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# Testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee on "Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy"

Chairman Garrett, Ranking Member Waters, and other members of the Subcommittee, thank you for giving me the opportunity to speak with you today about accounting and auditing oversight. I have served as a professor at the University of Tennessee for approximately 20 years, where I teach accounting, auditing, and corporate governance. In addition to my teaching and research, my remarks are informed by my service on the PCAOB's Investor Advisory and Standing Advisory Groups, both of which are outside advisory groups to the Board. Moreover, I have performed two coauthored studies for COSO that examine fraudulent financial reporting in the United States between 1987 and 2007.

I will focus my remarks today on auditing oversight, and will focus on six issues of concern to investors.

## Internal Control over Financial Reporting

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) exempts public companies with a market capitalization of less than $75 million from Section 404(b) of the Sarbanes-Oxley Act (SOX). Section 404(b) requires the issuer's external auditor to audit and issue an opinion on the effectiveness of the issuer's internal controls over financial reporting. In addition, the Dodd-Frank Act requires the SEC to study whether to extend the exemption from compliance with Section 404(b) to issuers with a market capitalization below $250 million.

I believe that expanding the number of public companies that are exempt from auditor reporting on internal control would ill-serve investors and the capital markets. Over the last five years, a large body of empirical research has emerged that establishes the importance of effective internal controls and the benefits of auditor reporting on internal control (see Schneider, Gramling, Hermanson, and Ye (2009) for a review of this literature). Ashbaugh-Skaife, Collins, Kinney, and LaFond (2008) find that issuers reporting material internal control deficiencies have lower quality accruals (accrual quality is a frequently-used metric used to evaluate the quality of financial reporting). In addition, issuers who remediate (fix) these internal control deficiencies experience an increase in accrual quality, whereas issuers who do not remediate the control deficiencies do not experience an improvement in accrual quality. Second, auditors' internal

control opinions have real effects in the managerial labor market. Li, Sun, and Ettredge (2010) find a positive relation between the auditor concluding that an issuer's internal controls are ineffective and turnover of the CFO. More importantly, when the auditor concludes that internal controls are ineffective, these issuers are more likely to hire a replacement CFO with better qualifications and, for these firms, internal control is likely to improve in the future.

The most compelling evidence on the value of auditor reporting on internal control comes from a study by Bedard and Graham (2011). Bedard and Graham examine issuers with revenues of $1 billion or less. They find:

- Auditors, rather than management, detect approximately 75% of the unremediated internal control deficiencies. As Bedard and Graham point out, "Importantly, this low level of client detection occurs when clients are aware that auditors will soon follow with their own tests."
- When managers detect the internal control deficiency, they tend to classify the deficiency as less severe, but auditors frequently override those classifications.
- A significant percentage of the internal control deficiencies in the control environment component and related to the revenue account are detected by auditor control testing. This is germane because fraud is often associated with control environment weaknesses and revenue is the account most typically misstated when fraud occurs (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010).

Finally, any decision to exempt smaller public companies from auditor internal control testing under Section 404(b) ignores the ample evidence that internal control problems are often most serious in smaller public companies. Doyle, Ge, and McVay (2007) find that issuers with more serious (entity-wide) control problems are generally smaller and younger. Audit Analytics (Whitehouse 2011) reports that larger public companies, which are subject to auditor reporting on internal control, experienced a 5.1% decline in restatements for non-GAAP reporting from 2009 to 2010, whereas those public companies not subject to auditor reporting on internal control experienced a 13.8% *increase* in restatements during the comparable time period. Finally, those companies charged with financial statement fraud by the SEC tend to be relatively small (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010). As Bedard and Graham (2011) conclude, "… the recent exemption of Section 404(b) for smaller U.S. public companies could result in failure to fully realize potential improvements in financial reporting quality in that sector of the market." Given the weight of the empirical evidence on the efficacy of auditor involvement in testing and reporting on internal control, exempting more issuers from such auditor involvement seems adverse to the interests of investors and the capital markets.

**Public vs. Private Nature of PCAOB Enforcement Proceedings**

I understand that Representative Lynn Westmoreland (R-GA) has introduced H.R. 3503 that would amend SOX to make PCAOB disciplinary proceedings public. I favor such legislation, as I believe that the existing non-public nature of PCAOB disciplinary proceedings does not serve investors or the capital markets. Under current law, PCAOB disciplinary proceedings against auditors and audit firms are non-public until the proceedings are settled or adjudicated. This structure provides an incentive for firms, particularly large firms, to litigate PCAOB enforcement actions because during the litigation process, including any subsequent appeal to the SEC, the existence and nature of the PCAOB enforcement action remains undisclosed to investors, companies, audit committees, and other capital market participants. More perniciously, during this entire time, the accountant or firm that is the subject of the PCAOB enforcement action is permitted to continue issuing audit reports on public companies, regardless of the seriousness of the charges being litigated.

It is important to understand that even if PCAOB disciplinary proceedings are made public, substantial protections remain for parties that may be subject to these proceedings. The Board only commences disciplinary proceedings after an extensive *nonpublic* (my emphasis) investigation, involving document production and on-the-record testimony. Moreover, the evidence gathered by the Board's Division of Enforcement and Investigations is presented to the Board, and it is the five Board members who must vote to commence a disciplinary proceeding. Given that two of these five Board members are CPAs, two are securities attorneys who have spent much of their career representing companies and auditors, and one is a former Congressional staff member, accountants who may face disciplinary proceedings would clearly appear to be facing a "jury of their peers."

The most compelling argument for making PCAOB disciplinary proceedings public is that the nature of these proceedings is private if brought by the PCAOB but public if brought by the SEC, even though the PCAOB is closely supervised by the SEC. As former PCAOB (acting) Chairman Dan Goelzer stated in his August 24, 2010 letter to Congressmen Frank and Bachus:

> If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding. Any administrative trial would be open to the public. If there were an appeal to the Commission and an oral argument, the public could attend. The ability – or inability – of the Commission's staff to prove its charges would be a matter of public record.

**Audit Firm Rotation**

The PCAOB has outstanding a Concept Release on auditor independence and audit firm rotation (PCAOB 2011a). I understand that Representative Michael Fitzpatrick is considering draft legislation that would prohibit the PCAOB from mandating audit firm rotation. The PCAOB has

not proposed audit firm rotation. Nonetheless, this is obviously a controversial PCAOB Concept Release, as evidenced by the fact that the Board has received more than 600 comment letters on the Release.

Before discussing the relative merits of mandatory firm rotation, it is important to understand that the Board's release on this topic emanates from a concern that auditors currently exhibit an inadequate level of professional skepticism. Without professional skepticism, audits are of little value. I believe that there is sufficient evidence to legitimately question whether auditors are sufficiently skeptical. First, in a study of how issuers choose audit firms, Fiolleau, Hoang, Jamal, and Sunder (2009) find: (1) there is significant management control in the selection of the external auditor (also see Cohen, Krishnamoorthy, and Wright (2010) for similar evidence), (2) auditors are required to provide references from senior officers of current and past clients, and repeatedly demonstrate responsiveness and commitment to the prospective client's management, and (3) there is extensive price competition, where one audit firm offered a bid materially below the previous year's audit fee. Based on this research, audit committees appear somnolent and captured by management. Management seems to want compliant and cheap auditors, and to know how to get them. Investors are an afterthought. And the behavior of auditors was the most discouraging of all – so eager to obtain new clients that the auditor talks about the client during the proposal process using the client's own code words among other potentially problematic behaviors. Second, the PCAOB's inspection process has found that at least one of the largest accounting firms used the following language in a recent proposal to a prospective client: "Your auditor should be a partner in supporting and helping [the issuer] achieve its goals …" (PCAOB 2011a). I chair the audit committee for a mid-size governmental entity, and we recently solicited proposals for our external audit. A national CPA firm that bid on the engagement used similar language about partnering with the governmental entity. Third, the PCAOB's inspection process continues to identify a sizable number of audit deficiencies, and these deficiencies are often related to inadequate professional skepticism (Ferguson 2012). In my view, any serious observer of the accounting profession needs to be concerned about the current level of professional skepticism exhibited by auditors.

Given that the PCAOB's mission is "to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports", exploring this issue is not only appropriate – not only is it within the clear mission of the Board as articulated by Congress -- it is arguably the very mission of the Board and the reason the Board exists.

Notwithstanding the importance of improving professional skepticism, I think it is an unresolved question as to whether mandatory audit firm rotation would improve skepticism and, if so, the optimal structure for implementing a mandatory rotation regime. The academic literature is mixed on the benefits of mandatory rotation. Bazerman (2012) favors fixed contract terms for audit engagements. Moore (2012) and Kaplan (2012) both support audit firm rotation. In an experimental study, Arel, Brody, and Pany (2006) find that auditors in a rotation regime make more independent judgments than auditors in a regime where tenure is not limited. In an

archival study, Harris and Whisenant (2012) study the effects of implementing mandatory rotation in three foreign countries (Italy, South Korea, and Brazil). They generally find improved audit quality after the introduction of mandatory auditor rotation, but audit quality appears lower in the last year of the previous auditor's tenure and the first year of the successor auditor's tenure. Conversely, Ghosh (2012) points out that audit quality is correlated with audit firm industry expertise, and that audit firms will have less incentive to specialize by industry if limits on auditor tenure are introduced. Moreover, Ghosh concludes, based on a review of the literature, that the majority of extant studies find that long auditor tenure is not problematic. In addition, Jenkins (2012) also is concerned that mandated auditor rotation might result in decreased use of industry-specialist auditors, which he believes will result in a decline in audit quality.

The relative merits of audit firm rotation are complex and deserve careful study. The PCAOB appears to be proceeding slowly and cautiously in examining this topic – i.e., the Board has only released a concept document (essentially a discussion document), the Board just completed two full days of hearings on this topic and appears committed to having more hearings, and no Board member appears to have prejudged the final outcome. A prudent course is to let the PCAOB continue to examine the issue of auditor independence and professional skepticism, including potential solutions, under the active supervision of the SEC, without interjecting Congressional action into the process.

Previous attempts by Congress to micro-manage standard setting in accounting and auditing have generally been failures (e.g., Congress' interjecting itself into the discussion of stock option accounting). For example, the proposed bill introduced by Representative Fitzpatrick, although less than one page in length, is potentially flawed. The proposed bill would prohibit the PCAOB from requiring public companies to use specific auditors. PCAOB Auditing Standard No. 5 (AS5) already requires an issuer to use the same auditor to audit the financial statements and internal control over financial reporting. This requirement in AS5 could be interpreted as the Board requiring an issuer to use a specific auditor. Eliminating this AS5 requirement would likely make audits more expensive and less effective.

In the interest of brevity, I will only briefly touch on the last three issues.

## Nature of the Audit Report

The PCAOB has outstanding a Concept Release on potential changes to the auditor's report (PCAOB 2011b). The current audit report is a standard three-paragraph report that is essentially identical for the overwhelming majority of all public companies. As a result, notwithstanding the significant fees associated with external audits, many investors view the information content of the standard audit report as lacking (Blake et al. 2011). The PCAOB's Concept Release discusses four alternatives: (1) supplementing the audit report with more information about the audit and the issuer's financial statements, (2) requiring an expanded use of emphasis-of-matter

paragraphs, (3) requiring auditor reporting on information outside the financial statements, and (4) clarifying certain language in the auditor's report.

I believe, as do two-thirds of the PCAOB's Investor Advisory Group (IAG), that the standard audit report is currently deficient as a communication vehicle, and that the audit report needs to be supplemented with more information about the audit and the issuer's financial statements. Based on a survey of institutional investors conducted by a sub-group of the IAG, we believe that the additional information needed by investors includes: (1) the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment, (2) disclosure of areas of high financial statement and audit risk and how the auditor addressed these risk areas in planning and conducting the audit, (3) discussion of unusual transactions, restatements, and other significant changes in the financial statements, and (4) discussion of the quality, not just the acceptability, of the issuer's accounting policies and practices.

**Audit Partner Identification**

The PCAOB has outstanding a Proposed Rule (PCAOB 2011c) that would, among other changes, require the identification of the name of the audit partner in the audit report. Notwithstanding that engagement partners are required to *sign* the audit report throughout the European Union, Australia, Korea, and many other countries, the PCAOB's more modest proposal to simply identify the engagement partner by name is largely opposed by the public accounting profession (although there is some corporate support for this proposal). I agree with the Board that identifying the engagement partner would enhance accountability and transparency. In addition, research that I have conducted finds that audit quality improved in the United Kingdom after partners were required to sign the audit report (Carcello and Li 2012).

**Related Parties and Significant Unusual Transactions**

The PCAOB has recently released a Proposed Rule (PCAOB 2012) on related parties and significant unusual transactions. Given that related party transactions and significant unusual transactions are often associated with fraudulent financial reporting (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010), I support this proposed PCAOB rule. Moreover, the PCAOB's Proposed Rule would require auditors to read and understand compensation practices of the issuer's senior management. Given that compensation-related incentives are often tied to fraudulent financial reporting (e.g., Feng, Ge, Luo, and Shevlin 2011), requiring the auditor to have a better understanding of the financial incentives that management may have to misstate the financial statements is prudent.

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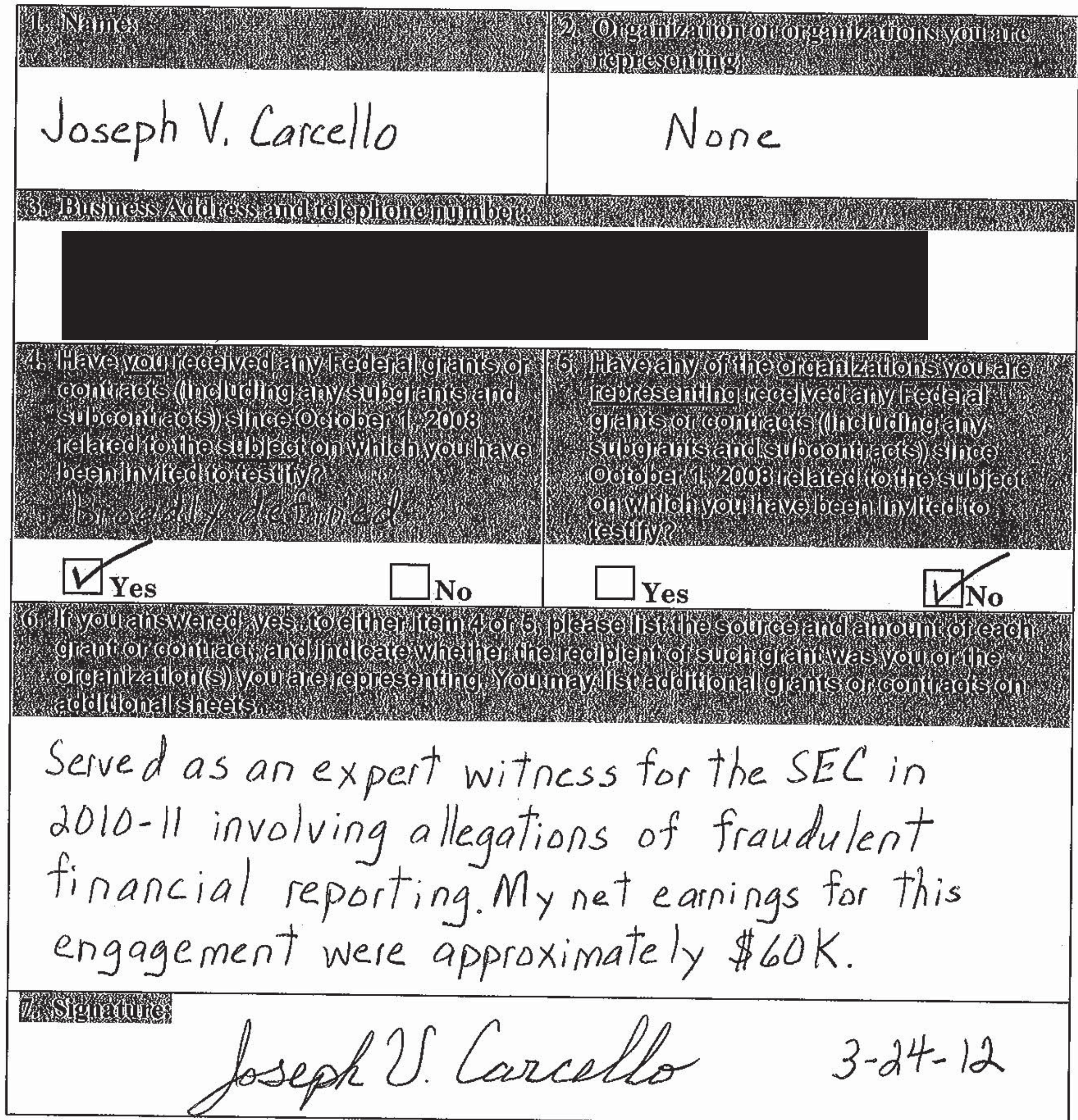
**United States House of Representatives**
# Committee on Financial Services

**"TRUTH IN TESTIMONY" DISCLOSURE FORM**

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.



| 1. Name: | 2. Organization or organizations you are representing: |
|---|---|
| Joseph V. Carcello | None |

**3. Business Address and telephone number:**

[redacted]

| 4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? | 5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? |
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| Broadly defined<br>☑ Yes ☐ No | ☐ Yes ☑ No |

**6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.**

Served as an expert witness for the SEC in 2010-11 involving allegations of fraudulent financial reporting. My net earnings for this engagement were approximately $60K.

**7. Signature:**

Joseph V. Carcello 3-24-12

*Please attach a copy of this form to your written testimony.*