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SPECIAL REPORT:

Auditing your audit

Best practices for determining audit quality

Various initiatives on producing audit quality indicators give audit committees some questions to ask or data points to consider in assessing their audits and their auditors. **Tammy Whitehouse** reports.

Audit committees increasingly are expected to take measures to assure they are getting a quality audit of financial statements, but no one has yet defined what constitutes a quality audit.

The Public Company Accounting Oversight Board took a crack at it with a research project that led to a concept release in 2015. The idea was not to produce a grade card, per se. In the absence of concrete data that can be tied to audit quality, the board was looking for a way to stimulate discussion on what kinds of data would be useful.

The board ultimately produced a set of 28 potential indicators that it considered "a potential portfolio of quantitative measures" that might provide insights into how to evaluate audit quality and how to achieve it. Some indicators relate to competence and availability of staffing, while others focus on the audit process and the audit results.

BENCHMARKING

The audit profession led an effort of its own through the Center for Audit Quality to define its approach to audit quality. That set of indicators is organized around firm leadership and tone at the top; the engagement team's knowledge, experience, and workload; monitoring, including review of PCAOB inspection findings; and auditor reporting. The International Auditing and Assurance Standards Board has undertaken similar efforts.

While no definitive or universally accepted framework has emerged, taken together, the various initiatives on producing audit quality indicators can give audit committees some questions to ask or data points to consider in assessing their audits and their auditors. The PCAOB's indicators, for example, suggest quality can be tied to staffing leverage, partner workloads, specialized skills, experience, industry expertise, turnover, training, compensation, fees, risks, independence, inspection results, restatements, internal control reporting, going concern reporting, and others.

The vast majority of such data is only available by asking the firms to provide it. As private businesses, audit firms are under no obligation to disclose, for example, staffing information or internal processes for managing or performing audits. Regulators encourage audit committees to ask firms for such information, however, and to expect candor in the responses.

In recent years, the major firms have begun producing voluntary quality reports *(2018 reports from major firms on Pages 4-6)*, and some are starting to provide more data that can be tied to audit quality indicators in those reports. While none of the data is standardized or consistent from one firm to the next, it's a start in giving audit committees more information that can help them assess audit firms and engagement teams. Audit committees, of course, can always ask as well.

"Deloitte is doing plenty that doesn't show up in its audit quality reports, Internally, we're doing a lot of work with audit quality indicators to measure all the things we can think to measure and to see if there's a correlation between those and the execution of high-quality audits."

Dave Sullivan, National Managing Partner, Deloitte

Deloitte, for example, was among the first firms to produce any kind of voluntary audit report, and now all the major firms have climbed onboard. As interest in the reports has grown, particularly in data that might help distinguish the firms from one another, the reports have grown in detail.

Deloitte's 2019 report will be issued soon, says Dave Sullivan, national managing partner for the firm, and it will contain more data than the year before. EY's latest report even includes a table that explains what information in the report is new from the year before.

"As each firm has published those reports, it's been a rising tide for all of us," says Sullivan.

To some extent, that may be what the PCAOB had in mind. The board's concept release says it expected that comparative information about audit firms might over time drive a demand for quality and even stimulate more competition among audit firms. The board envisioned it might also beat back pressures on audit firms to reduce audit effort or resources, perhaps in a race to the bottom over audit fees.

While supporting the provision of more detailed information, Sullivan says it all "still begs the question of what do those measurements mean? What is the interplay between that and audit quality?"

Deloitte is doing plenty that doesn't show up in its audit quality reports, says Sullivan. "Internally, we're doing a lot of work with audit quality indicators to measure all the things we can think to measure and to see if there's a cor-

DELOITTE

Professionals globally	264,000
Professionals in the US	84,000
Percentage of total audit hours performed by specialists	18 percent
Partners and managing directors to all other audit and assurance	1 to 7.6
Partners, managing directors, senior managers, and managers to seniors and staff	1 to 2.1
Partner and managing director tenure at firm	21.6 years
Senior manager tenure	11.1 years
Manager tenure:	6.3 years
Senior tenure	3.4 years
Staff tenure	1.3 years
Voluntary turnover rate	15 percent
Reissuance restatements as percentage of public companies audited	1.6 percent in 2016
ICFR reports restated as percentage of public company accelerated filers	1.6 percent in 2016

SOURCE: 2017 AUDIT QUALITY REPORT, DELOITTE

GRANT THORNTON

Global revenue	$5.0 billion
Americas revenue	$2.4 billion
Assurance revenue	$2.1 billion
Tax revenue	$1.0 billion
Advisory revenue	$1.7 billion
Other revenue	$156 million
Professionals	50,000
Number of countries where operating	135

SOURCE: GLOBAL TRANSPARENCY REPORT 2018, GRANT THORNTON

BDO USA

Number of offices	60+ for BDO USA; 1,500 BDO Global Network
Total Personnel	6,461 for BDO USA; 73,854 for BDO Global Network
Partners	563 for BDO USA; 6110 for BDO Global Network
Revenue	$1.41 B for BDO USA; 8.1B for BDO Global Network
BDO Assurance staff	2,725 on 6/30/17
Staff auditors	891
Seniors	849
Senior mgrs/mgrs	510
Directors	171
Partners	304
Partner to staff ratio	1:7.9
Staff auditor retention	78%
Manager retention	82%
Director retention	92%
Partner retention	91%
2017 assurance staff diversity	46% women; 33% minorities
Internal inspections	Inspected 150 engagements, or 5.8% of total engagement hours

SOURCE: 2018 DELIVERING ON OUR AUDIT QUALITY INTENTIONS, BDO USA

relation between those and the execution of high-quality audits," he says.

PCAOB inspection results represent one critical data point that is publicly available and comparable across firms. Reports are published annually on the largest firms, explaining how inspectors dug into the riskiest areas of the firms' audit files looking for mistakes. And they find plenty.

The PCAOB has long cautioned against extrapolating a deficiency rate in reports and applying it to the firm's entire scope of audit work, since inspections are designed to find errors. Given the same method applied across firms, however, it does produce the most comparable view of the firms available to investors into the quality of audit work in the most difficult audits.

In the past few inspection cycles, the board has provided even more data on the nature of the deficiencies it finds, giving particular insight into the difficulties the firms have had in the audit of internal control over financial reporting. While all the major firms have had their share of challenge, some firms struggle more than others.

The PCAOB even noted when it published its AQI concept release that audit quality as evidenced through its inspections process is uneven. "Some engagement teams do an excellent job, while others are deficient in important respects," the board said.

Auditors say they definitely feel the effects of audit committees asking more questions about audit performance,

KPMG

Investment in new audit technology platform	$150 million
Investment in new training facility	$400 million
Audit partners dedicated to Audit Quality and Professional Practice Group	10%
Restatements	3 in 2017, 3 in 2016, 1 in 2015
Audit manager retention	87%
Audit associate retention	78%
Experienced audit hires	230
Campus audit hires	1,375
Audit utilization rate	83.4%
Partners/managing directors	977
Managers	2,109
Associates	5,412
Total	8,498
Partner/managing director average years of service	22
Managers average years of service	8
Associates	2

SOURCE: PROGRESS THROUGH CHANGE, AUDIT QUALITY REPORT, 2018, KPMG

EY

Public company audits	939
Share of Fortune 500 companies	30%, including six of top 10
U.S. audit professionals	10,490
Partners	972 (9%)
Executive directors	151 (1%)
Senior managers, managers	2,289 (22%)
Seniors, staff	7,078 (28% seniors, 40% staff)
Public company audit hours by specialists	17.9% (10.1% IT, 6.7% tax, 1.1% valuation)
% women, minorities in U.S. audit	31% partners, 61% executive directors, 57% senior managers/managers, 60% seniors/staff
Overall retention	78%
Senior manager retention	90%
Seniors and staff retention	80%
Executive director retention	97%
Non-partner women and minority retention	71%
Percentage of partners in charge of audits who are women and minorities	23%
Percentage of new U.S. audit partners who are women or minorities	47%
Percentage of women and minorities on US Executive Committee	47%
Fiscal 2018 US revenue	$14 billion
Assurance portion of revenue	31%
Ratio partners to all professional staff	1:9.8
Ratio senior managers and managers to seniors and staff	1:3.1
Restatements	9 in 2017, 8 in 2016, 15 in 2015

SOURCE: OUR COMMITMENT TO AUDIT QUALITY, 2018, EY

even if the profession hasn't yet put its finger precisely on how to define audit quality. "They certainly dig deeper into our skill set," says Jeff Burgess, national managing partner at Grant Thornton. "They dig deeper into our industry knowledge, our knowledge of standards, and how we're going to deliver the service. They are very interested to know how we are going to communicate with them."

Many audit committees want information not just on the audit firm, but also on the engagement team, says Burgess, asking about expertise of the engagement partner. Increasingly, audit committees can even do their own independent research on engagement partners by using the "AuditorSearch" database that is currently made available by the PCAOB.

Audit firms are required to identify engagement partners for individual engagements as well as for their reliance on outside firms to assist with their audits. And, significantly, that information repository is growing on the PCAOB Website, where an audit committee can look up an engagement partner's growing history, perhaps revealing where that partner may have been attached to restatements or other filing anomalies. ■

PWC

Audit professionals	10,834
Partners	950
Managers	2,587
Senior associates	2,309
Associates	4,988
Partners: average annual hours worked beyond 40 hours per week	410
Managers: average annual hours worked beyond 40 hours per week	281
Senior associates: average annual hours worked beyond 40 hrs/wk	239
Associates: average annual hours worked beyond 40 hrs/wk	214
Voluntary turnover rate: Managers	13.1%
Voluntary turnover rate: Senior Associates	25.6%
Voluntary turnover rate: Associates	18.7%
Voluntary turnover rate: Total	19%
Ratio partner to manager	1:4.0
Ratio manager to staff	1:3.9
Ratio partner to staff	1:19.7
Internal inspections	142 engagements
Compliance rate of internal inspections	97%
Restatements	8 of 1,640 engagements
Percentage of restatements of financial statements for issuer audit clients	0.49%
Partner average years of experience at PwC	23 years
Percentage of audit hours provided by specialists	10.8%
Percentage of audit hours performed by service delivery centers	10.9%
Ratio of partners serving in technical support roles to audit partners	1:7.6
Percentage of audit hours using "Halo" data auditing technology for journals	58%
Professionals dedicated to independence policies, processes, systems, and training.	15 partners, 239 staff
Number of independence-related consultations	Approximately 37,000
Percentage of audit hours provided by specialists	10.8%
Percentage of firm personnel who are women	46%
Percentage of firm personnel who are minorities	33%
Partners who are women	22%
Partners who are minorities	14%
2018 new partner class who are women and minorities	43%
Number of internal audit inspections	142
Compliance rate for internal inspections	97%

SOURCE: OUR FOCUS ON AUDIT QUALITY, 2018, PWC

Deloitte wins, other Big Four firms lose audit clients in 2018

Tammy Whitehouse explores the latest findings from Audit Analytics' annual summary of accounting firms' client gains and losses, including details on the Big Four.

Deloitte led Big Four firms in picking up new audit engagements in 2018, while KPMG lost the largest number overall, according to the latest analysis.

In its annual summary of audit client gains and losses as reported in public company filings, Audit Analytics says Deloitte gained a net 28 engagements last year, winning over more than a dozen from EY alone. The firm won 10 large accelerated filers but lost three and added 14 accelerated filers while losing three, for a net increase of 18 large accelerated and accelerated filers. The firm added a total of 37 new engagements while giving up nine, for a net increase of 28.

KPMG, on the other hand, lost a total of 36 audit clients and wooed only nine, for a net decrease of 27 engagements. The firm lost 12 large accelerated filers and won only one, and it lost 13 accelerated filers while picking up only two, for a net decline among the largest companies of 22 engagements. More than a dozen of KPMG's former clients opted for other Big Four firms, and a similar number chose other global and national firms. Eight of KPMG's former clients chose regional or local firms as their new auditor going forward.

PwC also lost significantly more public company engagements in 2018 than it gained, losing 25 while picking up seven. Among large accelerated filers and accelerated filers, PwC picked up five new engagements but lost 16. More than half of PwC's former clients chose another Big Four firm going forward, with seven choosing a non-Big Four global/national firm and four choosing a regional or local firm.

2018 CHURN

EY held the steadiest among Big Four firms, ending the year with three fewer engagements. However, the firm saw plenty of churn as it gained 23 engagements and lost 26. EY lost the largest number of its engagements to Deloitte, along with a few others that chose either KPMG or PwC. Nine of EY's departures were large accelerated filers, but it also gained eight similarly sized companies. Among accelerated filers, EY gained eight and lost five.

The data for 2018 is somewhat similar to trends the past few years, where Deloitte has gained clients and the rest of the Big Four have lost. None of the major firms had any comment on the latest data.

Among the next tier of audit firms—those that are global or national firms but not as large as the Big Four—Marcum gained the largest net number of engagements at 31, adding 52 engagements and losing 21. Marcum merged with another firm in the third quarter of 2018, accounting for 28 of its new engagements for the year, said Audit Analytics.

Grant Thornton gained 18 engagements and lost 10 for a net increase of eight. BDO USA saw the same turnover as EY, winning 26 new clients and losing 23 for a net decrease of three engagements. ■

Transparency a game-changer for auditor evaluations

Under rising pressure to be more transparent about how they oversee auditors, proactive audit committees are raising their games when it comes to evaluating all aspects of their audit, writes **Tammy Whitehouse**.

It may have begun with Sarbanes-Oxley, but pressure on audit committees to get tougher on auditors is only continuing to grow.

Audit committees are expected to take a closer look at the audit firms they hire to perform the external audit, at the people doing the work, and at the quality of the work itself. They're expected to mediate more when auditors and management disagree, and there's plenty of ground for disagreements these days as the financial reporting supply chain navigates some of the biggest changes in accounting and auditing standards in decades.

Regulators both in the United States and abroad are calling out audit committees more often to take a more proactive approach to auditor oversight. Wes Bricker, chief accountant at the Securities and Exchange Commission, frequently calls out audit committees in public speaking engagements. Proxy advisory firms are telling shareholders to send a message to audit committees by scrutinizing auditors more closely and voting against ratification where there are signs of problems.

OVERSIGHT

Do audit committees feel the pressure?

"Very much so," says Ron Steger, a retired auditor who has served on five audit committees, two of them as chairman. "I started doing this five years ago, and on average I'm spending 30 to 50 percent more time than when I started."

While proxy advisory recommendations say audit committees generally should limit their service to no more than five audit committees to serve each effectively, Steger believes the number should be smaller. "Three would be the maximum I would be comfortable handling," he says.

In part, that's because the audit committee agenda in general has grown to include things like risk management oversight and cyber-security. Those are issues that increasingly fall to audit committees, commanding more of their time. But it's also due to snowballing expectations that audit committees should do more to oversee auditors, especially in light of the ebb-and-flow debate over mandatory audit firm rotation.

The Public Company Accounting Oversight Board tried—but abandoned—a move to set term limits on external audit engagements. A rotation requirement already exists in the United Kingdom, and the tension there has grown as regulators explore ideas as radical as breaking up Big 4 firms to address concerns that management and audit committees have gotten too cozy with auditors.

Even without a rotation requirement in the United States, that doesn't stop proxy advisory firms like Institutional Shareholder Services from advocating for shareholder proposals on rotating audit firms. Audit committees can't ignore that, says Steger.

"If ISS is raising tension on the auditor, maybe we should address it," he says. "We all have a large institutional shareholder base, and they take what ISS says."

Audit committees, after all, are the ultimate buyers of the external audit service. "They're the ones who stand in investors' shoes," says Cindy Fornelli, executive director of the Center for Audit Quality.

Absent explicit regulation telling audit committees to raise their game, they're certainly under rising pressure to be more transparent about how they oversee auditors and the extent to which they consider changing auditors. The SEC has considered a host of potential new disclosure requirements, but some audit committees have answered investor demand by increasing their disclosure voluntarily.

The CAQ, a public policy group supported by the audit firms, has been tracking those increased disclosures, and it finds a growing percentage of audit committees at S&P 500 companies are disclosing more about how they appoint the auditor, what they consider as they evaluate an audit firm, and how often they evaluate the auditor.

While not all audit committees are opting to provide such disclosure—in fact, it's not even a clear majority that do—For-

nelli believes more audit committees are being more proactive on such fronts than those that voluntarily disclose. "The fact that more audit committees are disclosing doesn't mean they are the only companies doing it," she says.

She's heartened, for example, to see nearly half of the audit committees at S&P 500 companies disclosing the considerations they weigh in appointing an auditor. "To me, that means they're looking at it annually," she says. "It's important for audit committees to assess the external auditor annually. It should be part of their compliance process."

For audit committees resolved to more proactively oversee, select, or replace auditors, the question is how, says Herbert Chain, assistant professor at St. John's University and an audit committee member for a public investment fund. "How does one expect the audit committee to do what is expected if they're not given the tools and information to be able to fulfill that responsibility?"

Practice is evolving, experts say. Having financial expertise on the audit committee is an important start, says Chain, and Sarbanes-Oxley addressed that, but making best use of that expertise is even more important. "It's a combination of experience of the audit committee members, especially the chair, combined with open, candid, fulsome discussion with the audit partner," he says.

The CAQ and even the audit firms provide guidance for audit committees on how best to engage with auditors to understand the work they're doing and ascertain whether it delivers an independent, skeptical view of a company's financial results. The CAQ publishes an assessment tool that's meant to walk audit committees through an assessment of the external auditor.

The assessment begins with a look at the primary members of the engagement team and whether they demonstrate the knowledge, skills, and experience necessary to address

"It's important for audit committees to assess the external auditor annually. It should be part of their compliance process."

Cindy Fornelli, Executive Director, Center for Audit Quality

the company's risks. Do they have the right resources, industry experience, and geographic reach, for example?

The CAQ advocates audit committees examine audit hours by various levels of audit expertise to determine if they're getting enough attention from the more experienced audit leaders. It tells audit committees to ask questions about audit firms' inspection findings with the PCAOB and what the firm is doing to address deficiencies. Criticisms by the PCAOB have been harsh the past several years, and some firms have addressed them more proactively than others.

Many audit committees routinely ask auditors about PCAOB inspection findings, says Michael Malloy, senior managing director at FTI Consulting. "It's not just getting the report," he says. "It's reading the report and asking questions about some of the findings. Oftentimes auditors need to explain a little more behind the nature of the comments."

> "We would always prefer to have an audit committee that's proactive and engaged in the process than one that's not."
>
> Jeff Burgess, National Managing Partner, Grant Thornton

The tool tells audit committees to consider, among other issues, their communication with the external auditor, which should have risen in recent years as auditors have adopted PCAOB standards about required communication. Audit committees should know not only what auditors are required to do, but they should consider how candidly auditors have observed communication requirements.

Communication will only grow in coming audit cycles as auditors prepare to comply with new PCAOB disclosures of "critical audit matters," which will begin appearing in audit reports for the largest companies this year. CAMs are items the auditor identifies that became the more difficult issues to address during an audit.

"It's a way we're seeing—and it's developing—it's an emerging way to evaluate the firm," says Chris Wright, managing director at consulting firm Protiviti. As part of preparing CAM disclosures, auditors must explain to audit committees what issues they've identified as CAMs and why. "It's a way for the audit committee to get a clear view of how well the auditor understands the company and the business."

There's no one method for assessing the external auditor, says Michael Mahoney, a partner at governance consulting firm Tapestry Networks. "There's no best practice," he says. "It's good practice, and it's what practice makes sense for your company."

A common tool, says Mahoney, is for audit committees to survey or interview those in the firm who interact with the auditor. Some audit committee chairs visit remote company locations, along with field auditors in that location. "That helps send a message to the local audit team that we think you're important, and we value your contribution to the audit," he says.

Some audit committee chairs even invite themselves to attend firm audit planning meetings, says Mahoney. "Chairs will say: I want to hear what they are saying about our audit, and I want to see how the different audit partners interact with each other and work with the lead partner," he says.

Fees are also a factor in how audit committees view their audit firm, although the relationship of fees to other factors depends on the audit committee, says Bill Eisig, managing partner at BDO USA. "It depends on the sophistication of the committee and the value they place on the audit proposition," he says.

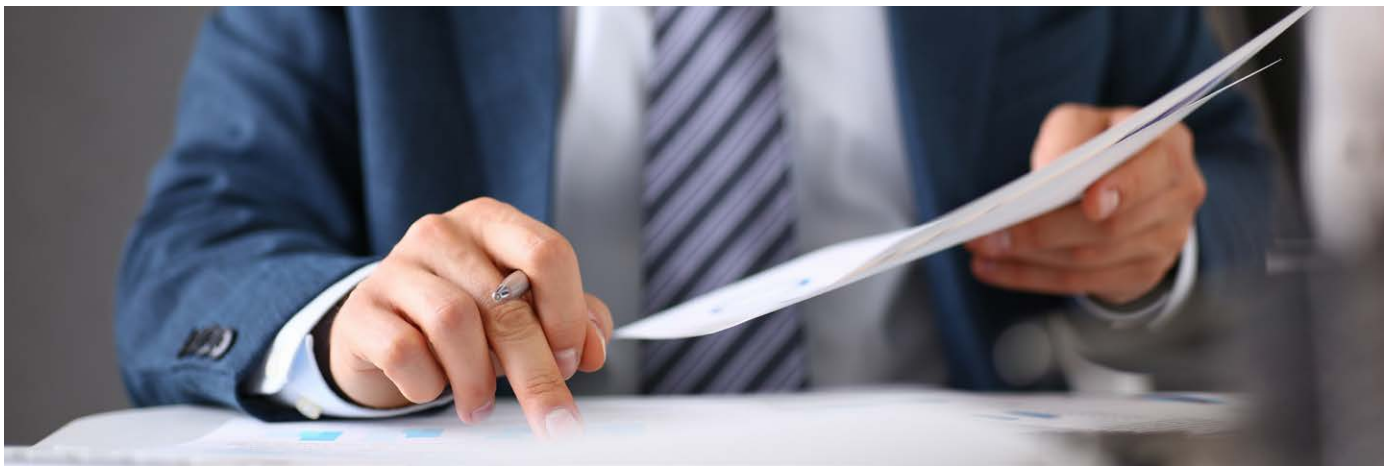
Committees that tend to view the audit as more of a compliance exercise also tend to be more focused on cost than other factors, says Eisig. "If they are not trying to differentiate the firms, if they don't see a difference, most people are going to pick the lowest price from among the quality offers," he says.

Audit committees are generally positive about working with more proactive, more engaged audit firms, says Mahoney. Jeff Burgess, national managing partner at Grant Thornton agrees. "We would always prefer to have an audit committee that's proactive and engaged in the process than one that's not," he says.

To some extent, auditors like working with proactive audit committees because it may help them navigate tricky discussions with management. "In those situations where maybe you have a difficult issue where management and the audit firm don't see completely eye to eye, it's helpful to have an engaged audit committee to help drive that to the appropriate final conclusions," says Burgess.

Ultimately, it's up to audit committees to "connect all the dots" in the financial reporting supply chain, says Jeanette Franzel, a former member of the PCAOB who now serves on an advisory panel at EY. "Audit committees are really feeling the pressure from a whole bunch of different stakeholders, and many of them are stepping up their game," she says. "The truth of the matter is audit committees have the first line of responsibility." ■

Why companies replace their external auditors



Analyzing public-company regulatory filings, **Jaclyn Jaeger** explores the factors behind why companies change external auditors.

Changing audit firms is a massive undertaking that requires careful consideration—but learning from the experiences of other audit committees that have gone through the process can simplify what's often a difficult decision.

An analysis of public company regulatory filings shows the factors behind why companies change external auditors and the circumstances under which proxy advisory firms are more likely to demand it.

Not surprisingly, a hike in audit fees is among the more mundane reasons for why companies decide to change audit firms. D.R. Horton and McDermott International are recent examples of companies whose audit committees decided to change audit firms following "a competitive request for proposal process," according to their respective regulatory filings. PwC, which has served as D.R. Horton's auditor since 2008, and Deloitte, which has been McDermott's auditor since 2006, were each replaced by EY.

AUDITOR CHANGES

The fact that public companies must rotate engagement partners every five years, as mandated by the Sarbanes-Oxley Act, sometimes plays a role in the decision-making process. "If a company knows the five-year rotation period is coming up, they'll look to see what the other firms have to offer," says Trent Gazzaway, Grant Thornton's national managing partner of quality and innovation for audit services.

Often, a company will change audit firms due to some sort of pain point, "and it's typically service related," says Jeff Burgess, Grant Thornton's national managing partner of audit services. "Rarely do they change because of the fee only, but the fee will quickly become an issue if there are service hiccups."

In recent months, there have been plenty of service "hiccups." In one example, WageWorks' audit committee in October 2018 fired KPMG as its auditor following an independent investigation of WageWorks' accounting practices, financial statement reporting, and internal control over financial reporting for fiscal years 2016 and 2017.

"The investigation included a review of the accounting for a government contract during fiscal 2016 and associated issues with whether there was an open flow of information and appropriate tone-at-the-top for an effective control environment," WageWorks said in a regulatory filing. Although WageWorks said "no illegal acts occurred," it concluded that its financial statements for 2016 "should be restated and should no longer be relied upon."

Following the audit committee's investigation, KPMG raised concerns primarily relating to the audit committee's lack of communication concerning allegations "made by former management's counsel" and that the audit committee knew that information was withheld from auditors. KPMG

advised the company that these disagreements "have not been resolved to their satisfaction as of the time the audit committee determined not to continue to engage KPMG," WageWorks' regulatory filing stated.

USA Technologies (USAT), a vending-machine payments provider, faced a similar issue with its independent auditor, RSM. In a Feb. 1 letter to USAT's audit committee, RSM resigned as the company's independent auditor, saying it could "no longer rely on management representations in connection with the audit of the company's 2017 internal control over financial reporting and consolidated financial statements." USAT disclosed the letter in a regulatory filing on Feb. 6.

Furthermore, USAT's board of directors, upon the recommendation of the audit committee and following discussions with management, determined that financial statements for the fiscal year ended June 30, 2017, as well as quarterly and year-to-date unaudited consolidated financial statements for Sept. 30, 2017, Dec. 31, 2017, and March 31, 2018 "should no longer be relied upon," as well as any related press releases, earnings releases, and management's report on the effectiveness of internal control over financial reporting. USAT's audit committee said it is "currently seeking a new independent audit firm" and "intends to engage such firm as soon as practicable."

Audit committees shouldn't necessarily terminate the relationship with their external auditor based on a restatement or negative inspection result alone, says Cindy Fornelli, executive director for the Center for Audit Quality. But it should certainly cause the audit committee to have a conversation with the auditor as to why it had those results and the circumstances around the restatements, she says.

Auditor ratification

Other times, amid rising tensions between a company and its audit firm, proxy advisory firms may be the ones to instigate a change in auditor, as opposed to the company. This is currently the situation faced by General Electric, in which 35 percent of GE shareholders voted in April 2018 against KPMG as GE's independent audit firm, after major proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis urged shareholders to withhold support for KPMG, which has held the role for more than a century (since 1909), according to the firm's 2017 audit report.

GE's circumstances are notable because votes in any significant number against auditor ratification are quite rare. According to an analysis conducted by Audit Analytics of shareholder votes filed between Jan. 1, 2015, and Dec. 31, 2017, on average, 98.7 percent of votes were cast in favor of auditor ratification. Just 0.9 percent voted against auditor ratification, while abstained votes made up the remaining 0.4 percent.

The against vote followed announcement of an investigation by the Securities and Exchange Commission into GE's revenue-recognition practices and internal controls over financial reporting related to long-term service agreements. Then, in January 2018, GE disclosed that it took a $6.2 billion charge in the fourth quarter of 2017 and plans to set aside an additional $15 billion over seven years to bolster insurance reserves. Following this update, the SEC expanded the scope of its investigation to encompass the process leading to the reserve increase.

"When you look at this list of factors and red flags, Glass Lewis made the determination, as well as many shareholders, that a rotation in auditor would be preferable," says Kern McPherson, senior director of North American research at Glass Lewis.

ISS expressed similar concerns: While it is "extremely rare" for ISS to recommend an against vote, "we felt there was a combination of factors that made it impossible for us to sign off on auditor ratification as if nothing were the matter," says Marc Goldstein, head of U.S. research at ISS.

Specifically, ISS said in its proxy analysis report of GE, "In light of concerns about GE's previously undisclosed liabilities and accounting practices at GE that have prompted an SEC investigation, accompanied by unqualified reports by GE's long-time auditor KPMG, support for the ratification of KPMG as auditor is not considered warranted."

GE said its audit committee will provide further details about its deliberations and its planned response to the shareholder vote in the company's March 2019 proxy statement.

In a third example demonstrating shareholder unrest, embattled Rite Aid disclosed in a November 2018 Form 8-K filing that a significant number of its shareholders (15.3 percent) voted against ratifying Deloitte. That's a jump from 5.5 percent of shareholder votes against ratifying the firm in 2017.

Deloitte has audited the accounts and records of Rite Aid and its subsidiaries since 2000. If the audit committee does not ratify the appointment of Deloitte, however, it said in a regulatory filing that it "will consider the appointment of another independent registered public accounting firm" at its next annual meeting.

Moving forward, shareholders will start to pay even more attention to company-auditor relationships, particularly since auditors are now required to add even more disclosures to their audit reports, including critical audit matters relating to the quality of audit reports. "All of a sudden,

"If a company knows the five-year rotation period is coming up, they'll look to see what the other firms have to offer."

Trent Gazzaway, National Managing Partner of Quality and Innovation for Audit Services, Grant Thornton

shareholders are armed with new information," McPherson says.

Proxy advisory firms, too, are raising their expectations. Glass Lewis, for example has formally codified a list of new factors it will consider that may trigger a recommendation against auditor ratification, including "the auditor's tenure, a pattern of inaccurate audits, and any ongoing litigation or significant controversies which call into question an auditor's effectiveness," according to its newly revised 2019 proxy voting guidelines.

Other factors

Aside from a change in audit fees or undesirable events like restatements, other factors can result in a new audit engagement. Take, for example, an unforeseen conflict of interest, like the one that recently arose between software firm Alteryx and its former auditor, PwC. In that case, following an internal review, PwC notified Alteryx on Jan. 17 that it had "increased its use of, and communications and services related to, the company's software platform with its clients and prospective clients in 2018 and that this creates the possible appearance of a business relationship contrary to auditor independence standards," Alteryx disclosed in a Form 8-K.

For this reason, Alteryx and PwC "mutually agreed that it was appropriate for the company to consider retaining a new independent registered public accounting firm," Alteryx said. Accordingly, Alteryx dismissed PwC, effective as of Jan. 24. Shareholders ratified Deloitte as Alteryx's new auditor.

Merger and acquisition activity also plays a role in new auditor engagements. For example, in the fourth quarter of 2018, Plante & Moran accounted for the largest number of new clients among all firms, with a net of 33 new audit clients, according to data compiled by Audit Analytics. Thirty of its new clients resulted from Plante & Moran's October 2018 merger with EKS&H. Prager Metis saw the second highest number of auditor engagements during this quarter, netting 26 new engagements, following its merger with Paritz & Co. in October 2018.

More and more, an audit firm's technology capabilities are increasingly serving as a big differentiator in audit committees' decisions to change auditors. "That's not externally visible, but we're hearing that a bit more often now," says Michael Mahoney, a partner at Tapestry Networks, a professional services firm.

Key lessons

All of the examples cited bring to the forefront both the risks and benefits of changing external auditors. According to a poll conducted last year by KPMG, 87 percent of 150 audit committee members surveyed overwhelmingly cited the "provision of fresh insights into the business" as the greatest perceived benefit of a new auditor. "A new perspective on existing accounting judgments" was the second-most-cited benefit, noted by 45 percent of respondents, followed by "increased audit quality" (24 percent) and "greater sector experience" (21 percent).

The most frequently cited risks were the potential for "reduced understanding of the business" (66 percent); "increased disruption of the business" (46 percent); and "a disruptive change of view on existing accounting treatments" (42 percent).

Other factors that should be considered include the audit firm's capabilities, the auditor's communication with the company, and its independence, professional skepticism, and value it provides relative to its fees. The auditor's self-assessment and regulatory reviews from the PCAOB should also be taken into consideration.

Whether an audit committee is seeking to change its audit firm or engagement team, it's important that they "take their time and do their homework to make sure it's a good fit," Fornelli of CAQ says. Once the audit committee selects an audit firm, best practice is to interview a few leading engagement partners to decide who is the right lead engagement partner for the company at that point in time. "You're going to live with these people for five years. It's important that there be a good relationship, that there be a good rapport, that there be good communication."

When it comes to choosing an audit firm, quality trumps size. "It does not need to be a Big 4 firm," Fornelli says. "I would really encourage audit committees to think long and hard about what their needs are and to select a firm based on what their needs are and not factor in the size of the firm." ■

How audit firms are polishing their images

Audit deficiencies are just part of the picture when it comes to the reputational damage suffered by nearly every big firm. **Jaclyn Jaeger** looks at how the big audit firms are tackling bad marks from the PCAOB.

Accounting firms have been plagued by reputational issues ever since the collapse of Arthur Andersen in 2002. The facts surrounding Arthur Andersen—the poster child of accounting firm failures—are well known: In June 2002, Arthur Andersen was convicted of obstructing a federal investigation for destroying numerous documents relating to the audit of its client, Enron, a now-defunct U.S. energy-trading and utilities company, notorious for perpetuating one of the biggest accounting frauds in history. Although the Supreme Court reversed Arthur Andersen's conviction, the damage had already been done, leading to its ultimate demise.

Since that time, numerous investigations and enforcement actions have rocked the audit profession. Whether by the Securities and Exchange Commission, the Department of Justice (DOJ), the Public Company Accounting Oversight Board (PCAOB), or an international audit regulator, no audit firm has escaped reputational damage in some form.

AUDIT FIRM REPUTATIONS

Deficiencies around Internal Control Over Financial Reporting (ICFR), particularly, continue to be the bane of audit firms' existence. "Although the number of deficiencies in testing controls that include a review element has decreased over the past few years, these deficiencies continue to be the most frequent findings observed when inspecting ICFR," George Botic, director of inspections at the PCAOB, said in remarks at the American Institute of Certified Public Accountants conference.

Specifically, common themes in PCAOB inspection findings the past several years generally focus on the audit of internal control, with inspectors flagging such issues as failures to sufficiently test the design or operating effectiveness of certain controls; failures to identify and test controls that addressed identified risks; or failures to test the relevant criteria for revenue recognition. In its inspection reports, however, the PCAOB cautions against regarding deficiency rates as indicative of audit quality at firms, as the inspection process is intentionally geared toward finding problems in higher-risk audits.

"Remediation methods that have worked in the past to address deficiencies may not address current and future deficiencies," Botic said. "I encourage firms to look deeply and broadly to understand the reasons why findings continue to recur and to consider their post-issuance review procedures when deficiencies are identified."

BDO USA: The audit firm with one of the poorest deficiency rates is not among the Big 4. In the PCAOB's 2016 report, 67 percent of mid-tier firm BDO USA's audits examined failed to comply with standards. Among the 24 audits selected for inspection, the PCAOB said it found multiple problems in 16 of those audits. Across the 16 audits, inspectors called out nearly 100 separate violations of auditing standards, including 38 separate instances of failing to comply with Auditing Standard No. 5, which governs the audit of ICFR.

A BDO USA spokesperson says the firm "does not comment on PCAOB inspection reports beyond our official response to the PCAOB contained in the report." Even in the report, however, BDO USA doesn't say much, only vaguely stating that it has "evaluated each of the matters" and has "taken appropriate actions."

In October 2018 the SEC suspended three former BDO USA auditors over allegations of backdating audit work papers when an engagement team fell behind and couldn't meet filing deadlines. BDO USA says it was "committed to audit quality and continuous improvement" and "regularly dedicates time and resources to the ongoing enhancement of our quality control programs and the audit services we provide our clients."

KPMG: Among the Big 4, KPMG has had an especially tumultuous few years. In its 2017 inspection report of KPMG, released in January 2019, the PCAOB highlighted several ongoing deficiencies with KPMG's audits. Specifically, among the 52 engagements it inspected, the PCAOB said it found deficiencies in 26 of those audits, which suggests, generally,

that auditors did not obtain enough evidence to support the opinions they issued, the PCAOB said.

Also, the board published new inspection findings for KPMG for 2016 and 2017, in addition to revised inspection reports for 2014 and 2015 to disclose certain quality control criticisms where it said the firm did not sufficiently remediate within 12 months of the original publication of those reports (the 12 months ended Oct. 15, 2016, and Nov. 9, 2017, respectively).

These reports cast new light on an information leak orchestrated by KPMG employees that compromised the regulatory inspection process. In January 2018, the DOJ and SEC brought charges—including for fraud and conspiracy—against the highest levels of KPMG's U.S. audit leadership, along with a staff member at the PCAOB. According to the SEC orders and Justice Department indictments, former PCAOB staff members hired at KPMG transferred confidential inspection-related information that gave KPMG auditors opportunities to shore up audit files in advance of PCAOB inspections.

It was KPMG that first alerted the PCAOB and SEC of this conduct when it was reported through an internal source in February 2017. This prompted the PCAOB to alter its 2016 KPMG inspection findings, ultimately finding deficiencies in 22 of the 51 total engagements (43 percent) covered by the 2016 report.

In a letter responding to the PCAOB, KPMG noted that it has since dismissed the employees who inappropriately used the PCAOB's confidential information. "The conduct of these individuals was contrary to the firm's code of conduct, what we expect and demand of our people, and intolerable," KPMG said.

KPMG also described extensive remedial measures in its report to the PCAOB, including enhanced supervision and review, a new approach to engagement monitoring, investments in new technology, and new leadership.

Deloitte, EY, and PwC: In comparison to KPMG, the other Big 4 scored reasonably well in the PCAOB's 2016 findings, with the PCAOB finding deficiencies in 27 percent of EY's engagements; 24 percent of Deloitte's engagements; and 20 percent of PwC's engagements.

Deloitte did even better in the PCAOB's 2017 inspection report, with a 20 percent deficiency rate—the lowest level the firm has ever recorded since the PCAOB first began providing data in inspection reports in 2009. In that report, the PCAOB said it inspected portions of 55 audit files at Deloitte, 52 of which were integrated audits on both financial statements and internal control over financial reporting. Inspectors said they found deficiencies in 11 of the audits.

Deloitte said in the report that it took appropriate steps under professional standards to address deficiencies. "We are confident that our ongoing digital transformation, along with the investments we continue to make in our audit processes, policies, and quality controls, are resulting in significant enhancements to our audit quality," Deloitte said.

Like Deloitte, EY continues to see improved scores in PCAOB's year-over-year inspection reports. Although the PCAOB's 2017 report of EY has yet to be released, EY's 27 percent deficiency rate in 2016 and its 29 percent deficiency rate in 2015 are marked improvements from its 36 percent in 2014; 49 percent in 2013; and 48 percent in 2012.

In further efforts to improve audit quality, EY U.S. announced on Jan. 23 the establishment of its independent audit quality committee (IAQC), whose members include a former PCAOB member, the chairman of the Financial Accounting Foundation, and former CEO of Vanguard Group. The purpose of this group is to "advise senior leadership on the many aspects of the firm's business, operations, culture, talent strategy, governance, and risk management that affect audit quality," EY said.

"At EY, we believe in the power of diverse points of view in all aspects of our business; this includes harnessing the value of independent perspectives to further strengthen audit quality," EY U.S. Chairman Kelly Grier said in a statement. "We believe that gaining insight and advice from the IAQC will help us fulfill our important role of delivering high-quality audits."

Grant Thornton announced on Jan. 30, 2019, that it, too, has created an audit quality advisory council to bring "deep, practical, and objective advice" to the firm's partnership board on how to deliver high audit quality. The inaugural council consists of a Grant Thornton partner, who is a current member of the partnership board, and two individuals from outside the firm. Deloitte, KPMG, and PwC already had governing boards.

Like Deloitte, EY, and PwC, Grant Thornton did reasonably well in the PCAOB's 2016 report, with a 24 percent deficiency rate—a significant improvement from the 41 percent score in 2015; 32 percent score in 2014; and 56 percent in 2013. It saw its worse deficiency rate (65 percent) in 2012. The PCAOB's 2017 inspection report on Grant Thornton has yet to be released.

Even firms that have scored well, however, have been caught up in some big corporate scandals over the years that have exposed significant problems in financial reporting. In one high-profile case, both Deloitte and PwC, for example, found themselves in legal hot water over their audit work at Taylor, Bean & Whitaker, a mortgage lender that went up in smoke in the financial crisis. Deloitte was TBW's independent auditor from 2002-2008, until the FBI raided TBW's headquarters in 2009 and the company ceased operations. Federal authorities described a long-running $2.9 billion fraud scheme at TBW and Colonial Bank, which was audited by PwC, to conceal massive losses in mortgage loans.

Other corporate scandals that have entangled PwC include MF Global; Tesco; and Bank of Tokyo Mitsubishi. For EY, some of its most notorious scandals include the Lehman Brothers and Weatherford International.

CONTINUED ON PAGE 18

Audit Inspection Results

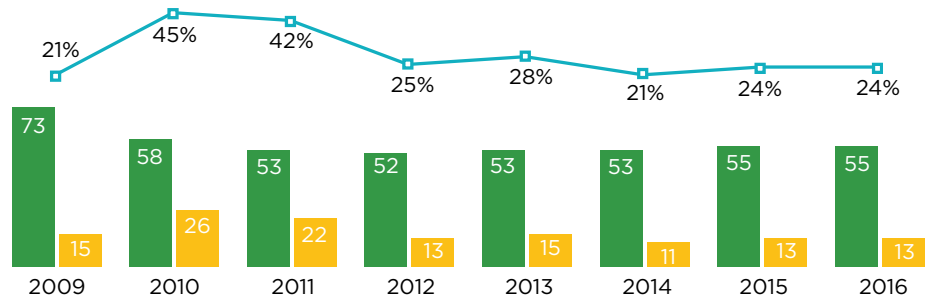
COMPILED BY TAMMY WHITEHOUSE

The Public Company Accounting Oversight Board publishes inspection reports on the largest firms annually. After several years of reporting, the board has steadily increased the amount of data it provides in each report. Over time, the reports are beginning to reveal differences in how the largest firms have adapted to the new regulatory regime. The following tables summarize audit deficiencies across the six largest firms from 2009 to 2016, the last year for which complete data is available for those firms.

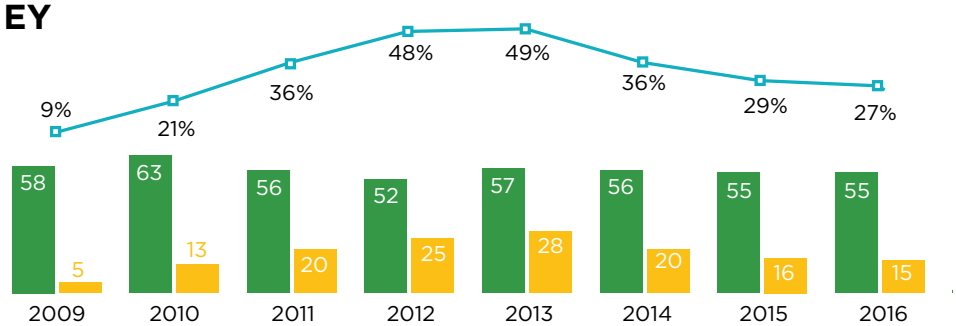
A second table, on Page 18, shows a selection of the increasing data that is available on the inspection of audits of internal control over financial reporting, the most common problem area identified in inspection reports across the major firms in recent years. Under inspection rules, quality control criticisms are not published in inspection reports unless a firm fails to address those criticisms to the board's satisfaction within a year. The board has the discretion to republish a firm's report where firms fail to timely address those concerns. Across the six major firms, the PCAOB has republished the following reports: Deloitte (2008, 2007), EY (2010, 2009), KPMG (2015, 2014, 2011, 2010), PwC (2009, 2008), Grant Thornton (2009, 2008), and BDO USA (2012, 2010).

% of all inspections found to be deficient from 2009-2016

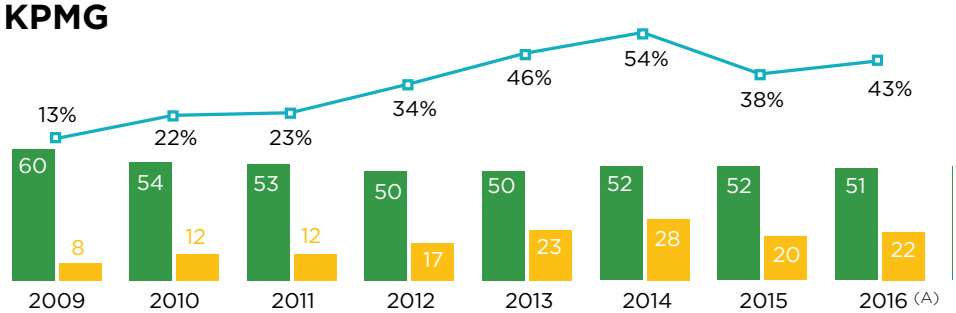
Deloitte



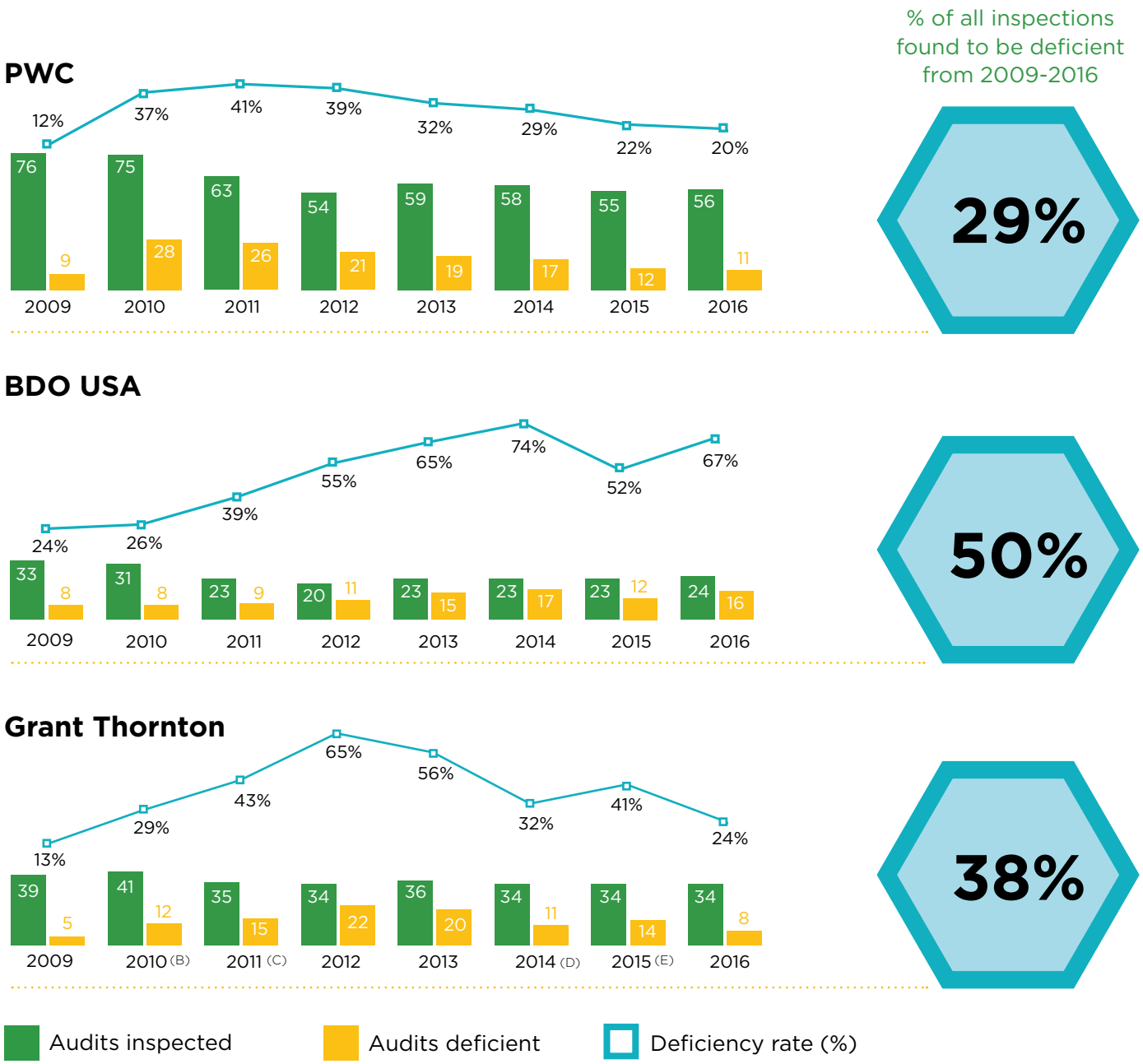
EY



KPMG



Audits inspected Audits deficient Deficiency rate (%)



Notes:

A. Report describes deficiencies in three additional audits that were inspected before the board discovered allegations of fraud in the inspections process

B. Report describes two additional audits with single deficiencies but includes them in a summary discussion rather than listing them individually

C. Report describes two additional audits with single deficiencies, but includes them in a summary discussion rather than listing them individually

D. Report describes 11 additional audits with single deficiencies, but includes them in a summary discussion rather than listing them individually

E. Report describes one additional audit with a single deficiency but includes it in a summary discussion rather than listing it individually

Source: CW analysis of firm inspection reports

Quality matters

Many audit firms contend audit quality is a key focus in their audit committees conversations. Grant Thornton, for example, talks "very openly with audit committees," both current and prospective clients, "about our processes to evaluate quality, which includes our inspection results from PCAOB," says Jeff Burgess, Grant Thornton's national managing partner of audit services. "Quality is the foundation for everything we do."

PwC U.S. says that "audit committee oversight of auditors is a key element of audit quality and the U.S. financial reporting ecosystem. Through timely, meaningful exchanges, we obtain audit committees' perspectives and fulfill our professional responsibilities to communicate certain items to them. These communications relate to many aspects of the audit, including auditor independence, the audit plan and strategy, perspectives on fraud risks, companies' accounting policies and practices, critical accounting estimates, significant unusual transactions, and the results of our audit."

EY U.S. stresses that independent auditors "have an important responsibility to promote trust and confidence in the capital markets by delivering high-quality audits." Each year, EY U.S. issues an audit quality report (AQR) to provide stakeholders—including current and prospective clients, audit committees, regulators, investors, peers, and employees—insights into "how we are conducting high-quality audits and our ongoing efforts to continuously improve quality," the firm says.

For the audit profession, 2019 may bring even greater clarity around audit quality. Botic said in his remarks at the AICPA conference in December, the PCAOB intends "to establish a program that seeks to identify practices employed by firms that promote or enhance the quality of audits." The PCAOB will then share these practices as part of its outreach initiatives. ■

Internal Control Deficiencies in 2016 Reports

	Deloitte	EY	KPMG	PwC	BDO USA	Grant Thornton
Integrated audits inspected	53	53	51	49	20	26
Integrated audits with ICFR deficiencies	12	14	19	9	11	4
ICFR deficiency rate	23%	26%	37%	18%	55%	15%
Identified ICFR deficiencies	21	34	47	25	38	8
Average ICFR deficiencies per deficient ICFR audit	1.75	2.4	2.5	2.8	3.5	2
Financial statement restatements following inspection by the date of inspection reporting	0	0	0	1	0	0
"Substantial adjustments" to financial statements	0	1*	0	0	0	0
Revised internal control opinions following inspection by the date of inspection reporting	0	2	1	2	0	0
Number of audits with deficiencies in:						
Selecting controls to test	5	7	13	5	7	4
Testing design effectiveness of controls	8	12	15	6	10	3
Testing operating effectivness of controls	8	12	16	6	10	3
Evaluating identified control deficiencies	1	3	0	1	2	0

Notes: *Report notes "substantial adjustments" to financial statements, but not a restatement

Source: CW analysis of firm inspection reports

workiva

WHITE PAPER

Beyond Quality: The Four-Part Approach for Audit Efficiency and Effectiveness

Written by Ernest Anunciacion

The Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing, colloquially known as the "Standards," is a set of core principles and a "framework for performing and promoting internal auditing." As they function as guide rails for the practice, not mandated tactics, the Standards offer best practices on how an auditor should conduct his or her work.

In many professions, the concept of quality is vague and frequently differs from person to person or team to team. However, the IIA and the Standards are articulate about what constitutes quality for the internal audit function, going so far as to establish a Quality Assessment Manual.

Accordingly, any discussion of quality in internal audit—and, subsequently, effectiveness and efficiency—must first begin with a clear understanding of the IIA's existing interpretation of quality, as well as an understanding of the actions that should be taken to promote it.

This paper will detail how internal audit leaders can improve the efficiency and effectiveness of their teams, despite time and resource constraints, using existing guidelines for improving audit quality.

The IIA and quality assurance

As the introduction to the Standards explains, the practice of internal auditing is conducted in diverse legal and cultural environments, spanning organizations "that vary in purpose, size, complexity, and structure." While these differences influence the internal audit practice in each environment, conformance with the Standards helps assure the fundamental responsibilities of the role are being met.

Chief audit executives need assurance that their internal audit activity is performing to expectations and that staff members are performing quality work. I have found that the only way to meet these expectations is through a comprehensive quality assurance program, which must include ongoing and periodic internal assessments. The Standards agree: section 1300 states that the chief audit executive "must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity."

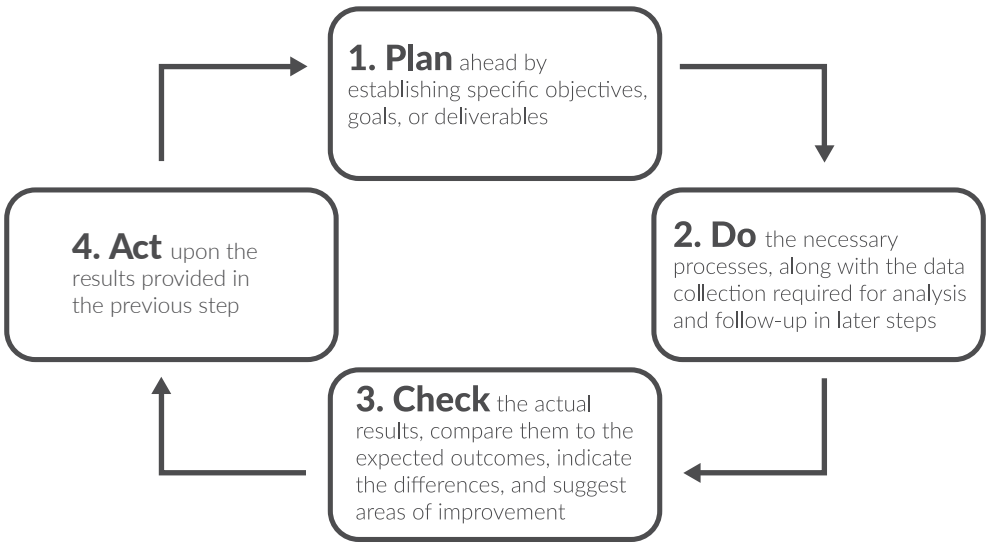
Additionally, these assessments, according to the Quality Assessment Manual, should not be an afterthought nor an element to be tacked on at the end of the year. Rather, they should be an ideology of constant, iterative growth:

"Quality should be built into, not onto, the way the activity conducts its business—through its internal audit methodology, policies and procedures, and human resource practices. Building quality into a process is essential to validate and continuously improve the internal audit activity, demonstrating value as defined by stakeholders."

With this core tenet in mind—that quality must be approached throughout the process, not just acknowledged at the end—the IIA suggests the following four-part approach to monitoring and improving audit quality.

Four Steps to Audit Improvement

The IIA suggests using the following four-part approach to monitoring and improving audit quality. It can also be used to improve audit effectiveness and efficiency.



Going further than quality

The four steps above give a high-level perspective on the creation of a quality assurance and improvement program for the internal audit function of an organization. With such a set of standards, quality is effectively a baseline expectation.

As a former practitioner for some of the largest companies in the country, I have learned that good work is not enough. Organizations must go further than quality. Improving efficiency and effectiveness throughout the methodology can streamline processes and save money, time, and resources.

What, precisely, do "efficiency" and "effectiveness" mean in the context of quality? Loosely defined, effectiveness is the results that come from work, while efficiency is the time and resources that are required to achieve those results. In essence, effectiveness is about doing the correct things, while efficiency is about doing things correctly.

High-quality work can be done in the absence of effectiveness and efficiency, but it is ultimately not as beneficial to the company if it fails to consider the resources used or if the right work is being conducted.

I recall a time when my team was scheduled to conduct a routine travel and expense audit. The testing procedures were fairly standard—however, the company had recently switched expense systems, and we failed to update the appropriate procedures.

All of my staff were allocated to other projects, and the only available team member was a new hire who came from the company's operations with no auditing background. Given the urgency to complete the engagement before the next audit committee meeting, I ended up postponing one of my audits to assist the new associate.

While we were able to complete the audit on time and identify transactions inconsistent with our policies, what should have been a 40-hour engagement required more time for me to coach the new associate. I failed to forecast the schedule appropriately to ensure that the best resources possible were available at that time. Also, I failed to ensure that the testing steps were updated accurately to reflect the new travel and expense system.

In this example, efficiency was sacrificed for quality and effectiveness. While some circumstances are unavoidable, proper planning can afford internal auditors the ability to improve and optimize their work.

To evaluate and find opportunities to improve your team's effectiveness and efficiency, use the aforementioned four-part approach—plan, do, check, and act—and take your internal audit processes further than quality.

Step 1: Plan for organizational growth

While the concept of quality is uniform for internal auditors of different varieties and capacities, effectiveness and efficiency can vary from organization to organization. Accordingly, clear definitions for these terms—the expectations for your team—must be established and adopted to plan for growth.

Use these questions as guidance when defining exactly what effectiveness and efficiency mean for you and your team:

- Are we equipped with the up-to-date tools needed to conduct the best work possible?
- Do we have the right resources and skill sets required to deliver our audit plan?
- Are we contributing to organizational improvement? If so, can others see this?

- Have we obtained any validation of our team's quality, such as notification from managers or executives?
- Is feedback effectively distributed to team members, so they know what areas to improve?
- What quantifiable metrics can we associate with these definitions?

While you and your team's definitions of effectiveness and efficiency are crucial, it is also important to gain the approval of key stakeholders involved in internal audit. A major reason that process improvement initiatives fail, according to one Harvard Business Review article, is that the people whose work will be directly impacted are often left out of the process.

Accordingly, feedback from stakeholders at the helm of the financial success of your company should also be incorporated. Here are a few stakeholders who should weigh in on your definitions of effectiveness and efficiency:

- **Internal stakeholders:** Board of directors, audit committee, executives, senior management, and department leads
- **External stakeholders:** Regulators, standard-setters, vendors, customers, and external audit teams

Step 2: Do the work needed to set expectations

The second step of this process continues to articulate the definitions of effectiveness and efficiency, and sets expectations for your team.

By this stage, you should have an internal definition of effectiveness and efficiency, and you have tempered that definition in the context of what key internal and external stakeholders need. To better set your organization up for success, make these definitions more actionable and specific through the assignation of qualitative and quantitative metrics.

As described in a Forbes article, Forrester reports 74 percent of firms say they want to be "data-driven," but only 29 percent are actually successful at connecting analytics to action. Actionable insights appear to be the missing link for companies that want to drive business outcomes from their data.

Make these definitions more actionable and specific for your team by assigning qualitative and quantitative metrics for each. To collect qualitative and quantitative metrics, try the following tactics:

- Look back at past performance data to determine quantitative metrics:
  - How many audits were scheduled?
  - How many were completed?
  - How was staff utilized?
  - What were the budgeted hours as compared to the actual hours?
- Go on a listening tour of departments impacted by your work to determine qualitative metrics:
  - What do clients think of your team's performance?
  - What do other internal stakeholders think of your team's performance?
  - Do they consider you and your team leaders in their role or order-takers?
  - Would they want to engage in future projects with your team?

One of the things I implemented in the past was a balanced scorecard—a view of metrics and key performance indicators detailing areas of strength and areas for improvement. As part of the audit committee presentations, we presented to the audit committee both the quantitative and qualitative metrics that comprised our key performance indicators. In addition to items such as budget, time, and expenses, we also included metrics that highlighted staff utilization, CPE tracking for active certifications, and net promoter scores from our internal stakeholders. My goal with the balanced scorecard was to be open and honest about our team's performance and back those statements with data-driven results.

With these actionable definitions in hand, the expectations for your team should be crystal clear. It is ultimately up to chief audit executives to hold their teams accountable for efficient and effective—along with quality—work.

Step 3: Check progress against set expectations

To check the quality, effectiveness, and efficiency of your team's work, internal audit leaders should look at individual performance on an ongoing basis—not just an annual one. After all, it is easier and less problematic for leaders to reevaluate individual performance in small increments before it becomes a major issue.

In organizations of all sizes, a traditional once-per-year approach to employee reviews is fading away in favor of more ongoing ones. As a Washington Post article describes, today's employees have come to expect instant feedback in many other areas of their

lives, and performance reviews should be the same. Besides, the article states, one report found that two-thirds of employees who receive the highest scores in a typical performance management system are not actually the organization's highest performers.

Chief audit executives should encourage the completion of self-appraisals. A Harvard Business Review article explains that an effective self-appraisal should focus on what you have accomplished and talk about weaknesses carefully, using language with an emphasis on growth and improvement, rather than admonishment. Highlight your team's blind spots that they might not be aware exists.

In short, employees want more frequent and iterative assessments of their work, and internal audit leaders need to step up to deliver this and ensure quality, effectiveness, and efficiency at all stages.

Step 4: Act upon what you have learned

By this step, internal audit leaders have an array of tools at their disposal, including:

- Actionable definitions of effectiveness and efficiency for their teams
- Qualitative and quantitative metrics to bolster these definitions
- Information gathered from self- and manager-guided evaluations
- An understanding of how team members have performed along these guidelines

With this information in hand, many opportunities for growth are apparent—simply compare where you want your team members to be against where they are right now. By implementing these fact-based changes into your internal audit processes, leaders set the stage for cyclical organizational and personal improvement.

According to a survey, this type of continuous improvement yields a positive ROI for organizations, helping increase revenue, along with saving time and money—an average annual impact of $6,000. Additionally, these improvements are designed to compound with each cycle.

Just as the approach to monitoring and improving audit quality is ongoing and cyclical—there are always improvements yet to be made—this approach to improving effectiveness and efficiency is fluid as well.

By weaving this four-part process into the fabric of your internal audit methodology, leaders can improve effectiveness and efficiency in their organizations.

In closing

Quality, effectiveness, and efficiency intermingle and collaborate to make a high-performing internal audit function. Years of internal audit experience have taught me that, when improving those three aspects, an often-overlooked tool is technology.

The IIA recognizes the importance of technology's role, as reflected in the Standards. Section 1220 states: "In exercising due professional care, internal auditors must consider use of technology-based audit and other data analysis techniques."

That said, according to the 2017 AuditNet Survey, the majority of internal audit functions only use basic technologies to support their activities. Improving the tools used in internal audit can ultimately improve quality, build more efficient teams, and prove the worth and effectiveness of the function throughout the organization.

About Workiva

Workiva, the leading cloud provider of connected data, reporting, and compliance solutions, is used by thousands of enterprises across 180 countries, including more than 75 percent of Fortune 500® companies, and by government agencies. Our customers have linked over five billion data elements to trust their data, reduce risk, and save time. For more information about Workiva (NYSE:WK), please visit workiva.com.

About the author

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wp20190320-j34650

New, tough regulator to oversee U.K. audit

The U.K. Financial Reporting Council will soon be replaced by a new regulator acting on recommendations from Sir John Kingman of the London Stock Exchange. **Paul Hodgson** has more.

The United Kingdom business secretary announced on 11 March that the Financial Reporting Council (FRC) will be replaced with a new regulator following a recent review conducted by Sir John Kingman of the London Stock Exchange. That overseer will have "a new mandate, new leadership, and stronger powers set down in law," according to the press release from the Department for Business, Energy & Industrial Strategy (BEIS), and it will be called the "Audit, Reporting and Governance Authority."

In addition, the BEIS published a consultation on implementing certain reforms that will open immediately and close on 11 June this year while the new regulator is being staffed and developed. The BEIS will work with the FRC to move forward 48 of the Kingman review's 83 recommendations, such as tackling a lack of transparency and enhancing enforcement activity. The government commissioned Kingman in April 2018 to make recommendations on how to reform the FRC and make sure that the U.K. had "a world-class audit and accounting regulator." That review was published on the 18 December last year.

The new authority will have access to greater sanctions in cases of corporate failure, including "new powers to require rapid explanations from companies and in the most serious cases publish a report about the company's conduct and management." For example, the regulator will now endorse an enforcement regime that holds directors to account for their duties in creating true, fair, compliant accounts and corporate reports and their ability to maintain open and honest relationships with auditors. In addition, a stronger corporate review process is being proposed that will cover the entire annual report, including governance reporting, and will be based on risk exposure. The new authority will also have the ability to order changes to corporate accounts directly without having recourse to the courts.

U.K. AUDIT NEWS

Another key responsiblity of the new agency will be to reclaim both the approval and registration of audit firms from the Recognised Supervisory Bodies; this will incorporate a range of sanctions, "including some that are less severe than the 'nuclear option' of audit firm deregistration." Audit Quality Reviews conducted by the authority will be published and will name both the auditor and the company being audited.

The new authority will also address conflict-of-interest issues within its staff, and be focused on current and future risks rather than retrospectively, as now, after a problem has been identified.

Some of the additional powers that will be part of its remit include:

- Address conflict of interest issues within the staff
- Focus on current and future risks, rather than post-risk once a problem has been identified
- Require firms to procure additional assurance on reports and accounts
- Require firms to have an independent boardroom evaluation, such as of an audit committee
- Require a formal response from the board, with a recovery plan if appropriate, in the event of a serious problem or flaw in reporting
- Order the removal of the auditor or an immediate retendering
- Issue a report to shareholders suggesting that the company's dividend policy should be reviewed
- Issue a report to shareholders suggesting the removal of a CEO, CFO, chair or audit committee chair, or for other strengthening of the board of directors

For more information on the Audit, Reporting and Governance Authority, including details on when it will come into force, go to https://www.gov.uk/. ■

The benefits and struggles of marrying audit with new tech

The never-ending quest to improve audit quality has firms and the audit committees of their corporate clients eyeing how to best deploy new technologies. **Joe Mont** reports.

The accounting and auditing worlds have come a long way from the days of ubiquitous HP 12c calculators.

As is the story throughout the business world, emerging technologies are revolutionizing the way work gets done. These cutting-edge tools have the promise and potential to be a boon to audit firms looking to improve the quality and efficiency of their work, differentiate themselves in an ultra-competitive environment, and perhaps even insulate themselves from risk and liability. Among the technologies being adopted by audit firms are artificial intelligence, machine learning, robotic process automation, blockchain, cloud-based storage and services, advanced data analytics, and data visualization.

In broad strokes, these new technologies can automate and streamline the time-consuming rote tasks and data gathering needed to inform and empower more intellectual, human tasks as analysis, judgments, exercising professional skepticism, fraud detection, and risk assessments. Inexpensive data storage, melded with massive troves of "Big Data," and parsed with increased computational power, can weave into the audit process to allow audit teams to parse and analyze far more information than they ever could before, improving audit quality in the process. The simple goal for all these complex tools: doing more, better and faster.

TECHNOLOGY

"As accounting and other routine tasks are automated, the CFO will create more meaningful and impactful roles for finance professionals, such as leading digitalization transformations, ensuring their organizations pivot wisely in this radically different marketplace," is among the conclusions of a November 2018 report by Accenture, "The CFO Reimagined: From Driving Value to Building the Digital Enterprise."

Dave Sullivan, national managing partner of the quality and professional practice at Deloitte, says firms are still assessing the many ways certain technologies can revolutionize the audit profession.

"I don't think we understand what the potential is, for some of these things yet, as we continue to develop tools," he says. "The audit profession is no different than any other business in America, in terms of trying to find ways to maximize the use of technology, especially for repetitive lower-value work. The audit will also always be staffed with professionals who need to make critical professional judgments. We don't see technologies making those professional judgments, but they may help us exert skepticism and objectivity as we go through things and are able to look at larger data sets."

One priority, Sullivan says, is creating better data sharing between his systems and client systems. "One of the issues, with respect to gathering data from our clients, is data wrangling—getting that data into our system—which sounds kind of basic, but with all the different systems that are out there and that clients may have, it is an area where we see potential as we as we develop new tools."

"There's huge potential, and I think we'll see a lot of change over the next five to 10 years, more change than we've seen in the last 30, but I don't think we know yet exactly where all this is going to take us as we continue to experiment," he adds.

"A lot of people may or may not realize that an audit process is very interactive," says Jeff Burgess, Grant Thornton's national managing partner of audit services. "It's not a process where we just go and do a bunch of procedures in a dark room somewhere and report out to the client. The audit process requires a lot from the company's finance team and others in the company. A lot of this technology can really help to reduce that time commitment that the company has to get through the audit and that's extremely attractive to the audit committees and to management."

To what extent is new technology having an immediate effect on accounting and auditing services?

"It is having a big and positive impact on the quality of the audit and of the value of the audit product for the marketplace," says Trent Gazzaway, Grant Thornton's national managing partner of quality and innovation for audit services.

"When we look at some of the technology—data analytics capabilities and artificial intelligence—we now have the ability as auditors to pull insights out of the company's information that really weren't possible to do before in any efficient manner."

"We can highlight and identify potential anomalies that deserve audit attention," he adds. "It gives us greater insight into the business itself and allows us to sit down with the company and talk in a greater level of detail about how their business actually functions. When you understand how a business is functioning, you're automatically going to be a better auditor. The financial statements are really telling the story of the business. The technology we've been working on is going to deliver back to the companies that we audit greater insights into their business that maybe they couldn't even pick up on their own."

Audit committee scrutiny

"We think high-quality-focused, effective audit is aligned with the way the entity manages its own data and operations," adds Brian Miller, national partner of transformation and innovation at BDO. "Audit committees and executive management expect auditors to keep pace with evolving technology and be prepared to leverage it to deliver the insights they expect from the capabilities and increased levels of data that are available … Some businesses already analyze their own data in a manner similar to auditors and cover some of the same ground. As business analysis becomes deeper, wider, more sophisticated, and more commonplace—with a focus on risk and performance—it seems likely they will align, at least in part, with the risks assessed by the external auditors."

"Really good audit committees are focused on the quality of your management team and your financial reporting capability. They're also looking at the evolving nature of the audit in terms of technology usage, adaptability, and use of data analytics," says William Eisig, managing partner of BDO's Atlantic region and national non-profit practice. "Audit has definitely become more specialized, more complicated, and more technology-driven. Audit committees have had to become more sophisticated over time."

This sophistication also plays a role in how audit firms assure themselves, and clients, that a given technology is not just a "flavor of the month" and will actually yield results.

"The obvious objective of technology is to generate a more efficient and more effective process," says Eisig. "It sounds simplistic, but it's actually really hard. Making sure that we are utilizing new technologies for more efficient and effective audit results is really where we're trying to laser-focus our efforts, whether that's exploring a bit more around artificial intelligence and data analytics. The objective is always a more efficient process to get to those results." ■

Despite decades of scrutiny, auditor independence remains a challenge

Even with clear-cut expectations, writes **Joe Mont**, audit firms still find new and unique ways to run afoul of the SEC's independence rules. Among the culprits: the money-making potential of non-audit services.

Since the Securities and Exchange Commission's birth in 1934, it has consistently emphasized the need for auditors to remain independent.

Way back then, ensuring auditors are independent of their audit clients was hardly a controversial concept. The modern terrain, however, is a lot muddier. The rise of the market-dominating Big 4 firms have all but rewritten what services a client should expect—if not demand—when engaging an audit partner.

As these, and other firms, seek to maintain their bottom-line growth and retain their client base, they are turning to non-audit compliance, technology, and consulting services to increase their value proposition with the goal of making themselves indispensable partners. The risk is how to balance these offerings without triggering regulatory concerns about their independence.

CONFLICT OF INTEREST

Over the decades, the SEC has developed and maintained its own rules to ensure that auditors are independent of their audit clients. The Sarbanes-Oxley Act of 2002 also mandated that audit committees be directly responsible for the oversight of the engagement of the company's independent auditor.

The SEC's general standard is easy to summarize: "An auditor's independence is impaired if the auditor is not, or a reasonable investor would conclude, that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the audit engagement."

Breaking the rules

Even with decades of fairly clear-cut expectations, audit firms still find new and unique ways to run afoul of the SEC's independence rules.

On Feb. 13, the SEC announced that Deloitte Touche Tohmatsu (Deloitte Japan) will pay $2 million to settle charges that it issued audit reports for a client at a time when dozens of its employees held bank accounts with that client's subsidiary.

Under the SEC's rules, accountants are not considered to be independent if they maintain bank accounts with an audit client with balances greater than Federal Deposit Insurance Corporation or similar depositary insurance limits. Eighty-nine Deloitte Japan employees had financial relationships with the audit client "that compromised their independence," the SEC charges.

Past enforcement actions have been less technical and more scandalous. For example, in September 2016, EY was fined more than $9 million for inappropriate relationships between the firm's employees and executives at the company it was retained by. From January 2012 to March 2015, a senior "coordinating partner" on the engagement team broke company rules, fostered an "inappropriate close personal relationship" and, in the process, racked up $109,000 in entertainment expenses of dubious necessity and value.

The SEC says, in its enforcement order, that an EY partner and the CFO of the firm it was auditing took at least seven out-of-town trips together, "all of which were social in nature and did not have a valid business purpose." The former EY partner, sometimes accompanied by his wife, also stayed overnight as a guest at the CFO's primary residence in New York and his vacation home in South Carolina and travelled to out-of-state football and hockey games. The partner either obtained most of the sports tickets directly from EY or sought reimbursement.

In a separate, but connected, enforcement action, from March 2012 to June 2014, a former EY partner and the former chief accounting officer of an EY audit client "maintained a close personal and romantic relationship" while the former was on the engagement team auditing his company.

Why is it so tough to avoid these independence conundrums (at least of the non-personal variety)? One reason is that to maintain market share, audit firms are increasing

the diversity of services they offer.

"Much of the difficulty comes from the competitive nature of the business," says Bill Thompson, a CPA who left the auditing world to serve as founder and president of CPA Mutual, a firm that provides professional liability insurance exclusively to CPA firms and consults on risk management regarding professional services, employees, and data security. "You're looking at quite a quite a lot of fees. I'm not sure how profitable auditing is compared to compliance work; I imagine the compliance work is much more profitable. They're concerned about their top-line growth."

When Thompson started CPA Mutual in 1981, firms were just starting to get into compliance services, IT services, business valuation services, and "all the other add-ons that the CPAs are doing."

"Those are pretty profitable niches to have if you're a CPA," he says. "It's kind of a protection mode. They don't want another CPA firm involved with the client because they're afraid they could possibly lose the business."

For audit firms that face enforcement actions for violating independence rules, the cost can be very high—and not just through SEC-levied fines. There is also personal liability. "A lot of the folks who get caught up in these disciplinary proceedings are basically banished from the industry for a couple years. Is it really worth it? I don't think so," Thompson says. "I'm also looking at it from a liability sand defense standpoint. It's really difficult for an insurance company these days to take a claim all the way through trial and not have the jury think the accountants were colluding, either with the client or on their own just to make a quick buck, and they weren't worried about the quality of their work."

Concerns should not reside solely with SEC enforcement. "The Department of Labor, especially when they're doing audits for pension and profit-sharing plans, is another reason why you've got to be extremely careful. Then the American Institute of Certified Public Accountants gets involved, and then

SEC standards for auditor independence

To determine whether an auditor is independent under SEC standards, an audit committee must consider all of the relationships between the auditor and the company, the company's management and directors.

The audit committee should consider whether a relationship with or service provided by an auditor, "creates a mutual or conflicting interest with their audit client; places them in the position of auditing their own work; results in their acting as management or an employee of the audit client; or places them in a position of being an advocate for the audit client."

Auditors are prohibited from providing the following non-audit services to an audit client and its affiliates: bookkeeping; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions; human resources; broker-dealer, investment adviser, or investment banking services; legal service; and expert services unrelated to the audit.

Other matters on the SEC's list:

- A one-year cooling-off period is required before a company can hire certain individuals formerly employed by its auditor in a financial reporting oversight role. The audit committee should also consider whether the hiring of personnel that are or were formerly employed by the audit firm might affect the audit firm's independence.
- Audit committees should not approve engagements that remunerate an independent auditor on a contingent fee or a commission basis. Such remuneration is considered to impair the auditor's independence.
- Audit firms may not have any direct or material indirect business relationships with the company, its officers, directors, or significant shareholders.
- Audit committees should be aware that certain financial relationships between the company and the independent auditor are prohibited. These include creditor/debtor relationships, banking, broker-dealer, futures commission merchant accounts, insurance products, and interests in investment companies.
- Subject to certain limited exceptions, the audit committee must pre-approve all permitted services provided by the independent auditor (tax services, comfort letters, statutory audits, or other). The audit committee should consider whether company policies and procedures require that all audit and non-audit services are brought before the committee for pre-approval.

—Joe Mont

the state societies are going to get involved," Thompson says.

What can audit firms do to avoid independence concerns? Similarly, what can companies do to make sure their outside auditor doesn't drag them into the enforcement crosshairs?

"The best thing to have is a friendly competitor that can, for example, do the compliance work and let you do the audit work," Thompson advises audit firms. "That's a great way to do business. You have to make a business decision on whether you want to do the audit, or whether you want to do the compliance work. You can do one or the other, but I wouldn't do both." As for companies retaining a firm: "professional skepticism is really important."

Trent Gazzaway, Grant Thornton's national managing partner of quality and Innovation for audit services, stresses the value of Sarbanes-Oxley standards and SEC requirements. "We've seen, since the implementation of them back in the early 2000s, how much better the profession in the U.S. has gotten," he says. In particular, the SEC's rundown of prohibited services is an important roadmap to follow. "It does a good job of carving out those things that have the greatest risk of impairing objectivity. I think that's been an effective way to drive increased auditor objectivity, without ultimately impairing quality," he says.

Gazzaway does add, however, that "a lot of our advisory people contribute greatly to the quality of the audits that we do, because of their expertise in valuation and information technology and in taxes and a whole host of other things. Having a multidiscipline firm drives quality as long as you have the protective measures in place to make sure you have objectivity and independence."

"Having the audit committee to complete that circle between the auditor and the client," is of vital importance, he says. "If the audit committee and management are in the role of pre-approving permitted non-audit services, that works very well."

Thompson, in a guide published on CPA Mutual's Website, suggests that all employees of CPA firms delivering professional services need "to identify, evaluate, mitigate, disclose, and monitor potential and actual conflicts."

Before undertaking any new client engagement, personnel should identify potential conflicts and impairment of objectivity. If a conflict is identified, the firm must evaluate the impact of the conflict and the level of risk to affected parties (financial, strategic, and reputational).

If the threat of impairment to the accountant's objectivity and the potential impact on the interests of the clients is sufficiently high, consent from the clients to continue the engagement should be obtained in the form of a conflicts waiver. Once an engagement commences, it must be routinely monitored to ensure that existing conflicts do not intensify, or new ones emerge. It may ultimately be necessary to decline, or resign from, the engagement.

As another safeguard: document, in writing, the firm's independence-related compliance policies.

Firms should also keep communications professional and focused on the engagement. Even something as simple as a joke or argument about a football team could be used to show evidence of a personal relationship that trumps professional objectivity. ■

Q&A

Outlook from audit committee chair and former EY auditor

__Jan Babiak__ is an independent board member on companies listed in three countries. She chairs the audit committees of Walgreens Boots Alliance Inc. and the Bank of Montreal and serves on the board of Euromoney Institutional Investors plc. She spent more than 28 years with EY, the last 20 of which were in London in various global regulatory, audit, assurance and cyber-security leadership roles before transitioning to her current portfolio of board leadership positions.

How have you transitioned your experience as a career auditor into chairing audit committees? How has that perspective shaped your approach to audit committee service?

Historically, audit committee chairs were and are predominantly retired CFOs. From that perspective, it's not surprising many of them think of an audit as something being done to them. When coming from that mind set, their approach can be "let's get the fees down." My perspective is different. I'm starting from the standpoint that the audit is one of the most important inputs to the board's role. Auditors are additional "on-the-ground" eyes and ears for the board. For me, fees are not the biggest thing. I want auditors to get a fair fee so they are not tempted to shortcut what they do, but I also have to take in the considerations of the shareholders, of course, so I also want a good price. I know how to get cheap audits, and with a cheap audit you don't get the best team. They will cut back and do the minimum they have to do, and that's not in the interests of the shareholders or the board. Most boards are comfortable with CFOs as audit committee chairs. They think it will be more helpful because of their experience with the Street and they can be a mentor to the CFO, but most career auditors can do that too. The best audit committees have both the CFO and auditor perspective. The responsibilities of audit committees are very broad, so it's good to have members who see it from both perspectives.

EXPERT PERSPECTIVE

Do you feel a sense of heightening expectation on audit committees to be more proactive in external audit management?

There's a growing expectation for the entire board to be more proactive across the entire board agenda. The types of roles we play in the boardroom are different than they were even a decade ago. Board members are more informed, more up-to-date, more prepared. The questions they ask are more sophisticated. There are fewer boards that just take what the CEO feeds them. That's old style. Cronyism is coming out of the board room, and audit committees are a lot more engaged than they used to be as well. When I think back to my interactions with and presentations to audit committees years ago, I did not get many questions that were deeply insightful. Now I am pretty impressed with my audit committee and board colleagues.

Are more audit committees regarding the audit as a critical service rather than a necessary compliance exercise?

It often depends on the audit committee chair. The audit committee chair is the one most likely to set the tone around how the board thinks about the audit. There have been plenty of cases where management, in a dutiful effort to protect budget, have put undue pressure on auditors to decrease scope. They might ask, for example, whether auditors need to spend a lot of time in a particular jurisdiction that is not material. But there are also high-profile examples of problems in a small jurisdiction that did serious damage to the brand and the share price of very large companies. Is it not in the interest of the company, even if the audit fees are a little higher, to have a bit more of a dive into that area? I don't think there's a trend one way or the other. I go to all the conferences, forums, and breakouts for audit committees, and I notice some audit committee chairs saying they have to get fees down and other saying it's not a priority. Auditor fees are usually a fraction of those paid to bankers and lawyers. For what they do for the board, it's really good value for the money. And if it's not, we can change firms or teams. Boards and audit committees have the explicit power and authority to do that.

To what extent do you rely on information directly from the audit firm? Do you also conduct any kind of research beyond your interaction with audit firms?

You look at what's coming out from the regulators, manage-

ment's experience working with the auditor, and your own experiences. Look at your experiences working with them in different environments. I work with all the firms either as auditors or consultants across my board portfolio, I go to the technical update conferences, read the regulatory reports, and I have my own view about the assessments. I talk to the firms about them. It would be a big concern if it were my specific audit team being described in those reports. Some of the companies where I do or have served as audit committee chair have been selected for the audit firm's inspection and I have been interviewed by the regulators as part of those reviews. In those cases, I am particularly interested in what comes out and I, with the audit committee and board, can then decide whether it is a minor concern or a major concern to us. But it is important to remember that it's the regulators' job to report their findings. If they're not writing something, everyone would be critical of them.


Babiak

We see audit committees increasing their voluntary disclosures regarding their oversight of auditors. Does that suggest increased oversight activity?

The first time I saw the Center for Audit Quality's disclosure barometer, to be absolutely honest, I was offended by it. Everyone gives us grief about the volume of disclosures, so why would we add more disclosure just to say we're doing our job. I thought it was clear from our charter. Then I started engaging with the shareholder community over it, and I was shocked by their support of it. They wanted it written in a report, with a signature on it, so they would know it was done. If it makes my shareholders happy, OK, then I'm going to do it. At one particular company, we expanded our disclosure, and it went from two paragraphs to more than two pages. The experience was enlightening. By actually putting it on paper, we ended up having a conversation we might not have otherwise had, and it caused us to clarify our policy around the approval of the external audit work. It was a good exercise.

Do you follow a formal process for assessing the performance of external auditors? Can you describe it?

Yes, and it differs by company and by country. In Canada, they are doing a lot to really push the way boards assess auditors. An evolving best practice has the audit committee and auditors agreeing on "audit quality indicators," and we have those reported to us at every meeting by the audit firm. Things like ratio of partner time to staff time usually goes into a bid for an audit, but then we never heard about it again. Now they have to report to us how many partner hours went into the audit by area and how many staff hours. We look at things like how much the external auditors are using digital tools to do the audit. We've set up AQIs to monitor what they do, and we survey the audit committee and management staff around performance against these and a number of other criteriThen we sit down and talk about what we want to be different and how happy we are with the outcomes. We also bifurcate the audit committee view from the management view. Management might find the auditor to be a real pain, but within the boundaries of a constructive debate that might be in the interest of the board and the audit committee.

What about changing audit firms?

It depends on the jurisdiction. In the U.K., with the rotational rules, audit committees have more experience with auditor changes there by far. Changing firms is a big, disruptive event. Even the bid process is a big effort, and it costs a lot of money. If you're going to change firms, you have to have a really good reason for doing so. If you're going to change teams, that should be done when you believe you are not getting the service you need or the challenge you need. People worry about long tenure, but I'm more interested in the people, whether the relationships are working. In the United States and many other countries, you have to rotate the engagement partner every five years. When you have a firm with a long tenure, how many CEOs, CFOs, audit committee chairs, and engagement partners have you had in all that time? All the people are changing. If you feel there is too much coziness going on or you are not happy with the quality of the audit, you may find a change in the engagement team is just as effective but much less disruptive than a change of firms.

Do you see benefits from increased auditor oversight?

That's a hard question for me to answer because personally I've always applied strong oversight of my auditors. I suspect that audit firms have mixed views when they know I am joining a board. They know I know my job and I'm going to fight for them, but on the other hand, I hold them accountable and they may be less likely to get away with something with me were they so inclined. I understand what the regulators expect of an audit committee, and I work hard to meet or exceed that expectation. The downside of an audit committee and its chair not doing their job effectively is that the company and shareholders are at greater risk. The benefit of increased oversight is a decreased likelihood of audit or even company failure. ■

U.K. narrow-minded to seek breakup of Big Four

Big Four accounting expert **James Peterson** discusses ways in which the United Kingdom may dismantle the Big Four, the possible consequences of each of the proposals, and which he thinks is the better solution.

"None of us has a clue … "

—PCAOB Chairman William McDonough, asked what audit regulators would do to prevent a Big Four collapse, Financial Times, *Sept. 27, 2005*

Passionate criticism has escalated dramatically, aimed at the Big Four accounting networks—Deloitte, EY, KPMG, and PwC—who together dominate audits of the world's large companies. The center is London, where the noise levels turned up with the multibillion pound collapse in January 2018 of giant public works contractor Carillion.

Lengthy proceedings and multiple inquiries by regulators and politicians were launched on fast tracks. A committee charged by Parliament and led by Sir John Kingman reported in December, proposing a thorough re-engineering of the profession's regulation.

Concerned by Big Four dominance, the Competition & Markets Authority's hefty report of Dec. 18 had recommendations to restructure the entire model—ideas pursued in a series of hearings by Parliament's Business, Energy and Industrial Strategy (BEIS) committee.

In a separate appendix, the CMA endorsed "the importance of understanding the purpose and scope of audit before assessing whether audit was failing to meet its objectives"—a head-scratching exercise further taken up in a year-long project led by former London Stock Exchange Chair Donald Brydon.

Desirably, insights gained by the City's great and good should temper the eagerness, as put by a member of the BEIS committee, to "just get on with it"—lest powers-that-be embark headlong on a journey without an identified destination. Yet the "solutions" being urged are of varying impracticality and ineffectiveness. They include two CMA headline proposals:

» First is that major portions of the Big Four's dominant 97 percent share of the audits of the FTSE 350 companies should be delivered over to the smaller firms, despite the compelling lack of capacity, experience, or risk tolerance of the so-called "challengers" to accept the largesse.

» Second is that FTSE 350 firms should be obliged to engage a smaller firm as "joint auditor," again despite the challengers' lack of capacity, and the absence of evidence that the global capital markets either value joint audit or see any positive impact on either competition or performance quality.

GUEST COLUMN

Also on the menu are proposals that the Big Four should somehow be "broken up" in various ways—for which the advocates argue that cleaving them into separate smaller entities would somehow benefit the goal of improved audit quality.

Reality intrudes. Even with vision and authority, which they now lack, the regulators would create no new competition if, for example, a Big Four firm were split by industries lines, so that—for example— its banking and petroleum and technology practices were put in one piece and its insurance and healthcare and retail went to another. Nor would there be anything but disruption, wasted duplication of costs and resources, and a weakening of the surviving pieces if the two halves of Big Four industry practices were forced their separate ways.

Two other varieties of "break up" may be mentioned quickly, because for separate reasons, neither appears likely to be consequential:

» First, criticism of the Big Four's provision of ancillary services to their audit clients has been largely rendered moot by the post-Sarbanes-Oxley restrictions in the United States, United Kingdom, and European Union, and the firms' own indicated readiness to relinquish such services except as "closely related" to the audits themselves.

» Second, "organizational separation" of audit and non-au-

dit practices—by way of separated leadership, staff, governance, and financial operations—can be achieved by the Big Four without the disruption of full structural separation.

A final Big Four "break up" proposal is more likely, and so deserves fuller attention—namely that their audit practices should be forcibly separated from the advisory and other ancillary services into which the firms have so robustly expanded over the last 20 years.

Here, absent supporting research or experience, the advocates fall back on enthusiasm and wishfulness, fantasizing that this purging of the Big Four would somehow restore them to a virtuous state of vestal purity.

It won't work that way. Instead, denuding the Big Four of their consulting and advisory practices would degrade their audit performance, hamper their ability to serve their clients and the capital markets, and further weaken their already imperiled financial structures.

That's because, to start, in a rapidly changing world, "audit only" fails to recognize the reshaped way information is gathered, analyzed, and verified. With the rise of artificial intelligence, data analytics, and drones and robotics, auditors will require more—not less—access to specialized skills and expertise.

As audit personnel are being displaced in the comprehensive data-gathering surveys of crop yields, offshore oil wells, and warehouse inventories, audit firms will require the scale, technical skills, and financial strength to adapt accordingly—lest they be displaced entirely by newly emerging providers.

Further, both the execution and the value of complex audits already require a broad range of specialist skills (see International Standards on Auditing 220 and the PCAOB's Auditing Standard 1201). As put in Deloitte's submission of Oct. 30, 2018, to the CMA:

"On complex audits we regularly use specialists from across corporate tax, transfer pricing, actuarial, IT and cyber risk advisory, data analytics, valuations and financial instruments together with industry specialists to identify risks and challenge management."

The ability to tap those skills within their own organizations allows the auditors to identify conflicting interests—where such infrastructure would not be available in monitoring outside suppliers even though required by the professional standards (see ISA 620.9, AS 1210.10-.11).

More practically, an audit-only firm would lack the ability to recruit, train, and retain those necessary skills if only utilized as audit support—whereas mainstream work for non-audit clients provides the basis for investment and growth at the necessary scale and skill level.

A final point is dramatically under-examined: The financial resources and stability of the Big Four are threatened by litigation and law enforcement impositions far beyond their ability to withstand and survive.

Estimates I have calculated and published over the last dozen years, that a Big Four firm would not survive an enforceable judgment of from $1 billion-$3 billion, have never been challenged or subject to open discussion—although fines on that scale have been commonplace since the crisis of 2007-2008, and it was the litigation exposure of Enron's $67 billion bankruptcy that proximately caused the disintegration of Arthur Andersen in 2002.

Audit services now represent considerably less than a majority of Big Four revenues—globally, from their Websites, the 2018 percentages are: Deloitte-24 percent, EY-36 percent, KPMG-38 percent, and PwC-41 percent. If deprived of the financial resources provided by their ancillary services, their fragility would reset dramatically downward, at a time when looming survival threats already abound.

Space limitations prevent treatment of other legitimate concerns over "audit only"—such as the negative impact on recruiting and career-building for the next generation, and the challenges of complexity and enforceability considering the multinational cross-border needs of a large-company audit.

Suffice, that "audit only" is not a policy that would serve the goal of improving and evolving this valuable service.

To summarize, across the pending menu of narrow and partial ideas, a sense of dreary frustration comes down to a matter of vision. While the regulators profess urgency, the competing awareness that no "silver bullet" exists suggests that they are on a journey without a map.

Put differently, the tensions between and among the Big Audit players are deeply interconnected. They include:

- The international scope and complexity of serving large global companies.
- Users' dissatisfaction with the binary "pass/fail" audit report.
- The demands of skills and resources for evolved deployment of the new tools of technology and data handling.
- The capital and organizational needs of the next generation of audit providers.
- The overhang of potentially devastating judgments under liability regimes imposing unachievable performance expectations of "zero defects."

Action on any one of these affects them all, and no solution can be adequate that is not holistic and comprehensive. The convocation of all the players necessary for discussion and debate at that level still remains to be launched. ■