March 17, 2014

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D. C. 20006-2803

Via email to comments@pcaobus.org

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the PCAOB Rulemaking Docket Matter No. 029; PCAOB Release No. 2031-009: Proposed Rule on Improving the Transparency of Audit: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section – American Accounting Association

Contributors:
Chair – Urton Anderson, University of Kentucky, phone (859)218-1788, email: urton.anderson@uky.edu
Lisa M. Gaynor, University of South Florida
Karl Hackenbrack, Vanderbilt University
Ling Lisic, George Mason University
Yi-Jing Wu, Case Western Reserve University

General Comments

The Committee commends the PCAOB ("the Board") for shifting the primary focus from 'accountability' (concept release 2009-005) to 'transparency'.[1] The Committee believes firm disclosure of the names, locations, and extent of participation of others has a far greater potential to be investor decision relevant than the disclosure of the name of the engagement partner. The following presents a number of specific comments or suggestions, organized along by the questions posed by the Board in concept release 2013-009.

Questions for Commenters (Responses to Selected Questions

1. Would the reproposed requirements to disclose the engagement partner's name and information about other participants in the audit provide investors and other financial statement users with useful information? How might investors and other financial statement users use the information?

> Engagement Partner's Name: Although the Committee is not unanimous on this issue, the majority believed that the disclosure of the name of the engagement partner will be of limited use to investors, and may be potentially harmful, when making investment decisions sans extraordinary circumstances, both initially and over time.
>
> Audit committees evaluate carefully the qualities of current and potential engagement partners, firms monitor engagement partner history closely and utilize that information to manage risk to the firm, and the Board uses firm-provided historical information about individual partners to select audits to inspect. Metrics beyond the name of the engagement partner are needed to make such consequential decisions.
>
> Investors are currently privy to the identity of an engagement partner only by chance or through specific inquiry. Even if they were privy to the partner's name, they are not privy to the additional metrics needed to assess a partner's ability to deliver a quality audit. It is not obvious to Committee members that the additional relevant, consequential information about an engagement partner that would affect investor investment decisions is publicly available or will become publicly available without additional regulatory demands. Such additional regulatory demands appear unlikely. See response to question 3.
>
> The Committee is not aware of research that directly addresses firm disclosure of the name of the engagement partner in the U.S. market. Research on audit firm characteristics suggests firm size and firm industry specialization is used by U.S. market participants (Dunn 1999; DeFond and Subramanyam 1998; Eichenseher et al. 1989; Knechel et al. 2007; Menon and Williams 1993; Teoh and Wong 1993).

[1] Addressing partner accountability through firm disclosure of the name of the engagement partner implies that existing mechanisms at level of the firm, the audit committee, the exchanges, the PCAOB, and the SEC are insufficient to motivate partner accountability. The Committee believes this is unlikely.

In non-U.S. markets, Chi et al. (2011, working paper) report that the 'number of years as a signing partner' is associated with a modest reduction of extreme negative discretionary accruals in the Taiwanese market. They also find the partner tenure with a client is negatively associated with bank loan pricing. Knechel et al. (2011, working paper) report that compensation policies that align partner incentives with shareholder incentives positively affect audit quality in the Swedish market. It is not clear how these modest results obtained in small markets inform policy for the U.S. market.

Information about Other Participants. For the most part we assume this would be other CPA firms or specialized experts. We believe that such disclosure, particularly when combined with an indication of the amount of effort they contribute to the audit would give investors potentially useful insight into the audit process and subsequently audit quality. Given these participants are likely to take part in a number of different audit engagements and potentially be used across audit firms the conclusions that could be drawn regarding reputation would be potentially less misleading than what could be inferred from information about a single partner who would be involved in a limited set of engagements over a couple of years or even over their career.

2. Would the name of the engagement partner or the extent of participation of other participants be useful to shareholders in deciding whether to ratify the company's choice of registered firm as its auditor? If so, how?

Audit firm reputation matters, both to shareholders and the audit committee that retains the firm. Given the pivotal role of the engagement partner in delivering quality professional services, any significant variance in audit quality among engagements within a firm would likely be attributable in part to the engagement partner. Hence the audit committee's careful evaluation of the proposed engagement partner. Though the Committee is doubtful firm disclosure of the name of the engagement partner is investor decision relevant, should the Board conclude such disclosure is relevant for investor decision making one would infer its believe that value maximizing shareholders too would use such information when asked to ratify a company's choice of audit firm. As noted above such use may or may not lead to better audit quality.

Likewise, information about other participants and the extent to which they participate would no doubt be used by shareholders. This may be particularly true when large portions of the effort is provided by other participants. To the extent that audit firm reputations drives how shareholders vote, for engagements with significant amount of other participants the percent voting for ratification would likely to drop. This might induce audit firms to use less outside participants which if outside participants were being used because of need expertise could reduce audit quality. If the use of outside participants is driven by cost, it might lead to an increase in audit fees, or if fees are constrained by market forces, to lowering audit quality by lessening the overall amount of effort.

3. Over time, would the reproposed requirement to disclose the engagement partner's name allow databases and other compilations to be developed in which investors and other financial statement users could track certain aspects of an individual engagement partner's history, including, for example, his or her industry expertise, restatement history, and involvement in disciplinary proceedings or other litigation?

a. Would such databases or compilations be useful to investors and other financial statement users? If so, how?

> We believe developing such databases in some cases would provide useful information to investors. As is the case with any professional service provider, an audit partner's reputation for the quality of his/her prior work matters. Specifically, a recent working paper Chi, Lisic, Myers, and Pevzner (2014) suggest that current and prospective audit clients care about the audit partner's history of audit failures. An audit partner's reputation for prior client misstatements is informative about current audit quality, and an audit partner's reputation for past client misstatements is associated with a larger decline in the audit partner's market share. Importantly, the informativeness of prior client misstatements about current audit quality is mitigated for partners with more overall audit experience and with more industry-specific experience. These findings suggest that 1) audit partner's history (restatement history at least) provides useful information to the investors about the audit quality of the partner, and 2) this effect varies with the audit partner's experience and hence, industry expertise (and other experience) information should be included in the database too. Similarly, we believe the partner's involvement in disciplinary proceedings and other litigation would be informative about the partner's audit quality.

b. Would they provide investors and audit committees with relevant benchmarks against which the engagement partner could be compared? If so, how?

> We believe this database would provide audit committees with relevant benchmarks against which the engagement partner could be compared. A caveat is that the audit committees should keep in mind that auditors specialize in certain areas/industries. If an audit partner specializes in risky industries, he/she should be compared with the peers who also specialize in risky industries. Comparing him/her with the entire database could provide misleading information. However, developing such a database is a useful first step and further refinement will come later.

4. Over time, would the reproposed requirement to disclose the other participants in the audit allow investors and other financial statement users to track information about the firms that participate in the audit, such as their public company accounts, size of the firms, disciplinary proceedings, and litigation in which they have been involved? Would this information be useful to investors and if so, how?

> Similar to our comment on Question 3, we believe development a similar database about other participants in the audit would provide useful information to the investors about the quality of these participants. In fact this information might

ultimately be much more useful than that of the database about audit partners as it would be comparable across more engagements and has additional information about relative effort.

5. Is the ability to research publicly available information about the engagement partner or other participants in the audit important? If so, why, and under what circumstances?

For the reasons articulated in our comment to Questions 3 and 4, we believe the ability to research publicly available information about engagement partner or other participants in the audit is important, particularly publically available information about other participants, because it could potentially provide useful information to the investors about the audit quality. In addition, with this publicly available database, independent academic researchers can conduct additional studies to validate or invalidate Chi et al.'s (2014) conclusions and obtain additional understanding of the audit process which could lead to improved audit quality.

8. Would the reproposed disclosure requirements mislead investors and other financial statement users or lead them to make unwarranted inferences about the engagement partner or the other participant in the audit? If so, how? Would there be other unintended consequences? If so, what are those consequences, and how could they be mitigated?

Audit partners are generally not the lead partner on a large number of engagements. Consequently, it is quite possible that incorrect inferences could be drawn about the quality of an individual audit based on the identity of the engagement partner. The existence of a myriad other factors that influence audit quality exacerbates the issue.

Other potential unintended consequences include:

- Disclosure might adversely affect attracting and retaining top talent in the profession.
- Disclosure might encourage defensive auditing, increasing the costs of audits.
- Partners might have an incentive to shed higher risk clients as a means of maintaining their 'audit quality profile'. This avoidance of risky clients is analogous to the under-investment problem when CEOs are evaluated solely on ROA; the CEO may forgo positive NPV projects because it brings down their overall ROA. Consequently, more senior partners may be unwilling to be the lead partner on a particular client when, in fact, it is precisely that type of client that would benefit most from that partner's efforts.
- The release notes security risks and increase liability arising out of increased transparency are modest, likely affecting few partners. That is little comfort to the few.
- Disclosure might engender direct calls and correspondence from shareholders, investors, analysts, activists, journalists, and other interested parties. This raises concerns about what the engagement partner may disclose, if anything. There are also concerns about harassment and more

generally attempts to contact or interact with partners in ways that are not productive or appropriate.

A recent paper, Lambert, Luippold and Stefaniak (2012, working paper), examines the unintended consequence partner name disclosure could have on audit partners' incentives and independence. They proposes that partner name disclosure will result in a fusing of the individual partner's reputation with the audit client. This fusing may then shift the partners' (real or perceived) incentive structure, which in turn has implications for audit partner independence. In an experimental setting, the researchers find that investors are less likely to invest in a peer firm linked to a restating firm via partner disclosure, particularly in the case of investors less experienced working with or preparing financial statements.

12. Would the reproposed amendments increase the engagement partner's or the other participants' sense of accountability? If so, how? Would an increased sense of accountability for engagement partners or other participants have an impact on audit quality? If yes, please provide specifics.

The Committee is not aware of research that directly addresses firm disclosure of the name of an engagement partner on partners' sense of accountability. That said, should such disclosure foster a partner's sense of personal accountability for an audit, existing research suggests a resultant reduction in information biases and enhanced consensus, effort, attention, and perhaps quality of audit documentation (Johnson and Kaplan 1991; Kennedy 1993; Brazel et al. 2004; DeZoort et al. 2006).

17. Would increasing the threshold for individual disclosure of other participants to 5% from the originally proposed threshold of 3% improve the relevance of the disclosure? Would it reduce potential costs? Would another threshold, such as 10%, be more appropriate? If so, why?

In our committee's response to the 2011 proposal, we argued for a 10% disclosure threshold because of concern with investors being overloaded with information. However, based on the Board's staff analysis reported pages A3-17 to A3-18, we support a 5% threshold.

22. If the Board adopts the reproposed amendments for auditors to disclose the name of the engagement partner and certain information about other participants in the audit in the auditor's report, should the Board also require firms to disclose the same information on Form 2 or another PCAOB reporting form? Why or why not?

Should the Board mandate that firms disclose the name of an engagement partner in the auditor's report, the Committee believes it is also useful require disclosure of the engagement partner name in Form 2. The convenience to investors of retrieving information about all of a firm's engagement partners (to assess firm quality) and all engagements of a single partner speaks for itself.

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