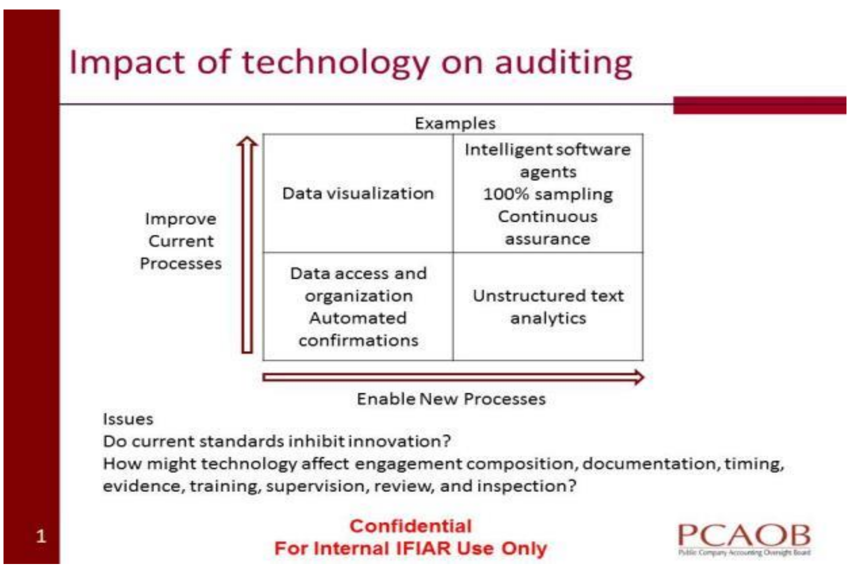
Audit Firms' Business Strategy including Services Offered and the Impact of Technology

Steve Harris of the Public Company Accounting Oversight Board (PCAOB) and Chair of the Investor and Other Stakeholders Working Group (IOSWG) moderated these sessions, which featured Greg Jonas, Director of the Office of Research and Analysis at the PCAOB, and Ken Kiyohara, Partner of Jones Day in Tokyo. Each speaker addressed two topics. Mr. Jonas spoke on the impact of technology on auditing and about aligning incentives for audit quality. Mr. Kiyohara spoke on how audit firms are marketing new services and the role of audit committees.

Mr. Jonas opened his presentation by making reference to the Goodfellow matrix used by Brian Hunt in Session 6 (see minutes for this session) and asking whether the current state of the market for audit services is boxed into a commodity trap with a product (annual audit) that is losing relevance? He referred to another of Jim Goodfellow's slides (see below)) that shows the impact of technology on auditing. Firms are investing heavily in two directions. The first improves current processes, such as confirming transactions with third parties, and more extensive data analytics, including graphing results in a manner that provides incremental insight into audit risk (visualization). To a lesser degree, firms are using technology to enable new processes, such as analysis of textual information that resides outside the client's general ledger. Regulators can expect new developments in coming years, some of which could significantly change the nature, timing and extent of auditing.



Issues raised in the two sessions related to technology included:

- Do current audit standards inhibit technological innovation that could improve audit quality? If so, how might they need to change to encourage helpful innovation?
- Are firms' investments in technology motivated by efficiency or effectiveness? How can regulators ensure that the drive for efficiency does not overwhelm efforts to improve quality?

- How might technology affect the nature, timing and extent of audit procedures? For example, can more extensive data analytics be an effective substitute for other substantive audit procedures?
- How might technology affect the composition of the engagement team, and the nature of training and supervision and review of the team's work?
- How might technology affect the nature of regulatory inspections?

Ken Kiyohara opened the discussion on non-audit services by stating that the bottom line was that the auditor should not lose sight of auditor independence and professional skepticism when dealing with non-audit services. There was potential value in the proper use by auditors of expertise in IT, forensic accounting, valuation and appraisals. However, if the audit partner engages in marketing as well as audit, his independence is likely to be compromised.

Issues raised in the debate on non-audit services and independence included:

- Should auditors be approved by regulators or chosen by a third party allowing the imposition of specific conditions of independence? Is this preferable to mandatory rotation?
- Are non-audit services really a threat, since many jurisdictions with large market capitalizations have a quasi-total ban on the use of non-audit services for audit?
- Is it possible to even compare non-audit services from network to network as they each have a different definition of non-audit services?
- What are the longer term effects on the structure of the firm's talent base and leadership of the growth of non-audit services?
- How will mandatory rotation and mandatory tendering affect a company's ability to use the non-audit services of that firm? Will there be internal arguments over whether a firm will bid on one line of service (audit) to the exclusion of others (tax, consulting)?

Mr. Jonas began his presentation on aligning incentives for audit quality by presenting a chart showing the desired state - incentives aligned beginning with investors, through to audit committees and through them to audit leaders and the audit team. In reality, however, alignment is not perfect. Mr. Jonas pointed to four areas where misalignment exists and should be corrected:

1) insufficient information to judge audit quality affecting investors and audit committees; it should be corrected by audit quality indicators, audit committee outreach and root cause analysis
2) audit leaders' incentives may be unaligned with audit quality; it should be corrected by enabling the market to demand and reward quality, and by holding managing partners accountable for an environment conducive to audit quality
3) audit partners may be distracted by non-audit performance incentives; it should be corrected by a restructuring of the auditor's report card to give higher value to quality and risk management over traditional performance differentiators (revenue, margin, sales, client service)
4) broad scope of practice may undermine audit partner incentives; it should be corrected by addressing the negatives in the changes in scope of practice (reduced clout of audit partners, inadequate investment in audit, potential divestment or other separation of the advisory practice from the audit firm)

Issues raised in the discussion on aligning incentives included:

- Is the divorce of consulting and audit practices inevitable as consulting builds out its global practice and no longer needs or wants the audit brand name to attract business?
- Are there universal audit quality indicators or should they be tailored to specific markets?
- Can audit quality indicators be understood by shareholders or are they best used by audit committees who have more context? Should the results of audit quality indicator analysis be made public?
- Should managing partners have capped salaries or bonuses or a clawback system where part of the auditor's annual remuneration is segregated and paid out only if there are no audit quality issues over a period of time?

Ken Kiyohara closed the session with a discussion of the critical role of audit committees. He recommended the use of a third party auditor to report to the audit committee when there is some concern on material matters of the audit.