Trusting What You Can't See:

Audit Oversight and the PCAOB

J. Robert Brown, Jr[1]

I thought about a number of possible topics for the discussion today.

I considered talking about the relationship between the SEC and the PCAOB.

There's also the role, if any, of the auditor in providing assurance on non-GAAP and ESG metrics and the possible role of the PCAOB in leading the discussion.

I think it would be interesting to talk about the use of academic research in driving the regulatory mission of the PCAOB, particularly insights gleaned from the non-public data that the PCAOB receives from audit firms. And then there's the issue of audit firms in China.

But instead of those topics, I thought today I would talk about trust.

Audits are about trust. Trust in the audit raises investor and public confidence in the company's financial disclosure. Confidence in the financial disclosure in turn drives the capital markets.

The PCAOB's mission, to put it succinctly, is to ensure trust in the audit.

To do this, Congress expected the PCAOB to be independent of the audit profession -- another topic for future discussion by the way -- and to act in the interests of investors and the public. While Sarbanes-Oxley included a number of mechanisms designed to address independence, the investor protection part of the equation mostly fell to the PCAOB to implement.

So let's step back and ask the question, has PCAOB oversight resulted in investor trust in the audit?

I think it's fair to say that the PCAOB has improved the auditing process, at least when measured against conformity with PCAOB standards. PCAOB conduced inspections increased investor confidence.

Nonetheless, I wonder whether we can say that investors and the public truly trust the audit and the role of the auditor. As we watch failures like Wirecard and the debate taking place

[1] Former Board Member, Public Company Accounting Oversight Board, Feb. 2018-Jan. 2021. For past remarks and speeches, some of which relate to the topics in these remarks, see https://pcaobus.org/about/the-board/board-bios/j.-robert-brown-jr. This paper is based on a keynote speech given at "What Investors Need to Know about Audits," CFA Society New York, February 23, 2021.

globally over audit quality, there are clear indications of concern from investors that they are not receiving the quality that they want and expect from auditors.

So what does the PCAOB need to do to address this problem of insufficient trust in the audit?

In a nutshell, the PCAOB must do more to ensure that the audit reflects the interests of investors and the public. That means better understanding investor concerns with financial disclosure and integrating those concerns into the standard setting and inspections process. This also means placing less emphasis on the importance of deficiencies in an audit as a primary indication of audit quality and more on the role of the audit in enhancing the reliability and comparability of financial disclosure.

So today I want to talk about the importance of trust, the consequences that occur when trust is not present, and the role of the PCAOB in helping to ensure investor trust in the audit process.

I. The Importance of Trust

Let's start with why trust is so important.

Auditors are gatekeepers that look over the shoulders of management in connection with the preparation of the financial statements. The audit is designed to improve the reliability[2] and quality of financial reporting.[3]

What does this mean in actual practice?

Investors want financial statements that are complete and accurate. That won't happen if the numbers don't add up, if fraud has occurred, or if the financial statements fail to conform to GAAP.[4]

But quality is more than that, much more than that.

---

[2] *See* Carol Callaway Dee, et al., Client Stock Market Reaction to PCAOB Sanctions against a Big Four Auditor, 28 Contemporary Accounting Research 263-291 (Spring 2011) ("Audits are valued by investors because they assure the reliability of and reduce the uncertainty associated with financial statements").

[3] *See* Mark DeFond & Jiying Zhang, A review of archival auditing research, 58 Journal of Accounting and Economics, 275, 279 (2014) ("we define higher audit quality as greater assurance of high financial reporting quality.").

[4] *Id*. at 276 ("We observe that most of the commonly used definitions of audit quality portray auditing as a binary process, whereby auditors either succeed or fail in detecting GAAP violations.").

Financial statements increasingly consist of estimates and valuations.[5] These are areas of the financial disclosure process that are subject to judgment and prone to management bias.[6] While the subjectivity associated with these determinations cannot be eliminated,[7] an audit can ensure that they are undertaken in a comparable and reliable manner.[8]

The quality of an audit though depends upon "an auditor's competence, effort level, and independence,"[9] Yet these elements are, for the most part, unseen by investors and the public. Nor can they be gleaned from the relevant auditing standards. Principles based, an approach designed at least in part to reduce litigation risk,[10] standards are mostly guide posts, leaving the step actually taken up to the judgment and discretion of audit firms.[11]

Notwithstanding this lack of transparency, investors and the public are nonetheless asked to trust that audits were adequately executed. And they are asked to do so despite structural concerns about an audit firm's independence, objectivity and quality.

---

[5] Brant E. Christensen, Steven M. Glover, and David A. Wood, Extreme Estimate Uncertainty in Fair Value Estimates: Implications for Audit Assurance, 31 A Journal of Practice & Theory 127-146 (2012) (At 128 ("Estimation uncertainty, or lack of measurement precision, inherent in financial statement's has increased over time and can be very high for some accounts.")

[6] Reasonable Assurance, Standing Advisory Group Meeting, PCAOB, Oct. 4-5, 2005 (*available at* https://pcaobus.org/News/Events/Documents/10052005_SAGMeeting/Reasonable_Assurance.pdf) ("even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors.").

[7] *See* Extreme Estimate Uncertainty, note 5 *supra*, at 128 ("No amount of auditing can remove the underlying estimation uncertainty of reported values that are determined by management –derived estimation models that are hypersensitive to small changes in inputs – inputs that are subjectively chose by management from within a reasonable range.").

[8] *See* International Accounting Standards, Concept Release, Exchange Act Release No. 42430 (Feb. 18, 2000) (*available at* https://www.sec.gov/rules/concept/34-42430.htm) ("Our efforts, at both a domestic and international level, consistently have been based on the view that the only way to achieve fair, liquid and efficient capital markets worldwide is by providing investors with information that is comparable, transparent and reliable.").

[9] Timothy B. Bell, Monika Causholli & W. Robert Knechel, Audit Firm Tenure, Non-Audit Services and Internal Assessments of Audit Quality, 53 J. of Accounting Research 461-509 (June 2015) ("Overall, these definitions related to an auditor's competence, effort level, and independence. Lack of effort or competence prevents an audit from detecting issuers to be resolved, and lack of independence prevents an auditor from correcting issues identified in the client's pre-audit financial statements.") (citation omitted).

[10] The Commission on Auditors' Responsibilities: Reports Conclusions and Recommendations, 1978 (Cohen Report), at 130 ("The profession's positions, of course, are motivated by a form of self-interest. It is self-interest, however, that appears principally in attempts to preserve a standard of quality and in reactions – possibly excessive – to fear of litigation.") (*available at* http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1978_0101_CohenAuditors.pdf). Of course, the entire premise may be incorrect, as some have noted. *See* Commissioner Charles C. Cox, Public Accounting: Whose Profession Is It Anyway?, 1986 Thirteenth Annual AICPA National Conference on Current SEC Developments, Washington, D.C., Jan. 7, 1986 ("Strict and clear audit standards should lead to reduced liability which will be more stable than any limitation artificially imposed.").

[11] Litigation risk continues to be a factor in the standard setting process. *See* The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, PCAOB Release No. 2017-001 June 1, 2017, PCAOB Rulemaking Docket Matter No. 034 ("The Board specifically sought comment on what effect the communication of critical audit matters would have on private liability and whether there were any steps the Board could or should take to address any likelihood of an increase in potential liability in private litigation.").

The method of compensating audit firms raises concerns about the adequacy of the audit. As we all know, audit firms are paid by the client that they audit. The goal of maintaining the account and the resulting revenue stream can conflict with the obligation to exercise sufficient professional skepticism and result in in excessive deference to judgments made by management.[12]

There is also the commercial nature of audit firms. Audit quality is a cost. Firms often, if not usually, have a difficult time competing on the basis of quality.[13] As a result, investments in audit quality may not improve the bottom line. This can result in an approach that favors profitability over audit quality even in circumstances where it shouldn't.[14]

The audit profession during the era of self-regulation attempted to address some of these concerns. In order to promote investor trust in the audit, firms voluntarily agreed to subject themselves to peer review, to continuing professional education requirements, and to the implementation of a system of quality control that met applicable standards.[15]

Self-regulation didn't work. There was no meaningful role for investors, inadequate transparency, and insufficient accountability to the public. The system largely depended upon the profession's willingness to act in "[e]nlightened self-interest".[16] And let's be blunt, enlightened self-interest wasn't enough to ensure sufficient audit quality.[17]

---

[12] This is true particularly given that rigor in the audit is not always appreciated by management. *See* Assess, Assure and Inform: Improving Audit Quality and Effectiveness, Report of the Independent Review into the Quality and Effectiveness of Audit, Sir Donald Brydon, CBE, London, Dec. 2019, at 9.4.5 (*available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf) ("There is disturbing academic evidence based on data from the United States (I am unaware of a parallel study in the UK) that infers that auditors are punished (for instance through lower fee growth) where they have been stricter in their assessment 'undermining the idea of a healthy market for audit in the absence of additional independent checks on client management.'").

[13] *See* John C. Coffee, Why Do Auditors Fail? What Might Work? What Won't?, Law Working Paper N. 436/2019 (2019) (*available at* https://scholarship.law.columbia.edu/faculty_scholarship/2293/) ("The deeper problem then is not that competition is limited or that the desire for more lucrative consulting work creates a conflict of interest, but that the client, itself, does not want aggressive auditing and outsiders (including investors) cannot distinguish superior from mediocre auditing services.").

[14] *See* J. Robert Brown, Jr., Board Member, PCAOB, Maintaining Investor Trust: Independent Oversight in the System of Quality Control, Massachusetts Public Employee Retirement Administration Commission Virtual Conference (Sept. 17, 2020) (*available at* https://pcaobus.org/News/Speech/Pages/Brown-Maintaining-Investor-Trust-Independent-Oversight-System-Quality-Control.aspx)

[15] Report of the National Commission on Fraudulent Financial Reporting, 1987 (Treadway Commission) (*available at* https://egrove.olemiss.edu/aicpa_assoc/421/) ("Firms that join commit themselves to the requirements set by each section, including peer review and continuing professional education, and to the quality control standards enunciated by the AICPA covering accounting and auditing practice.").

[16] Public Oversight Board, "What is QCIC? What is peer review? What is the POB? What is self-regulation? A special report," Public Oversight Board, AICPA, SEC Practice Section (1989) (*available at* https://egrove.olemiss.edu/aicpa_assoc/332) ("Although generally invisible to the public, internal monitoring of audit quality is considered the most pervasive and probably the most productive of all types of regulation. Enlightened self-interest leads alert management to place quality control at the top of its priority list and to discipline professionals who depart from these standards."). *See also* Cohen Report, *supra* note 10, at 130 ("The profession's positions, of course, are motivated by a form of self-interest.").

[17] Prepared Statement by Lee J. Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditors' Responsibilities, Managing Director Emeritus, Bear Stearns, Accounting Reform and Investor Protection, Hearings before the Committee on Banking, Housing, and Urban Affairs, US Senate, 107th Cong., 2nd Sess., S. Hrg. 107-948

When Enron and Worldcom occurred, trust did not disappear. It was not there to begin with.[18]

II. Trust and the PCAOB

That PCAOB was expected to play a major role in returning trust to the audit.

Congress advanced this goal at the PCAOB in two ways. The new regulator was to be independent of the auditing profession.[19] And the PCAOB was to exercise oversight in the interest of investors and the public.[20]

To improve investor confidence, the PCAOB scaled up an inspection program.[21] The focus was on whether audit firms met the relevant standards, with any significant deficiencies set out in a public inspection report. Audits likely improved, at least as measured against compliance with auditing standards. But the approach was at best a beginning and, standing alone, not sufficient to ensure trust in the audit.

(March 6, 2002) ("Despite a series of SEC cases and private litigation which revealed clearly substandard auditing work, no major firm appears to have been publicly sanctioned as a result of a peer review.").

[18] Umit G. Gurun, Noah Stoffman & Scott E. Yonker, Trust Busting: The Effect of Fraud on Investor Behavior, 31 The Review of Financial Studies 1343, 1344 (2018) ("We find that the shock to trust led investors to move money out of risk investments and into low-risk bank deposits.. . . There is no evidence that the withdrawals are reversed – even up to four years after the fraud was revealed – suggesting that trust shocks have long-lasting effects on investment decisions.").

[19] The budget would be funded not from the profession but from public companies and, later, registered broker-dealers. Practicing auditors could not sit on the Board, taking the standard writing pen away from the profession. Whether these steps were sufficient to ensure that the PCAOB remained independent of the profession is a topic for future discussion. The intent was to prevent capture. *See* Investor Protection through Audit Oversight, Sep. 21, 2012, Lewis H. Ferguson, Board Member, California State University 11th Annual SEC Financial Reporting Conference, Irvine, CA (*available at* https://pcaobus.org/news-events/speeches/speech-detail/investor-protection-through-audit-oversight_419 ("To prevent capture by the accounting profession, Congress provided that while two of the five PCAOB board members had to be CPAs, no more than two could be."). The approach did not, however, foreclose all significant avenues of potential capture. *See* Daniel Aobdia, Do practitioner assessments agree with academic proxies for audit quality? Evidence from PCAOB and internal inspections, Journal of Accounting and Economics, 67(1), Feb 2019, 144-174 ("PCAOB funding sources also ensure that the PCAOB is not financially dependent on the largest audit firms. However, the SEC, a government agency, appoints the PCAOB Board members and must approve the PCAOB's budget, litigation, and rules. While the PCAOB may not be regulatory captured by the auditing profession, the SEC, especially its office of the chief accountant, might be").

[20] 15 USC §7211(a).

[21] Lindsay M. Johnson, et al, U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination, 36 Contemporary Accounting Research 1540, 1551 (2019) ("participants generally reported that PCAOB oversight is improving public confidence in the profession. In other words, they acknowledged that the public, a key stakeholder in the financial reporting process, believes that the PCAOB serves a valuable role to external stakeholders.").

For one thing, measuring audit quality through compliance with standards did not set a sufficiently high bar. When opening its doors, the PCAOB adopted the existing standards written during the era of self-regulation.[22]

They were the same standards in place when Enron and Worldcom collapsed after receiving clean audit opinions. They were the same standards written with inadequate investor input and criticized during the hearings on Sarbanes-Oxley. And while some of them were subsequently rewritten or amended, they mostly continued to reflect the "principles" based approach developed and favored by the audit profession.

For another, the focus on ensuring compliance with auditing standards was largely disconnected from the impact of the audit on the quality of the financial statements. In fact, inspection reports specifically disclaimed any such relationship and the reports failed to provide investors with perhaps the single most useful piece of information, the identity of the issuer where the deficiency was discovered.[23]

The approach also created the potential incentive for firms to excessively focus on a reduction in deficiencies rather than improvements in financial disclosure.[24] And this occurred as academic literature suggested that investors did not rely on the number of deficiencies as a means of assessing audit quality.[25]

---

[22] *See* J. Robert Brown, Jr., Board Member, PCAOB, Statement Regarding the PCAOB's Revised Research and Standard-Setting Agendas: Reducing Credibility, Accountability and Confidence in the Financial Reporting Process (Oct. 13, 2020) (*available at* https://pcaobus.org/news-events/speeche s/speech-detail/statement-regarding-the-pcaob-s-revised-research-and-standard-setting-agendas-reducing-credibility-accountability-and-confidence-in-the-financial-reporting-process) ("The Board adopted, on an 'interim' basis, the same standards that were written during the era of self-regulation and sharply criticized in Congressional hearings. An expediency, the decision was accompanied by a commitment to reexamine the standards 'as soon as possible'. Nonetheless, seventeen years later, despite a very different auditing environment, many of these standards remain in place without material change.").

[23] *See* J. Robert Brown Jr., Board Member, PCAOB, Seeing Through the Regulatory Looking Glass: PCAOB Inspection Reports, CFA Institute's Corporate Disclosure Policy Council and Capital Markets Policy Council, Virtual (July 23, 2020) (*available at* https://pcaobus.org/news-events/speeches/speech-detail/seeing-through-the-regulatory-looking-glass-pcaob-inspection-reports_724).

[24] Sarah B. Stuber & Chris E. Hogan, Do PCAOB Inspections Improve the Accuracy of Accounting Estimates?, 59 Journal of Accounting Research 331-370 (Oct. 24, 2020) ("In general, our findings are consistent with auditors managing inspection risk, rather than necessarily improving audit quality.").

[25] *See* Myungsoo Son, Hakjoon Song & Youngkyun Park, PCAOB Inspection Reports and Shareholder Ratification of the Auditor, 17 Accounting and the Public Interest 107, 125 (2017) ("The PCAOB inspection reports can be a reliable and direct source to inform shareholders of audit quality, which they would not observe otherwise. However, our results suggest that shareholders seem not to incorporate the inspection reports as an indicator of auditor quality in their decisions of auditor ratification."). *See also* Lisa Milici Gaynor, et al., Understanding the Relation between Financial Reporting Quality and Audit Quality, 35 *AUDITING: A Journal of Practice & Theory* 1–22. (2016) ("inspection deficiencies are rarely linked to misstatements, restatements, or even to incorrect audit opinions (e.g., issuance of an unqualified opinion when a material misstatement was present). Thus, though PCAOB-cited deficiencies provide some information about audit quality with respect to process, they rarely provide a measure with respect to outcome.").

III. Ensuring Investor Trust in the Audit

More needs to be done by the PCAOB to ensure trust in the audit. Specifically, the views and goals of investors and the public must be better integrated into the oversight process. To do so, the PCAOB needs to take a number of affirmative steps.

A. Feedback Loop

The PCAOB cannot act in the interests of investors and the public if it doesn't know what those interests are. There needs to be a well-developed feedback loop with investors that involves constant effort, constant interaction, and constant solicitation of views, with what is learned integrated into the oversight process. If anything, the PCAOB has in recent years gone in the opposite direction.[26]

And in putting in place this feedback loop, the PCAOB has to ask the right questions. The conversation should not be limited to technical advice on standards or approaches. The feedback loop should be used to identify areas of concern by investors with financial disclosure and the role that the audit can play in addressing these concerns. These comments must then be integrated into the oversight process, including inspections and standard setting.

B. Standard Setting

With respect to auditing standards, let's be frank. The existing set of standards do not collectively reflect the interests of investors and the public.

For investors to trust the audit, the standards need to better incorporate their views and expectations. This requires at least two broad changes.

1. Bringing Balance to Standard Writing

First, investors generally favor an approach to regulation that involves a mix of principles and prescriptive requirements.[27] Prescriptive requirements establish a floor for an audit and allow investors to know that certain procedures will always be performed. Investors know that firms will observe inventory, a rare prescriptive requirement that emerged from financial scandals in

[26] *See* J. Robert Brown, Jr., Board Member, PCAOB, The Future of Audit Oversight (Jan. 15, 2021) (*available at* https://pcaobus.org/news-events/speeches/speech-detail/the-future-of-audit-oversight).
[27] J. Robert Brown, Jr., Board Member, PCAOB, The Future of Audit Oversight (Jan. 15, 2021) (*available at* https://pcaobus.org/news-events/speeches/speech-detail/the-future-of-audit-oversight) ("Investors generally favor standards that reflect a blend of principles and objective bright-line factors. Objective factors establish a predictable and consistent floor with overlying principles providing flexibility for discretion and judgment.").

the 1930s.[28] This approach should also recognize the significant differences in firms with respect to size, resources and number of clients.

Implementation of this approach will of course generate criticisms that audits are becoming a checklist, with insufficient opportunity for professional judgment. Such a criticism, however, would be misplaced. Prescriptive requirements and principles are a balance. Right now the balance weighs almost entirely in one direction.

2. Audit Quality and Commercial Interests

Second, standards should more explicitly address the conflict between audit quality and commercial interests.[29] In particular, this requires the use of governance mechanisms designed to ensure that the latter does not improperly influence the former. This is particularly true with respect to the systems of quality control implemented by audit firms.[30] Any system of quality control that does not seek to structurally insulate audit quality from commercial interests will be susceptible to claims that commercial interests predominated and drove the decision making process, even when it shouldn't have.

An area where this tension between commercial interests and audit quality likely exists is with respect to the use of technology in audits. Technology can qualitatively improve an audit. Full population testing, rather than sampling, is one area of significant promise.

But the standards do not require or even encourage this approach. Instead, the most that can be said is that they don't "preclude" the use of technology.[31] With the principles based approach in this area recently reaffirmed at the PCAOB, the matter has been left to the discretion of each firm.[32] And while firms may have a commercial incentive to introduce technology that

---

[28] *See* Charles D. Niemeier, Board Member, PCAOB, Independent Oversight of the Auditing Profession: Lessons from U.S. History, German Public Auditors Congress of 2007, Nov. 8, 2007 (*available at* https://pcaobus.org/news-events/speeches/speech-detail/independent-oversight-of-the-auditing-profession-lessons-from-u-s-history_32).

[29] Daniel Aobdia, The Impact of the PCAOB Individual Engagement Inspection Process – Preliminary Evidence, 93 The Accounting Review 53, 55 (July 2018) ("enforcing an adequate level of audit quality can help mitigate an important conflict of interest that an auditor is hired and paid by the issuer to potentially provide unfavorable opinions about its financial statements").

[30] *See* J. Robert Brown, Jr., Board Member, PCAOB, Maintaining Investor Trust: Independent Oversight in the System of Quality Control, Massachusetts Public Employee Retirement Administration Commission Virtual Conference (Sept. 17, 2020) (*available at* https://pcaobus.org/News/Speech/Pages/Brown-Maintaining-Investor-Trust-Independent-Oversight-System-Quality-Control.aspx).

[31] Data and Technology Research Project Update, 2020 (*available at* https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/data-technology-project-spotlight.pdf?sfvrsn=bb1f64f2_0) ("To date, the results of our activities indicate that PCAOB auditing standards are not precluding or detracting from firms' ability to use technology-based tools in ways that could enhance audit quality (for example, to perform more thorough and better-informed risk assessments). But we have heard—and we acknowledge—that our current standards do not explicitly encourage the use of such tools, indicate when their use might be appropriate, or highlight related risks or pitfalls associated with their use.").

[32] *Id*. ("We generally believe that principles-based auditing standards are more likely to be adaptable to evolving situations, such as the increasing use of technology-based tools.").

promotes efficiency and facilitates interaction with clients, they may not have the same incentive to develop and introduce technology designed to improve audit quality.[33]

C. Inspections

With respect to inspections, this is the place where the PCAOB has made the biggest difference. But more needs to be done.

1. Inspections and Financial Disclosure

The focus of inspections needs to shift away from a primary emphasis on deficiencies to actual improvements in the quality of financial disclosure. In part this means inspecting audits of issuers that have a higher risk of fraud or GAAP violations and, in selecting areas of the audit to inspect, placing greater emphasis on areas of qualitative materiality.

It also means using inspections to more directly improve the quality of financial disclosure, particularly with respect to areas identified by investors as inadequate.

Academic research shows that the PCAOB has the ability to significantly alter audit firm behavior. When the PCAOB targets an area for inspection, audit firms react,[34] a powerful tool for generating improvements to financial disclosure.[35] The PCAOB could publicly identify for upcoming inspections areas of concern noted by investors in the financial statements. Audit firms would presumably devote greater effort to these areas.

Footnote disclosure comes to mind. Targeting particular footnotes might not result in a significant number of deficiencies given the vague nature of the disclosure requirements under GAAP.[36] But it would focus firm attention on the areas, potentially generating improvements in the quality of the disclosure And if it didn't, the results, when made public, could be used as a basis for amending the relevant accounting standards.

---

[33] *Id*. ("Some firms have developed tools intended to, among other things, improve communications between the auditor and the company or among members of the engagement team (including other auditors), track information received during the audit, automate the documentation of procedures performed, and facilitate the efficiency of supervisory review.")

[34] *See* Daniel Aobdia, The Impact of the PCAOB Individual Engagement Inspection Process – Preliminary Evidence, 93 The Accounting Review 53, 55 (July 2018) ("I find that audit firms take corrective action on engagements with Part I Findings.").

[35] Lindsay M. Johnson, et al, U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination, 36 Contemporary Accounting Research 1540, 1554 (2019) ("Overall, norms conveyed by firm leaders via firm policies and enhanced control environments suggest that auditors perceive the PCAOB possesses high power, as firm leaders have made extensive changes to firm policies to increase the likelihood of compliance and, accordingly, avoid negative inspection findings.").

[36] Jaehan Ahn, Rani Hoitash, and Udi Hoitash, Examining the Joint Disclosure of Text and Numbers in Complex Financial Statement Notes (April 22, 2020). Northeastern U. D'Amore-McKim School of Business Research Paper No. 3582662 (*available at* SSRN: https://ssrn.com/abstract=3582662) ("accounting standards typically focus on numerical disclosures requirements while often neglecting to provide detailed guidance regarding the requisite narrative needed to explain, expand, and provide context that is necessary to understand the disclosed numbers.").

2. Inspections and Accounting Comparability

Improvement in financial disclosure also means a more explicit effort to use inspections to provide investors and the public with the information they need to trust what is in the financial statements. One place where this could occur is with respect to the comparability of financial disclosure.[37]

Accounting standards are designed "to consistently measure and report an outcome across different companies. . ."[38] Audit firms play a role in ensuring comparability.[39]

In conducting an audit, firms review the reasonableness of assumptions used by management in making estimates and valuations.[40] The omission of a significant assumption common to the industry could affect both reasonableness and comparability.[41] The valuation of long term assets in the hydrocarbon industry may lose their comparability to the extent some companies consider the impact of climate change while others don't.[42] The PCAOB could use the inspections process to provide the public with insight into the degree of comparability in the financial statements and the role of the auditor in ensuring comparability.

3. Inspections and Management Bias

Finally, inspections should take into account more explicitly the potential bias that arises from the payment of audit fees by the client. This means targeting audits and areas of the audit that involve an elevated risk of excessive deference to management.

I can think of at least two circumstances where audits may be particularly prone to increased pressure from management.

---

[37] *See* Matthew Ege, Young Hoon Kim, and Dechun Wang, Do PCAOB Inspections of Foreign Auditors Improve Global Financial Reporting Comparability? (November 8, 2019) (*available at* SSRN: https://ssrn.com/abstract=3483635) ("Financial reporting comparability is important for investors and lenders because they can better evaluate alternative opportunities when accounting information is more comparable.").

[38] W. Robert Knechel, Do Auditing Standards Matter?, 7 Current Issues in Auditing American Accounting Association A1–A16 ("A critical distinction is that 'accounting standards' define how to consistently measure and report an outcome across different companies, while 'auditing standards' define a process to verify the outcome.").

[39] *See* Jere R Francis, Matthew Pinnuck and Olena V. Watanabe, Auditor Style and Financial Statement Comparability (June 21, 2013) (*available at* SSRN: https://ssrn.com/abstract=2287631) ("Our study provides evidence that an economic institution – the auditor – is also an important factor in the production of financial statement comparability.").

[40] See AS 2501.16 (*available at* https://pcaobus.org/oversight/standards/auditing-standards/details/AS2501)("The auditor should evaluate the reasonableness of the significant assumptions used by the company to develop the estimate, both individually and in combination.").

[41] See AS 2501.16 b(1).

[42] *See* J. Robert Brown, Jr., Board Member, PCAOB, It's Not What You Look at that Matters: It's What You See, Revealing ESG in Critical Audit Matters, ICGN's Global Virtual Summit, Virtual (Nov. 4, 2020) (*available at* https://pcaobus.org/news-events/speeches/speech-detail/it-s-not-what-you-look-at-that-matters-it-s-what-you-see-revealing-esg-in-critical-audit-matters).

One involves earnings releases. Companies often issue earnings releases before the audit of the annual financial statements has been completed. To the extent the audited numbers differ significantly and adversely from those in the earnings release, a company's stock prices may decline and the tenure of management may be shortened.[43] Management, therefore, has additional incentive to put pressure on audit firms to make sure this does not occur,[44] potentially affecting the quality of the audit.[45]

There is also a risk of excessive deference in connection with efforts to seek an increase in audit fees once the audit is underway. Although fees are commonly negotiated in advance, unexpected circumstances arising during an audit may result in a request for additional fees.[46] Data from overseas suggests that this occurs frequently and that management may refuse to approve the increase.[47] Engagement partners seeking approval of an increase presumably have an incentive to maintain a positive relationship with management, something that could result in excessive deference.

These are only a few examples of instances where audit firms likely have less incentive to challenge management and to exercise the necessary degree of professional skepticism. I'm sure there are plenty of others. They should be regular targets for the PCAOB inspection process.

D. Transparency

Finally, to repeat something that I have said numerous times before, independent oversight will not ensure trust in the audit absent adequate transparency. Without transparency there can't be accountability.

---

[43] Nathan T. Marshall, Joseph H. Schroeder and Teri Lombardi Yohn, An Incomplete Audit at the Earnings Announcement: Implications for Financial Reporting Quality and the Market's Response to Earnings, 36 Contemporary Accounting Research 2035-2068 (2019) ("They also document a negative market reaction to earnings revision announcements and a lower (higher) market response to good (bad) earnings news that foreshadows an impending revision.").

[44] *Id*. ("managers have incentives to avoid downward adjustments to previously announced earnings and may pressure auditors to avoid downward earnings revisions prior o or at the 10-K filing date").

[45] *Id*. ("the auditor is likely to anchor on the financial results in the earnings announcement when completing the audit and rationalize detected misstatements as immaterial rather than critically and independently evaluating the audit evidence, especially if an earnings adjustment could lead to adverse consequences for the firm").

[46] The future of audits, BEIS, UK Parliament, April 2, 2019, at Para. 145 (*available at* https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171808.htm) ("Fees are largely negotiated and agreed upon before the audit. . . We were also told that auditors negotiate additional fees to cover the extra work.").

[47] *Id*. at para. 146 ("In private, though, we were told that companies can refuse to pay; and audit partners can also be reluctant to ask for more fees in order to preserve a good relationship. We were surprised to find out that half of audits in the last five years at Deloitte and PwC ended up costing over 10 per cent more than originally budgeted. Of these audits incurring significant cost overruns, the Big Four negotiated an increased fee in between 60 per cent and 83 per cent of cases. Deloitte also clarified that in only 24 per cent of cases did the increase fully cover the overrun.").

Accountability is necessary because all regulators, sometime during their lifecycle, invariably go through periods where they lack the incentives to fulfill their statutory mission.[48] But transparency is particularly important to the PCAOB. The most significant failure of the self-regulatory period was the lack of public insight into how oversight was actually exercised.[49] This lack of transparency raised concerns that decisions were made in the interests of the profession rather than those of the public.

The same concern can arise with respect to the PCAOB.[50]

While transparency is to some degree a balance, the PCAOB, in my view, does not have the balance right.[51] Little is done today in a transparent manner. Unlike the early days of the PCAOB, public meetings are rarely held. Advisory groups, groups designed to explore issues of interest to investors and other stakeholders, don't hold open meetings.[52] Disclosure in inspection reports remains inadequate, particularly the non-disclosure of the public companies where the deficiencies were uncovered.[53]

Indeed, transparency appears to be going in the wrong direction. This can be seen with respect to changes to the disclosure in enforcement settlements. In settling actions against auditors, the PCAOB traditionally revealed the identity of the company where the problem audit occurred, rare exceptions aside. That, however, changed in 2019.[54] The issuer is today rarely disclosed, reducing the value of the information to investors and the public. The PCAOB took this step by fiat, without first seeking input from investors and the public.

---

[48] J. Robert Brown, Jr., Board Member, PCAOB, Grading the PCAOB: Transparency, Accountability and Investor Protection, Fall Conference of the Council of Institutional Investors, Minneapolis, MN, Sep. 17, 2019 ("As academics have long recognized, regulators can sometimes lose their way. They may do so for any number of reasons, whether ossification, capture, or bureaucratic overconfidence.") (*available at* https://pcaobus.org/news-events/speeches/speech-detail/grading-the-pcaob-transparency-accountability-and-investor-protection_703

[49] The Road to Reform, A White Paper From The Public Oversight Board On Legislation to Create a New Private Sector Regulatory Structure for the Accounting Profession, March 19, 2002 ("Because it is not a transparent system (details of peer reviews are not made public) and is limited in scope (audits subject to investigation or litigation are not looked at as part of a peer review), peer review has come under considerable criticism from Members of Congress, the media, and others.").

[50] *See supra* note 19.

[51] Some of the necessary steps are discussed here: Statement by Board Member J. Robert Brown, Jr. on His Service at the PCAOB, Virtual, January 12, 2021 (*available at* https://pcaobus.org/news-events/speeches/speech-detail/statement-by-board-member-j.-robert-brown-jr.-on-his-service-at-the-pcaob).

[52] J. Robert Brown, Jr., Board Member, PCAOB, PCAOB 3.0: The Evolving Role of Investor Protection at the PCAOB, 50th World Continuous Auditing & Reporting Symposium, Nov. 6, 2020, Virtual (*available at* https://pcaobus.org/news-events/speeches/speech-detail/pcaob-3.0-the-evolving-role-of-investor-protection-at-the-pcaob#_ftn43 ("In the early days of the PCAOB, public meetings were held monthly. The public had a front row seat in the creation of a new regulatory organization. The PCAOB's bylaws, however, only require public meetings on a quarterly basis.").

[53] *See* J. Robert Brown Jr., Board Member, PCAOB, Seeing Through the Regulatory Looking Glass: PCAOB Inspection Reports, CFA Institute's Corporate Disclosure Policy Council and Capital Markets Policy Council, Virtual (July 23, 2020) (*available at* https://pcaobus.org/news-events/speeches/speech-detail/seeing-through-the-regulatory-looking-glass-pcaob-inspection-reports_724).

[54] *See* J. Robert Brown Jr., Board Member, PCAOB, Issuer Disclosure in Settled Enforcement Actions at the PCAOB, CFA Institute's Corporate Disclosure Policy Council, Washington, DC, Sept. 6, 2019 (*available at* https://pcaobus.org/news-events/speeches/speech-detail/issuer-disclosure-in-settled-enforcement-actions-at-the-pcaob_701).

And let's be clear, this absence of transparency is selective and disproportionately affects the public.[55]

IV. Conclusion

So coming full circle, trust in the audit, in my view, remains an elusive, unmet goal. Without change, there is an eventual risk of a return to the pre-Enron era when there was acquiescence by investors but not trust. To the extent that deficiencies are declining, as some recent public statements have suggested, this may well be reminiscent of the clean opinions given in the era of self-regulation. From a peer review perspective, everything looked good. Then there was Enron.

Perhaps some would say that the strengthened role of audit committees, another SOX innovation, addresses these concerns. While a topic for future discussion, suffice it to say that this is another area where investors are asked to trust without much transparency.

Ensuring investor trust in the audit can be accomplished without changing the statute. The basic tools are there. In addition, the PCAOB has a highly qualified and professional staff committed to the investor protection mission. So what's missing? Investor pressure. The mission is designed to protect investors and the public and they must insist on a more investor oriented approach to audit oversight.

---

[55] *See* J. Robert Brown, Jr., Board Member, PCAOB, PCAOB 3.0: The Evolving Role of Investor Protection at the PCAOB, 50th World Continuous Auditing & Reporting Symposium, Nov. 6, 2020, Virtual (*available at* https://pcaobus.org/news-events/speeches/speech-detail/pcaob-3.0-the-evolving-role-of-investor-protection-at-the-pcaob#_ftn43).