and said that they would be carefully weighed: *“If it’s unworkable, we need evidence and analysis. Some audit firms and companies may do field testing of the proposal to help sort out these issues.”* On the other hand, Ms. Franzel noted that *“many investors have called for more information, based on a view that the proposal doesn’t go far enough – we have the whole spectrum of views.”*

#### What are the potential unintended consequences?

In her statement on the proposal, Ms. Franzel asked whether the new information would make auditor reporting less comparable and consistent across entities. Another board member, Jay Hanson, asked if it would lead to disclosures that are exempted by other applicable rules. Mr. Hanson also noted that there is no data correlating audit tenure with audit quality, but requiring disclosure of audit tenure might imply such a correlation. Regarding the expectation that most audits will have critical audit matters, Mr. Hanson asked

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<sup>26</sup> See in particular appendices 5 and 6.

<sup>27</sup> Jeanette Franzel, [“Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information.”](#)

<sup>28</sup> Steven B. Harris, [“Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information”](#) (speech at a PCAOB open board meeting, Washington, DC, August 13, 2013).

if it would cause auditors to “believe that they *must* come up with a critical audit matter, no matter how straightforward the audit.”<sup>29</sup>

In a pre-meeting conversation, an audit chair raised the issue of legal liability: *“It could heighten liability exposure for the auditor, and for the audit committee as well. The auditor will be asked to articulate the assumptions they are concerned about. What happens when there is fraud that they didn’t anticipate? Does it open them up to the plaintiff’s bar? That could be serious.”* Other audit chairs worried about the effect on the dialogue between the auditor and the company: *“Public reporting would have a dampening effect on the candor of discussions. It’s hard for auditors to write a report that is helpful to investors and not harmful to the company and the discussion.”* At the meeting, a member pointed specifically to the communications between the auditor and the audit committee: *“When the auditor communicates with us, we often see things that are not ‘critical.’ I’m worried that we won’t see as much. We could end up with a less robust flow of information.”*

#### Is the definition of “critical audit matters” clear?

Board member Harris noted in his public statement that the “language endorses a subjective standard in determining what a critical audit matter (CAM) is,” which could allow the auditor to leave out important matters and would make effective enforcement of the proposed rule difficult. He suggested that it might be better to have the auditor discuss a “precise list of issues,” such as what arguments the auditor had with the CFO and what the going-concern assumptions are.<sup>30</sup> Some audit chairs raised similar concerns. One asked, *“By whose standard is something a critical audit matter?”*

On the other hand, board member Lewis Ferguson, in his public statement, expressed support for the proposed approach because “it allows auditors substantial latitude to exercise professional judgment in determining what items to include as CAMs but constrains that judgment by an objective standard, the reasonable and experienced auditor looking at the same evidence.”<sup>31</sup> In the meeting, audit chairs raised the idea of using the list of items in the PCAOB standard for required communication between the audit form and the audit committee (AS-16) as the starting point in defining a critical audit matter.<sup>32</sup>

#### What are the implementation challenges and cost implications?

Both Ms. Franzel and Mr. Hanson raised questions about the potential costs and efforts involved in implementing various aspects of the proposals. In a pre-meeting conversation, an EY partner noted that an increase in effort related to documentation of critical audit matters and non-critical audit matters was likely, and EY’s published commentary on the proposals noted that the requirements regarding other information in the annual report would also entail additional audit effort and cost.<sup>33</sup> Audit chairs tended to agree. One said

<sup>29</sup> Jay D. Hanson, [“Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information”](#) (speech at a PCAOB open board meeting, Washington, DC, August 13, 2013).

<sup>30</sup> Steven B. Harris, [“Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information.”](#)

<sup>31</sup> Lewis Ferguson, [“Statement on Proposed Auditing Standards Regarding the Auditor’s Report and the Auditor’s Responsibilities Regarding Other Information.”](#) (speech at a PCAOB open board meeting, Washington, DC, August 13, 2013).

<sup>32</sup> Public Company Accounting Oversight Board, [Auditing Standard No. 16: Communications with Audit Committees.](#)

<sup>33</sup> EY, [“Sweeping Changes to Auditor’s Report May Be on the Horizon.”](#) *To the Point*, September 26, 2013, 3.

that the costs of disclosing critical audit matters would involve *“drafting the report and negotiating the format with the company and legal counsel.”* Another audit chair pointed out that even if costs do not increase initially, the effort needed for the audit firm to respond to follow-up questions prompted by the initial findings could escalate costs: *“It’s the thin tip of the wedge.”* Other audit chairs linked the costs to liability: *“Audit firms are not keen to render opinions with increased liability without a reasonable amount of liability insurance.”*

Members also suggested that evaluating “other information” in the annual report would increase costs: *“The firms would have to staff up with consultant types. More money would be needed, and there would be a learning curve.”* However, another member disagreed on how much extra work would be involved: *“They already have to read all the information. They already have to opine that it’s not inconsistent with the audited information. There’s [only] a subtle difference between what they do now and what this component of the proposal calls for.”*

#### Can field testing provide additional data?

Ms. Franzel noted that some auditors have announced plans to “field test” the proposed requirements in certain client engagements. Audit chairs were enthusiastic about the need for field testing to ensure that the proposed standards can work practically and effectively with real data. One audit chair suggested that the resulting auditor’s reports should also be tested with investors. In his comment letter on the proposals, ACLN member Denny Beresford called for robust field testing: *“This should be done with enough different accounting firms and with enough different sample clients within those firms to form a representative basis of what such a new requirement would actually entail.”*<sup>34</sup>

#### Are there other ways of providing more information to investors?

In a pre-meeting conversation, an audit chair noted that some of the additional information is already discussed by the audit committee and could be a component of an enhanced audit committee report. One member referred to the recent review of audit committee reporting to shareholders during the 2013 proxy season undertaken by EY that shows that audit committees are already disclosing more information than is required, and there was an increase in such disclosure over 2012.<sup>35</sup> For example, 31% of Fortune 100 companies disclose auditor tenure as proposed by the PCAOB for the auditor’s report.<sup>36</sup> The Center for Audit Quality and several nationally recognized governance organizations, including Tapestry Networks, are currently developing guidance for enhanced audit committee reporting.

At the meeting, audit chairs asked about alternative approaches more generally. One asked, *“Does more auditor reporting solve the underlying issue? Or should the problem be taken up by someone else?”* Ideas included suggesting that the SEC enhance disclosure of critical audit matters by management in the MD&A. Ms. Franzel acknowledged that this project was opening a broader discussion about reporting that includes

<sup>34</sup> Dennis R. Beresford, [Comment letter on Rulemaking Docket No. 34](#), October 11, 2013.

<sup>35</sup> EY, [Audit Committee Reporting to Shareholders: 2013 Proxy Season Update](#) (London: Ernst & Young Global Limited, 2013), 1.

<sup>36</sup> [Ibid.](#), 3.



management and audit committees and their respective reporting roles: *“This is inherently part of a broader analysis of reporting and disclosure. We will need to look at this issue holistically.”*

Members responded very positively to the idea of a more comprehensive, systemic approach. Immediately after the meeting, an audit chair said, *“I hadn’t heard that before, and we should think about it.”* Another audit chair drew out some of the implications of a holistic approach, suggesting that it could allow more room for non-regulatory measures initiated by the private sector: *“A few bad apples create issues for us all. Is there a way to police ourselves?”*

Responding to one audit chair’s suggestion that mandating executive sessions of the audit committee and external auditors might meet some of the objectives of better auditor reporting, Ms. Franzel brought up the disparities in performance among audit committees: *“We have substantial anecdotal evidence that audit committee practices are all across the board – while we hear from audit committees who appear to be diligent in their audit oversight activities, we also have indicators that some companies’ audit committees are not doing their jobs. So there is an opportunity for the audit committee community step up and improve the consistency and quality of practice across companies.”*

Ms. Franzel also reiterated the importance of feedback from the audit committee community, and that, *“audit committees or their representatives should submit comments on the PCAOB’s reporting model proposal to help the Board fully understand their perspectives and needs.”*

### **Audit quality indicators may provide for better evaluation of audits**

Another project being undertaken by the PCAOB is an initiative to develop measures of audit quality, called audit quality indicators (AQIs). The purpose of these indicators, as spelled out in a briefing paper prepared for a May 2013 meeting of the SAG, would be to inform PCAOB regulatory processes and policy making, potentially help other stakeholders (such as audit committees, investors, company management, and audit firms) conduct their work, and encourage audit firms to compete on audit quality.<sup>37</sup>

Commenting on the audit deficiencies that the PCAOB continues to uncover in its inspections despite a general sense among many stakeholders that audit quality has improved, Ms. Franzel said in a recent speech, *“This discrepancy points out a glaring issue: A generally understood and measurable definition of audit quality has not emerged over the decades that this issue has been debated and questioned.”*<sup>38</sup>

An audit chair said, *“It’s a tough project to make progress on, but it is worth working on given the fact that the only real indicators that we have of audit quality today are the inspection reports for the firms. The public simply sees that the Big Four show 35% to 40% failure rates, and it comes across as very negative.”*

Ms. Franzel responded, saying, *“Deficiencies have gone up but it doesn’t mean audit quality is down. Inspection findings provide a single indicator of audit quality relative to compliance with applicable standards.”* Other organizations are also developing measures of audit quality. The IAASB issued a consultation paper, *A Framework for Audit Quality*, in January 2013, and the Center for Audit Quality is in

<sup>37</sup> PCAOB Standing Advisory Group, *Discussion – Audit Quality Indicators* (Washington, DC: PCAOB Standing Advisory Group, 2013), 2.

<sup>38</sup> Jeanette M. Franzel, *“Accountability: Protecting Investors, the Public Interest and Prosperity.”*

the first phase of a multiyear project to develop measurements of audit quality. Ms. Franzel has mentioned the efforts of these organizations and the need for collaboration.<sup>39</sup> An audit chair commented, *“It’s good to hear Jeanette Franzel articulate that they are willing to engage in discussion so there aren’t dueling indicators.”*

While the PCAOB’s effort is still in the early stages, the briefing paper prepared for the SAG discussion in May lays out several elements of a framework for measuring audit quality, including specific examples of potential AQIs. The framework consists of three segments:<sup>40</sup>

- **Operational inputs.** There are six areas of operational input: partner workloads, staff workloads, audit team, supervision and review, continuing education, and professional experience. Specific examples of AQIs in this area include specialist hours as a percentage of overall engagement hours, training hours per audit professional, and the ratio of partners to staff.
- **Audit process.** The audit process also consists of six elements: tone at the top, personnel management, risk assessment and response, information and communication, control activities, and monitoring. Specific examples of AQIs in this area include number and substance of firm leadership communications on audit quality, number and nature of internal quality review findings, and number and nature of PCAOB inspection findings.
- **Audit results.** Elements include reliable financial statements, assurance about internal control, going-concern warnings, and robust audit committee communications. Examples of AQIs include frequency and market impact of financial statement restatements for errors, number of audit reports lacking a going-concern opinion that were followed by a bankruptcy, and surveys of audit committees about the quality of communications from the auditor.

The briefing paper notes that AQIs could focus on several different levels: the audit engagement, the office or region, the affiliate firm, or the global network. Others suggest that AQIs could also be applied at the level of the audit industry as a whole. The unit of analysis would affect the usefulness of the AQIs for different stakeholders. An audit chair noted that industry-level metrics might be less relevant for audit committees: *“Broad industry gauges could be shared with auditors and investors. The audit committee might be made aware of them, but they are less relevant to their work. It may not be relevant for a particular auditor or registrant.”* The issue of usefulness for different stakeholders also raises the question of where and to whom any AQIs should be reported.

One audit chair underscored the importance of well-defined metrics: *“I’m a big fan of measurement – it can lead to deeper conversation – but it depends on how the metrics are defined. Are they meaningful or just noise?”* The SAG took up the topic of AQIs again in its November 2013 meeting.

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<sup>39</sup> Jeanette M. Franzel, *“Accountability: Protecting Investors, the Public Interest and Prosperity.”*

<sup>40</sup> See PCAOB Standing Advisory Group, *Discussion – Audit Quality Indicators*, 4–5, A1–13–A1–14.

## The PCAOB is looking to improve clarity of inspections process and subsequent reporting

As explained in a PCAOB publication for audit committees about the inspection process for public company audits, “Inspections include evaluation of the firm’s performance in selected audit engagements and evaluation of the design and operating effectiveness of a firm’s quality control policies and procedures.”<sup>41</sup> Firms that audit 100 or more issuers per year are inspected annually. The public portion of inspection reports (Part I) lists deficiencies identified in engagements (without identifying the public company that was audited), and the non-public portion (Part II) reports on the quality control evaluation, elements of which may be made public if PCAOB criticisms are not remedied to the Board’s satisfaction within 12 months from the date of the inspection report. The PCAOB also publishes occasional public reports about inspection findings that are focused on general issues and observations rather than individual firms.

In a recent speech, Ms. Franzel summarized trends in inspection findings of audit deficiencies over the last several years:

We have seen the number of Part I findings trend downward since 2010 in the areas of auditing financial instruments and fair value measurements and disclosures. Yet, fair value measurements and disclosures remain as an area of frequent findings, even if the numbers are lower. At the same time, we’ve seen a spike in deficiencies related to internal control over financial reporting and business combinations. And audit deficiencies in the areas of revenues and inventory continue to be frequently cited in Part I.<sup>42</sup>

Ms. Franzel also noted in a speech earlier this year that if firms show significant improvements in the level of compliance with PCAOB professional standards on audits, the Board will have an opportunity to consider adjusting its inspection approach and methodology.<sup>43</sup> ACLN members and other experts have identified several issues associated with the inspection process, many of which the PCAOB has also acknowledged:

- **Timeliness of reports.** An audit chair said, “*The reports that come out are very dated ... The issues are from a couple of years ago.*” In a January 2013 speech, Ms. Franzel noted that timeliness had been a challenge and that the agency wanted to develop processes and tracking metrics to reduce backlogs.<sup>44</sup> In the meeting, Ms. Franzel said the backlog had now been significantly reduced and timeliness is being improved on the current inspection reports.
- **Readability and usefulness of reports.** The PCAOB’s strategic plan for 2012 to 2016 identifies as a near-term priority “improving the timeliness, content and readability of inspection reports, including through outreach designed to improve usefulness of reports.”<sup>45</sup> At a SAG meeting in May 2013,

<sup>41</sup> Public Company Accounting Oversight Board, *Information for Audit Committees About the PCAOB Inspection Process* (Washington, DC: Public Company Accounting Oversight Board, 2012), A-1.

<sup>42</sup> Jeanette M. Franzel, “[Achieving High Quality Audits to Promote Integrity and Investor Protection](#)” (speech at the NACD Board Leadership Conference 2013, National Harbor, MD, October 13, 2013).

<sup>43</sup> Jeanette M. Franzel, “[Accountability: Protecting Investors, the Public Interest and Prosperity.](#)”

<sup>44</sup> Jeanette Franzel, “[Protecting Investors by Seizing the Opportunity to Strengthen Audit Quality](#)” (speech at American Accounting Association Midyear Conference and Doctoral Consortium, New Orleans, LA, January 18, 2013).

<sup>45</sup> Public Company Accounting Oversight Board, *Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2012-2016*, 5. A PCAOB staff briefing paper for the May 15–16, 2013 SAG meeting describes the board’s initiative and related issues in more detail. See [http://pcaobus.org/News/Events/Documents/05152013\\_SAGMeeting/Future\\_Board\\_Reports.pdf](http://pcaobus.org/News/Events/Documents/05152013_SAGMeeting/Future_Board_Reports.pdf).

participants noted that general reports on inspections would be more valuable if they took a more balanced approach that pointed out not only deficiencies but also areas where auditors have been successful.<sup>46</sup> Ms. Franzel indicated that she welcomed Mr. Hanson's suggestions to PCAOB inspectors that they begin to analyze and provide feedback to the audit firms on what she called "*the root cause of a good audit.*" She is pleased that inspectors are introducing some verbal feedback to firms along these lines as part of the 2013 inspections.

- **Levels of disclosure.** ACLN members would like as much information as possible, including information about Part II of the reports. The PCAOB has articulated the legal constraints on what it can share with audit committees,<sup>47</sup> but it has encouraged information sharing by audit firms and inquiries by audit committees.<sup>48</sup>

In its publication for audit committees about the inspection process last year, the PCAOB offers a detailed explanation of the process and how audit committees can benefit from inspections. It lists questions that audit committees can ask their audit firms about inspections, paraphrased as follows:<sup>49</sup>

- **Was the company's audit selected for inspection?** If the company's audit was selected, what is the PCAOB looking at, and what deficiencies has the PCAOB identified?
- **Did the PCAOB identify deficiencies in other audits that involved issues similar to those presented in the company's audit?** Are the deficiencies in the company's audit similar to deficiencies identified in other audits?
- **How has the audit firm responded to the PCAOB findings?** Does the audit firm agree with the PCAOB's findings, and if not, why not? If the firm agrees, what has it done in response?
- **What topics are included in Part II findings?** Audit firms may not want to share the details of Part II findings for a number of reasons, but audit committees can ask for certain generic information about the findings, such as what changes the firm is making to address any quality control deficiencies, the progress of the quality control remediation process, and whether the PCAOB has provided initial indications that the audit firm may not have sufficiently remediated any items.

At the meeting, members asked for more information about the inspection process itself, including, for example:

- **How the PCAOB selects audits for inspection.** Ms. Franzel explained, "*We do have a risk model. It includes industry related factors, company related factors, and firm related factors. We do look at company size. Regarding the firm, sometimes there are problem offices. There is some random selection as well, and we also look at emerging accounting issues.*"<sup>50</sup>

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<sup>46</sup> PCAOB Standing Advisory Group, [webcast of meeting, May 16, 2013](#).

<sup>47</sup> See Public Company Accounting Oversight Board, [Statement Concerning the Issuance of Inspection Reports](#), (Washington, DC: Public Company Accounting Oversight Board, 2004), 6.

<sup>48</sup> Public Company Accounting Oversight Board, [Information for Audit Committees About the PCAOB Inspection Process](#), 10-12.

<sup>49</sup> [Ibid.](#), ii-iii.

<sup>50</sup> [Ibid.](#), A-1 through A-3.

- **How the PCAOB rewards inspection staff.** In response to a question about whether inspectors are rewarded for finding problems, Ms. Franzel made it clear that performance measurement is not based on finding deficiencies: *“We don’t reward based on findings. We don’t set that tone. We use measures similar to other professional services firms – performance evaluations are competency based.”*

Ms. Franzel and the members also discussed some of the difficulties of auditing internal controls. These difficulties have become apparent in recent inspection findings related to internal control audits. Ms. Franzel said, *“Sometimes the root problem is the internal controls at the issuer. If the controls are not being implemented in a tight manner, they are hard to audit.”* A member remarked, *“You could challenge the audit of internal controls at any company in America – it’s a subjective process.”*

Nevertheless, Ms. Franzel reminded members of a finding shared by the PCAOB in its December 2012 public report on inspections: *“If you’re an audit committee chair and the auditor has problems with internal controls, you need to look hard at the financial reporting and auditing overall.”* Ms. Franzel noted the finding from the December 2012 report, which said that in 85 percent of those engagements where the firm did not have sufficient evidence to support the internal control opinion, the firm also failed to obtain sufficient audit evidence to support the financial statement audit opinion.<sup>51</sup>

Ms. Franzel concluded the discussion of inspections by agreeing with several members who expressed concern about PCAOB’s use of the term “audit failure” to describe Part I inspection findings: *“The term ‘audit failure’ is very inflammatory. When people hear that term they think, ‘Enron,’ which becomes an impediment to dialogue.”* She expressed hope that in the future a more specific approach to labeling deficiencies could be a potential solution by using terms that indicate gradations of severity for those deficiencies included in Part I of the inspection reports.

### **The PCAOB and audit committees have complementary objectives**

Ms. Franzel told audit chairs at the meeting: *“We have different roles but common objectives. We are all part of the system designed to help ensure independent, reliable auditing, and fragmentation in that system is dangerous.”*

The PCAOB has acknowledged the importance of reaching out to audit committees, both to gather input for its activities and decision making and to help audit committees perform their duties. The PCAOB’s strategic plan for 2012 to 2016 includes among its near-term priorities “enhancing PCAOB’s outreach to and interaction with audit committees to constructively engage in areas of common interest, including auditor independence and audit quality.”<sup>52</sup>

In a public statement late last year, Mr. Hanson noted that the PCAOB had already taken concrete steps to engage with audit committees. In addition to releasing the documents on inspections discussed earlier, in 2012, it issued a new standard on communications between auditors and audit committees (AS 16), which

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<sup>51</sup> PCAOB, *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (PCAOB: December 10, 2012).

<sup>52</sup> Public Company Accounting Oversight Board, *Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2012-2016*, 5.

came into effect for audits of fiscal years beginning on or after December 15, 2012.<sup>53</sup> Recently, Mr. Hanson mentioned a discussion that took place at the May 2013 SAG meeting:

In May, we discussed with the SAG potential outreach approaches, ranging from the issuance of additional publications, to attendance at conferences or webcasts, to hosting town hall-style meetings or round tables specifically tailored toward audit committees. We are considering changes to our website to make it easier for audit committee members to find relevant information. We have actively reached out to corporate governance organizations to increase participation by PCAOB Board members and staff in conferences and other events that are targeted toward audit committee members.<sup>54</sup>

ACLN members have long supported efforts by the PCAOB to listen to audit committee members more and consider their role in the audit value chain when designing policy. Ms. Franzel noted that audit committee input on the issue of mandatory rotation had a major influence on the PCAOB's project and the current approach of focusing on other ways of promoting auditor independence, including outreach to audit committees. In response to members' questions about the PCAOB's understanding of the audit committee's expanding role, she agreed that the PCAOB should continue to deepen its outreach: *"I would like to look at the issuer universe and pick companies where we would have sessions with the audit committees. We could get out there with a structured set of discussion items, to really gain an understanding of what is impacting audit committees in their oversight roles at both large and small companies."* Several audit chairs offered to invite Ms. Franzel to meet with their own audit committees.

## Conclusion

Ms. Franzel and the ACLN members engaged in a fruitful dialogue on important parts of the PCAOB's current agenda. Ms. Franzel spoke of the common objectives held by audit committees and the PCAOB, including improving audit quality and auditor independence. Ms. Franzel emphasized that potential changes to the auditor's report should be weighed as part of an integrated, multifaceted effort to provide transparency and increase the informational value of audits to investors and other stakeholders. She touched on the effort to develop audit quality indicators, underscoring the importance of more information for evaluating audits, and she offered insights into the PCAOB's inspection process. Input from audit committees, Ms. Franzel said, has already made a difference to several PCAOB initiatives, and outreach to audit committees will continue and expand.

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<sup>53</sup> [Ibid.](#)

<sup>54</sup> Jay D. Hanson, ["Remarks at the National Audit Committee Forum"](#) (American Institute of Certified Public Accountants, New York, September 13, 2013).

## Appendix 1: Biography of Jeanette Franzel

Jeanette M. Franzel was appointed by the Securities and Exchange Commission as a member of the Public Company Accounting Oversight Board (PCAOB) in February 2012.

The PCAOB's mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest through high quality, independent, and reliable audits. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

The board has oversight of PCAOB's operations including the four primary responsibilities under Title I of the Sarbanes-Oxley Act: (i) registration of accounting firms; (ii) inspections of registered firms' audits and quality control; (iii) establishment of auditing and related attestation, quality control, ethics, and independence standards; and (iv) investigation and discipline of registered public accounting firms and their associated persons for violations of specified laws or professional standards.

Prior to joining the PCAOB, Ms. Franzel served nearly 23 years at the Government Accountability Office (GAO), ending her tenure as a managing director overseeing all aspects of the organization's financial audit oversight of the US federal government. During a decade in GAO's senior executive service, she supervised audits for large complex agencies as well as small programs with limited resources.

From 2008 through 2011, Ms. Franzel's team performed oversight of the US government's efforts to help stabilize the financial markets and promote economic recovery.

From 2003 to 2012, she oversaw the periodic updating and issuing of the GAO's Government Auditing Standards ("The Yellow Book"), which is used throughout the world. She also provided extensive policy and technical support to the International Organization of Supreme Audit Institutions which develops auditing standards for national audit offices around the world.

In 2011, Ms. Franzel was the recipient of GAO's Distinguished Service Award and the AICPA's Outstanding CPA in Government award. In 2010, she received the International Achievement Award from the Association of Government Accountants.

Prior to her career in accounting and auditing, Ms. Franzel taught elementary school and high school in South America.

## Appendix 2: Participants

ACLN members participating in all or part of the meeting sit on the boards of over 25 public companies:

- Ralph Babb, Audit Committee Chair, Texas Instruments
- Denny Beresford, Former Audit Committee Chair, Legg Mason
- Les Brun, Audit Committee Chair, Merck
- Michele Hooper, Audit Committee Chair, PPG Industries
- Judy Richards Hope, Former Audit Committee Chair, General Mills and Union Pacific
- Mike Losh, Audit Committee Chair, Aon and TRW Automotive
- Blythe McGarvie, Audit Committee Chair, Viacom
- Oscar Munoz, Audit Committee Chair, United Continental Holdings
- Tom O'Neill, Former Audit Committee Chair, Archer Daniels Midland
- Bill Osborn, Audit Committee Chair, Caterpillar
- Steve West, Audit Committee Chair, Cisco Systems

EY was represented in all or part of the meeting by:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Managing Partner

## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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