February 3, 2014

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Exposure Draft on *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit* (PCAOB Release No. 2013-009, December 4, 2013; PCAOB Rulemaking Docket Matter No. 029)

Dear Ms. Brown:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") Exposure Draft on *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit* (the "ED"). Our comments reflect an academic perspective from our involvement in audit research and education over more than three decades and the interface of our academic experiences with our respective audit standard-setting and regulatory activities.

The ED would require disclosure in the auditor's report of the name of the engagement partner; the names, locations, and extent of participation of other independent public accounting firms that participated in the audit; and the locations and extent of participation of other participants not employed by the auditor that took part in the audit. Below we comment on some specifics of the ED, but we also address various issues related to the analysis of economic considerations as discussed in the ED, including overarching concepts and relevant research.

Perspectives on Overarching Concepts

The ED includes a section on economic considerations. This section discusses the economic rationale for the proposal, the potential costs and benefits of the proposal, and the alternatives considered.

The rationale for the ED is somewhat unusual in that it does not generally involve arguments for improving audit quality, which is part of the mission of the PCAOB. Rather, the ED argues there are potential benefits of *disclosure* in the auditor's report of the name of the engagement partner and others involved in the audit. For example, the ED argues that the name of the engagement partner:

- Would "provide a signal about the quality of the audit of the financial statements that could reduce the level of information asymmetry between company management and investors;"

- "Would allow investors and other users of financial statements to supplement the audit firm's name with more granular information when forming an opinion about the nature of the audit;" and

- Investors would "benefit from knowing the quality and reputation of not only the firm, but also of the engagement partner on the audit of the company in which they invest" (pp. 27-28).

Apparently the PCAOB envisions the proposed disclosure as a first step in the development by *third-parties* of databases that would, over a period of years, compile information about individual engagement partners and that such information would somehow be useful to investors (pp. 12-13). In addition, the PCAOB envisions that these databases would be readily accessible to and used by investors. From an academic perspective, we have several comments about these arguments.

Audits are conducted by engagement *teams* that include multiple partners and staff, whose work is supplemented by and subject to monitoring and oversight from a number of audit firm partners and staff not specifically assigned to the audit engagement. The ED seems not to consider the reasonableness of and implications from singling out one particular audit team member and expecting that team member to garner an individual reputation among investors that is meaningfully separate from that of the audit firm.[1]

Analogies to physicians and lawyers in the ED (p. 13) do not appear salient given the team setting for public company audits and considering the nature of the demand for and supply of audit services vis-à-vis services from physicians and lawyers. For example, a specific patient or legal client is the sole consumer of these services and has a personal and direct relationship with the service provider. In addition, physicians typically serve many patients and some schedule up to four patients an hour – while an audit partner may serve one issuer engagement a year.

Auditing essentially involves three-party relationships that include the issuer, the audit firm, and investors.[2] The issuer's audit committee represents the interest of investors in exercising its responsibilities for oversight and monitoring of the external audit and the issuers' relationship with the audit firm in accordance with the Sarbanes-Oxley Act of 2002. However, investors themselves are not a party to the audit contract and have very limited capabilities to express views on *audit firm* selection, irrespective of a particular audit partner on the engagement team.

These perspectives emphasize the importance of considering potential unintended consequences when assessing the costs and benefits of what the PCAOB is proposing in the ED. To illustrate, one might hypothesize that naming the engagement partner could actually result in reduced audit quality. This could occur, for example, if the "best" engagement partners resist taking on more challenging audits in order to avoid the risk of a low "audit quality rating score" in third-party

[1] In addition, if not otherwise disclosed that the audit firm is dividing responsibility with another audit firm(s), the audit firm assumes responsibility for the work of others and must comply with PCAOB auditing standards and thus this aspect is subject to PCAOB inspection.
[2] We use the term "investors" to include other users of issuers' audited financial statements and audits of internal control over financial reporting, if applicable.

databases. We know of instances of such behavior in academic settings where a highly rated teacher avoids a difficult course or challenging teaching assignment and thus avoids the risk of lower ratings from students.

Importantly, the ED does not seem to reflect that the PCAOB – as both the regulator and inspector of public company audits – has access to vastly more information on audit quality at the engagement level and the factors that contribute to audit quality, including the role (and not merely the identity) of the engagement partner, than investors and other third-parties ever can have.[3] Audit committees also have access to substantial information about participants in the audit engagement and can monitor partner performance more reliably than can diverse investors. Given the nature and scope of the PCAOB's and the audit committee's information sets, it would seem that any "reduction in information asymmetry" related to audit quality for investors would be trivial or non-existent from simply disclosing the names of the engagement partners.

Moreover, information publicly available and used by outsiders to measure engagement partner performance could also be misleading. For example, research that correlates the name of the engagement partner with publicly available data about relative accounting accruals or even restatements by a particular issuer, may result in a "partner quality score" that conflicts with the engagement partner's performance based on the PCAOB's targeted inspection data that are not publicly available.

Thus, rather than focusing on disclosing various participants in the audit in order to promote "research by investors and others," we suggest that a key issue is how the PCAOB might capitalize on its unique data and access to audit firms and personnel to conduct and facilitate research within the confines of its legislative mandates.

Perspectives on Relevant Empirical Research

In addition to our overarching comments above, we would like to provide some perspectives on the discussion of relevant empirical research in the ED. We very much appreciate that the PCAOB is using research to inform its activities. The ED cites research that provides both confirming and disconfirming evidence regarding possible outcomes from adopting aspects of the proposal. However, it is also important that the PCAOB appreciate the limitations of the research cited regarding *this particular initiative* and we hope the following comments will be helpful.

Conducting research for predicting the effect of changes in public company auditing rules and standards is difficult. Rules and standards rely on complex judgments applied in a complex and uncertain environment of multiple behavioral, economic, regulatory, and cultural factors that interactively affect the appropriate professional behavior. Thus, the effect of rules or standards with a somewhat similar *combination* of conditions may not predict or validly generalize to the proposed combination.

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[3] This point likewise applies to other audit firms that participated in the audit.

In addition, valid archival audit quality-related research by independent researchers can be hampered by limited data availability. As we previously noted, outsiders do not have access to the individual and engagement performance data available to audit firms, the PCAOB, and audit committees. As a result, most independent archival studies (and third-party developed databases) on audit quality must use data that can be no better than "second-best."

The archival studies discussed in the ED rely on evidence from other countries that have enacted requirements for partner signing of audit reports and/or disclosing the name of the engagement partner. Examples are from the U.K, Sweden, the Netherlands, and Taiwan. Each of these countries has a regulatory environment, legal structure, corporate governance, capital market, and many other factors including culture and traditions that differ from that of the U.S. Thus, the PCAOB should be cautious about generalizing findings in these studies to a U.S. setting.

We comment on two studies that illustrate the limited generalizability of findings and second best measures. Our comments *are not* about the validity of the research *per se*, but rather the relevance of these studies for predicting effects of U.S. adoption of the proposals in the ED.

One study, Carcello et al., suggests that initiating a regulatory requirement for partner signatures (characterized as similar to partner naming) improved audit quality in the U.K., on average, because it can be correlated with a statistically significant decline in U.K. companies' abnormal accounting accruals, among other measures, in the first year after introducing the requirement in the U.K. as a severe economic crisis was unfolding.[4] However, the measures used in the study do not indicate whether financial statements are materially misstated or auditors fail to comply with auditing standards. Further, as to the relevance of accruals as a general measure of financial reporting (earnings) quality, a noted accounting scholar, Professor Ray Ball of the University of Chicago, recently stated "surely one must be skeptical of published research containing statistics that imply things such as the majority of the variation in accruals is due to [earnings] manipulation in the form of 'discretionary' accruals" (p. 850).[5]

A second study, Knechel et al., uses partner name and other data from Sweden. This study relies almost entirely on going concern paragraphs resulting from *statutory* audits of very small *private* companies (e.g., those with as few as four employees) where, on average, a Big Four audit partner signed a statutory audit report every third working day throughout the year.[6] Again, we do not comment on validity of the study itself, but question the validity and relevance of its measures and results for evaluating the ED proposals for audits of U.S. *public* companies of any size.

Finally, in our view, discussion in the ED could benefit from considering other aspects of the long-standing research literature on the economics of auditing. This literature includes both

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[4] See "Costs and Benefits of Requiring an Engagement Partner Signature: Recent Experience in the United Kingdom," by Joseph V. Carcello and Chan Li in *The Accounting Review*, Volume 88, No. 5 (September 2013): 1511-1546 (ED, p. 29).

[5] See "Accounting Informs Investors and Earnings Management is Rife: Two Questionable Beliefs," by Ray Ball in *Accounting Horizons*, Volume 27, No. 4 (December 2013): 847-853.

[6] See the working paper on SSRN by W. Robert Knechel, Ann Vanstraelen, and Mikko Zerni, "Does the Identity of Engagement Partners Matter? An Analysis of Audit Partner Reporting Decisions" (September 2013) (ED, p. 28).

conceptual and empirical work on quality-differentiated audit services and surrogates (proxies) for audit quality.[7] Contrary to suggestions in the ED (p. 27), audit firm name is not the only potentially observable surrogate for audit quality.[8]

Perspectives on Economic Considerations

The PCAOB is now formally engaging in economic analysis to consider whether its proposed rules and standards are appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation. To assist in the economic analysis process, the PCAOB is experimenting with the formation of a Center for Economic Analysis. We understand that the Center will advise the PCAOB on how economic theory, analysis, and tools can be better used to enhance the effectiveness of PCAOB program areas, including standard setting, inspections, and other oversight activities. In addition, the Center will promote and encourage economic research relating to the role of the audit in capital formation and investor protection. The Center also plans to host a conference on economic research relating to the role of the audit in the capital markets in 2014.

The 2014 budget of $258.4 million approved by the PCAOB provides $1.2 million in funding for this Center. The Center's funding includes resources to hire five new full-time employees (at least four of which will be economists) and four economic consultants. Further, the 2014 budget provides for hiring two more economists in the Office of the Chief Auditor. These new hires are in addition to the four economists in the Office of Research and Analysis and the two or three economists in the Office of the Chief Auditor already on-board at the end of 2013. As one Board member noted: "Economists seem to be popping up everywhere at the PCAOB."[9]

We recognize the need for the PCAOB to have staff and/or consultants with expertise in economic analysis. We are very supportive of inter-disciplinary research;[10] and, we applaud the PCAOB for attracting highly respected scholars. However, we have also come to understand the complexity of auditing and its effective regulation via standards, inspections, and enforcement.

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[7] The ED states: "The capacity to differentiate between alternative products is a fundamental requirement of competitive markets. Investors, for example, benefit from knowing the quality and reputation of not only the audit firm, but also of the engagement partner on the audit of the company in which they invest" (p. 28). While we apologize for any confusion, as we understand it, the focus of the 2012 Jumpstart Our Business Startups Act is on competitive effects for emerging growth companies and other issuers, not audit firms. Moreover, since the ED focuses on quality-differentiation among suppliers within the market for public company audits (rather than differentiation between product markets), the point as stated in the ED may not be relevant from an audit perspective either.

[8] We also note that the PCAOB's initiative on audit quality indicators (i.e., surrogates for audit quality) discusses a large number of potential indicators of audit quality. The PCAOB's outreach activities indicate stakeholders, including investors, generally give top ranking to "output" indicators that are currently publicly available. Notably, the engagement partner's name is *not* among the potential audit quality indicators on the PCAOB's long list and neither is a rating by PCAOB inspectors of engagement partners.

[9] See the comments of Lewis H. Ferguson at the November 25, 2013 PCAOB Open Board Meeting. It is also noteworthy that the Office of the Chief Auditor appears to have a staff of less than 30 people developing and drafting auditing, independence, quality control, and other attestation standards compared to the 17-18 people currently or budgeted to be involved with economic analysis at the PCAOB.

[10] For example, see "Science, Politics, and Accounting: A View from the Potomac," by Zoe-Vonna Palmrose in *The Accounting Review,* Volume 84, No. 2 (March 2009): 281-297.

As we have emphasized in our comments, public company auditing also has a number of unique institutional features, which are not necessarily analogous with other economic settings.

Because of these considerations, standard economic models and analyses require adaptation for the regulated public company audit context which, in turn, requires appreciation of both the uniqueness of the audit environment and the audit process itself. This context involves judgment and decision making by individuals and requires theories from psychology as well as other disciplines. Thus, considering the costs and benefits of proposed PCAOB audit rules and standards calls for research based on more than expertise in traditional economics alone.[11]

For these reasons, we take this opportunity to respectfully suggest that at least some of the *academic scholars* involved in the PCAOB's economic analysis and other research-related endeavors should have some audit expertise. We hope that the Center for Economic Analysis will consider this perspective in developing and implementing its initiatives.

The PCAOB's Strategic Plan for 2013-2017 (November 26, 2013) discloses that the PCAOB has developed internal guidance on economic analysis. We respectfully suggest that the PCAOB could encourage independent scholarly research by accountants, psychologists, and others relevant to its economic analysis if the Board would make this internal guidance transparent and publicly available.

Concluding Remarks

In analyzing the costs and benefits of PCAOB initiatives, including those in this ED, we encourage the PCAOB to consider the impact an initiative would have on the ability of regulated audit firms to attract and retain the quality of professional talent necessary to conduct effective and efficient audits.

Instituting a naming requirement that is expected to result in third-party databases that use *second-best* metrics with questionable construct validity for determining audit quality is likely to cause, among other consequences, the best partners to avoid more challenging audit engagements. This cannot be in the public interest.

As auditing educators, we are concerned about the potential chilling effects of such initiatives on attracting and retaining partners and staff for public company auditing. We hope that the PCAOB will also appreciate the implications of its initiatives for attracting the "best and brightest" students to prepare for careers auditing public companies.

In conclusion, we hope that the PCAOB finds our perspectives helpful. We would be pleased to discuss them further with the Board and staff.

[11] This statement holds even when including behavioral economics within economics.

Sincerely,

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