Transparency of Firms that Audit Public Companies

Consultation Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

September 2009

This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.

Foreword

The IOSCO Technical Committee has published for public comment this consultation report on Transparency of Firms that Audit Public Companies. This Report explores the potential effects of enhanced transparency of audit firms, specifically whether it will improve audit quality and the availability and delivery of audit services.

We welcome empirical data and economic information, as well as anecdotal experience from investors, auditors, issuers, and other stakeholders on the following discussion and inquiries.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 15 January 2010**. To help us process and review your comments more efficiently, please use only one method.

1. **E-mail**

- Send comments to AuditorTransparency@iosco.org
- **The subject line of your message should indicate "Public Comment on the Transparency of Firms that Audit Public Companies: Consultation Report".**
- Please do not submit any attachments as HTML, GIF, TIFF, PIF or EXE files.

OR

2. **Facsimile Transmission**

Send a fax for the attention of Greg Tanzer using the following fax number: + 34 (91) 555 93 68.

OR

3. **Post**

Send your comment letter to:

Greg Tanzer
Secretary General
IOSCO General Secretariat
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "Public Comment on the Transparency of Firms that Audit Public Companies: Consultation Report".

<u>Important</u>: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

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I. INTRODUCTION

Audited financial statements are a primary resource for investors' evaluation of public companies. Financial frauds over the last decade focused attention on the role of auditors in the capital markets and caused securities regulators to examine more closely the reliability of public company financial statements, including ways to improve audit quality and the availability and delivery of audit services[1] to public companies.

The International Organization of Securities Commissions (IOSCO) considers audit quality and the availability and delivery of audit services to be important to investors and other stakeholders. Accordingly, the IOSCO Technical Committee formed an Audit Services Task Force (the Task Force), which sponsored the IOSCO Roundtable on the Quality of Public Company Audits from a Regulatory Perspective (Roundtable).[2] During the Roundtable and in other fora,[3] commentators raised lack of transparency of audit firms as an issue. Following the Roundtable, the Task Force determined to study whether enhancing the transparency of audit firms' governance, audit quality indicators, and audited financial statements may serve to maintain and improve audit quality and the availability and delivery of audit services.

Currently, many jurisdictions require audit firms to disclose certain information, but are also evaluating if additional disclosures should be required. Also, some audit firms voluntarily disclose information. However, some market participants question the value of the current required and voluntary disclosures as anything more than marketing promotion for audit firms.[4] In this report, the Task Force explores the potential effects of enhanced transparency of audit firms, specifically whether it will improve audit quality and the availability and delivery of audit services. Enhanced transparency of audit firms may increase investor confidence in financial reporting and provide additional information when market participants make decisions, including investors' decisions about whether to invest in companies or ratify the appointments of issuers'

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[1] For purposes of this paper, availability and delivery of audit services relates to how professional human resources are organized and managed to serve the market rather than the availability of human resources themselves.

[2] The Roundtable was held in Paris, France, on June 1, 2007. Information regarding the proceedings, including video archives and a copy of the transcript, may be found at http://www.iosco.org/library/videos/pdf/transcript1.pdf.

[3] Commentators include, for example, individuals who testified before the U.S. Department of the Treasury's Federal Advisory Committee on the Auditing Profession (U.S. Treasury Advisory Committee). See, for example, the written submissions of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, *available at* http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf; and Christianna Wood, Senior Investment Officer, Global Equity, California Public Employees' Retirement System, *available at* http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf. Also, *see* Sections VII:20-23 and VIII:14-17 of the U.S. Treasury Advisory Committee Report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf. The U.S. Treasury Advisory Committee was formed to provide advice and recommendations to the Secretary of the U.S. Treasury and the Department of the U.S. Treasury on the sustainability of the public company auditing profession.

[4] For example, these views were expressed during the U.S. Public Company Accounting Oversight Board (PCAOB) October 2008 open meeting with their Standing Advisory Group (SAG). Details of the webcast are available at http://www.pcaobus.org/News_and_Events/Webcasts.aspx#57.

audit firms, audit committee decisions related to auditor appointments and fulfilment of their oversight responsibilities, and regulators' decisions related to investor protection.

The report will also consider the limitations relating to disclosures, including the possibility that negative consequences may result from enhanced transparency and that interpretations of disclosures can be subjective, thereby failing to achieve the intended objectivity. The report also notes that limitations are a factor when determining whether audit firms should provide additional disclosures. Accordingly, the report examines alternative formulations for transparency in terms of subject matter of disclosures, cost, and to whom the disclosures will be made, as well as how to mitigate potential limitations, including negative consequences, arising from increased transparency.

The Task Force acknowledges that its initial analysis will benefit with input from investors, audit oversight authorities, industry and other relevant stakeholders, and for this reason, this report seeks public feedback on audit firm transparency.

II. Possible Effects of Transparency Related to Audit Quality and Availability and Delivery of Audit Services

Audit Quality

The term "audit quality" is difficult to define and is subjectively applied. Accordingly, what constitutes a quality audit differs by investor or other stakeholder. Reaching consensus on one definition that effectively captures the level of auditor performance that can serve as an indicator of a quality audit is difficult. An alternative to defining audit quality is to consider the attributes, behaviors, or indicators of audit quality. Examples include competence and industry expertise of the audit personnel, firm culture that promotes audit quality, firm-wide quality control systems, and auditor oversight.[5]

Currently, audit firms principally compete on factors including reputation, size, industry expertise, and audit fees. Audit committees, investors, and other stakeholders have insight into these factors but have limited ability to provide market incentives for audit firms to compete directly on audit quality because of lack of significant transparency about how audit firms manage and compare in terms of audit quality.

Additional transparency about these attributes, behaviors, and indicators of audit quality may provide the market with information necessary to create an environment where audit firms compete on, and thus raise, audit quality. For example, transparency may sharpen the focus on the importance of audit quality, which may impact how audit firms internally manage audit quality. As measures of quality enter the public domain, audit firms could compare measures against their competitors, which may create incentive to "be the best." Also, financial statement users, such as investors and audit committees, will have information available to make comparisons among audit firms and inform their decision-making, creating pressure for audit firms to raise audit quality. Additionally, over time these disclosures may become more integrated within the culture of an audit firm. Thus, improvements to audit quality may result from increased transparency of audit firms.

Request for Consultation:

1. Is a definition of audit quality necessary to evaluate audit quality or can audit quality be evaluated from an understanding of the attributes, behaviors, and indicators of audit quality?

2. In addition to competence and industry expertise of the audit personnel, firm culture that promotes audit quality, firm-wide quality control systems, and auditor oversight, are there other examples of attributes, behaviors, and indicators of audit quality that should be considered?

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[5] The Financial Reporting Council (FRC), in *The Audit Quality Framework*, February 2008, discusses and identifies key drivers which are attributable to audit quality, with the aim of supporting effective communication between auditors, audit committees, investors and regulators.

Availability and Delivery of Audit Services

The availability and delivery of audit services for larger public companies is currently dominated by four large multi-national networks of audit firms. These four audit firms audited 98% of the 1,500 largest public companies in the U.S. with annual revenues of more than $1 billion in 2006[6] and 96% of the FTSE 250 companies in the UK as of February 2008.[7] The effect of this concentration may be limiting large companies' auditor choice. While the current level of concentration has not been shown to be a significant impediment to large companies obtaining the audit service they need, the possibility of one of the four largest audit firms leaving the market creates concern for the future about the ability of large public companies to acquire the audit services that they and investors need.[8] This concern has caused widespread exploration of potential methods of mitigating this concentration by eliminating barriers to entry and creating entrance opportunities to the large company audit market.[9]

One of the barriers to providing audit services to large multinational companies is a perception that only the four largest audit firms have the capability to audit larger public companies and that they provide higher quality audits than other audit firms.[10] Some believe enhanced transparency of audit firms may improve the availability and delivery of audit services to larger public companies by allowing other audit firms to compete with larger audit firms.[11] Although regulators of the audit profession may readily request information from audit firms, recurring disclosures provided to the regulators are typically limited. Enhanced transparency therefore may improve the ability of regulators and other stakeholders to monitor the viability of audit firms, allowing regulators to conduct contingency planning and undertake actions to maintain availability and delivery of audit services in the event of a threatened loss of any of the large audit firms.

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6 See pages 18-20 of the January 2008 U.S. Government Accountability Office (GAO) report, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, at http://www.gao.gov/new.items/d08163.pdf.

7 See page 22 of the May 2008 FRC paper, *Choice in the UK Audit Market Progress Report and Further Consultation* at http://www.frc.org.uk/documents/pagemanager/frc/FRC%20Update%20Choice%20May%202008%208%20May.pdf.

8 See page 5 of the January 2008 GAO report, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, at http://www.gao.gov/new.items/d08163.pdf.

9 See various recommendations throughout the U.S. Treasury Advisory Committee Report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf and the FRC paper, *Choice in the UK Audit Market Progress Report and Further Consultation* at http://www.frc.org.uk/documents/pagemanager/frc/FRC%20Update%20Choice%20May%202008%208%20May.pdf.

10 See pages 38 and 39 of the January 2008 GAO report, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* at http://www.gao.gov/new.items/d08163.pdf, which discusses companies believe small and mid-size firms do not have the capability to audit larger companies.

11 The U.S. Treasury Advisory Committee suggests that "requiring firms to disclose indicators of audit quality may enhance…the ability of smaller audit firms to compete with larger audit firms, auditor choice, shareholder decision-making related to ratification of auditor selection, and PCAOB oversight of registered audit firms." See Section VIII: 15 of the report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

Enhanced transparency by audit firms provides another source of information for investors, audit committees, and other stakeholders when evaluating audit firms, which may allow for other audit firms to demonstrate they are capable of serving larger public companies. However, enhanced transparency may have a limited effect on the availability and delivery of audit services if stakeholders continue to select larger audit firms due to existing relationships and perceptions about the larger audit firms' reputations. Also, even with greater transparency, the market may decide or perceive that larger audit firms are more capable of serving larger companies. For example, mid-size and smaller audit firms may be disadvantaged through disclosure of an audit firm's listing of audit clients, if the number of clients they have within an industry is less than larger audit firms. As a result of this disclosure, market participants may perceive mid-size or smaller audit firms do not have the industry expertise to serve them. Despite these limitations, investors, audit committees, and other stakeholders may be able to make more informed decisions with additional transparency.

The remaining discussion of this report focuses on specific possible disclosures related to audit firms' governance, audit quality indicators, and financial statements that may provide useful information when evaluating audit quality or may impact or give information relevant to the availability and delivery of audit services among audit firms. The discussion focuses on existing disclosures and additional disclosures, both qualitative and quantitative. Also, the report explores the parameters that should be considered in evaluating audit firm disclosures. For example, the report considers whether disclosures should be at the firm level, the engagement level, or both, and the intended audience for particular disclosures. The examples discussed in the following sections are not intended to be exhaustive or prescriptive but rather to provide conceptual ideas for consideration and to catalyze additional ideas.

III. TRANSPARENCY OF AUDIT FIRMS' GOVERNANCE

The governance, including the organizational structure, of audit firms is perceived to have a significant influence on audit quality and an audit firm's ability to continuously provide audit services to the market.[12] This report considers audit firm governance to include policies and structures that comprise how the entity is organized as well as the systems, policies, and procedures established to achieve various goals, including audit quality.

Selected Developments Internationally

Currently, in certain jurisdictions audit firms have begun or may begin shortly to disclose governance information as a result of legal and regulatory requirements. Also, some audit firms voluntarily disclose governance information. Examples of legal requirements for transparency of governance include the European Union's Directive 2006/43/EC of the European Parliament and of the Council, (8th Company Law Directive),[13] the Japanese Amended Certified Public Accountants Act 1948 (Japan CPA Act),[14] and the Canadian Public Accountability Board (CPAB) rule 212.[15] Additionally, in the United States, the Public Company Accounting Oversight Board (PCAOB) has issued rules on *Periodic Reporting by Registered Public Accounting Firms*[16] and the Department of the Treasury Advisory Committee on the Auditing Profession (U.S. Treasury Advisory Committee).[17] provided recommendations to expand transparency of audit firms' governance.

EU: The 8th Company Law Directive

The 8th Company Law Directive on statutory audits was adopted by the European Union (EU) in 2006 with a requirement for EU member states to implement its provisions by June 2008.[18]

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[12] See the consultation paper, *Audit Firm Governance*, published by the Institute of Chartered Accountants in England and Wales, which discusses an audit firm governance code intended to mitigate the risks of market exit and to provide a benchmark against which audit firms' current and future governance practices can be measured. The paper suggests audit firms comply or explain to help audit committees and other stakeholders make better informed decisions. The paper is available at http://www.icaew.com/index.cfm/route/161379/icaew_ga/en/Home/Institute_of_Chartered_Accountants_in_England_and_Wales.

[13] See Directive 2006/43/EC of the European Parliament and of the Council as of May 17, 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC available at http://eur-lex.europa.eu/LexUriServ/LexUriServ. do?uri=OJ:L:2006:157:0087:0107:EN:PDF.

[14] See Article 34-16-3 of the Japan CPA Act at http://www.fsa.go.jp/common/law/02.pdf.

[15] See the rule at http://www.cpab-ccrc.ca/ContentEnglish/CPAB_English_WhoWeOversee_participatingFirms_con.htm.

[16] See the rules at http://www.pcaobus.org/Rules/Docket_019/2008-06-10_Release_No_2008-004.pdf.

[17] The U.S. Treasury Advisory Committee issued a final report on October 6, 2008. The report includes recommendations to be considered by different market participants; therefore, none of the recommendations are currently required. The final report can be viewed at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

[18] Paragraph 1 of Article 53 of the 8th Company Law Directive provides that EU member states shall adopt and publish the provisions necessary to comply with the Directive before June 29, 2008.

Article 40 of the Directive, *Transparency Report,* (Article 40 Transparency Report) sets forth certain disclosure requirements related to an audit firm's governance,[19] which include the following:

a. A description of the legal structure and ownership;

b. Where the audit firm belongs to a network, a description of the network and the legal and structural arrangement in the network;

c. A description of the governance structure of the audit firm;

d. A description of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;

e. An indication of when the last quality assurance review took place;

f. A list of public interest entities[20] for which the audit firm has carried out statutory audits during the preceding financial year;

g. A statement concerning the audit firm's independence practices, which also confirms that an internal review of independence compliance has been conducted;

h. A statement on the policy followed by the audit firm concerning the continuing education of statutory auditors; and

i. Information concerning the basis for the partners' remuneration.

Japan: The Japan CPA Act

The Japan CPA Act and corresponding regulations, which came into effect in April 2008, introduced public transparency requirements for audit firms in Japan.[21] To ensure audit firms have proper quality control systems, audit firms are required to publish explanatory documents annually that include the following qualitative information related to governance:

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[19] Article 40 has other disclosure requirements, including the provision of certain financial information, that are not addressed herein because they do not focus directly on governance disclosures.

[20] The 8th Company Law Directive defines 'public interest entities' in Article 2 as

> entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC, credit institutions as defined in point 1 of Article 1of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC. Member States may also designate other entities as public interest entities, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees.

[21] Individual CPAs who do not belong to audit firms but audit large companies are also required to make public disclosures regarding governance information.

a. Purpose and history of the firm;

b. Limited or unlimited liability;

c. Overview of business;

d. Outline of audit services and non-audit services;

e. Performance of business operations and maintenance of "service control framework" (including measures aimed at ensuring proper execution of service, policy-setting and implementation of quality control management, measures to ensure non-CPA partners do not adversely affect quality of audit services, date of most recent quality control review by the Japanese Institute of Certified Public Accountants, confirmation by representative person as to policy-setting and implementation of quality control management);

f. Situation of alliance with other CPAs or audit firms;

g. Situation of alliance with foreign auditors (if it is a member of a network, overview of arrangement of such network);

h. Information on number of partners of audit firms, constitution of decision-making bodies, and locations and offices;

i. Organizational structure; and

j. Name of audited entities.

Canada: CPAB

The CPAB oversees auditors of Canadian reporting issuers and requires each of its participating audit firms to disclose non-public quality control reports.[22] Also, for each audit firm, the CPAB's website includes a public profile that includes the number of the firm's offices, the number and names of "authorized signing individuals" in total and by office, and the names and number of "reporting issuer audit clients by firm and by office."[23]

United States: The PCAOB and the U.S. Treasury Advisory Committee

The PCAOB rules, *Periodic Reporting by Registered Public Accounting Firms*[24] would require similar disclosure requirements of the CPAB regarding governance disclosures. The U.S. Treasury Advisory Committee also recommended increased transparency of an audit firm's governance. Specifically, the Committee recommended that:

> [T]he PCAOB require that, beginning in 2010, larger audit firms (those with 100 or more public company audit clients that the PCAOB inspects annually) produce a public annual report incorporating (a) information required by the Article 40 Transparency Report deemed appropriate by the PCAOB. . . and

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22 Although individual audit firm quality control deficiencies are kept confidential, the CPAB has issued public reports describing, generally, deficiencies observed across many firms.

23 See the CPAB rule at http://www.cpab-ccrc.ca/ContentEnglish/CPAB_English_WhoWeOversee_participatingFirms_con.htm.

24 See the final rules at http://www.pcaobus.org/Rules/Docket_019/2008-06-10_Release_No_2008-004.pdf.

(b) such key indicators of audit quality and effectiveness as determined by the PCAOB.[25]

Information Provided on a Voluntary Basis

Many audit firms voluntarily provide governance disclosures, usually on their websites and as part of their transparency reports. For example, in the United States, where limited requirements currently exist for audit firms to publicly report information about their governance, the disclosures often include information about the audit firm's governance structure, description about the audit firm's commitment to quality and integrity, and code of conduct. Also, disclosures required by the Article 40 Transparency Report are not yet effective but audit firms have started to provide the information on a voluntary basis through transparency reports.[26]

Possible Examples of Governance Disclosures

As noted above, governance disclosures differ across jurisdictions, perhaps due in part to the different objectives that these governance disclosures are intended to achieve. Notwithstanding these differences, some of these disclosures may be relevant to evaluating audit quality or the availability and delivery of audit services among audit firms. In addition, disclosures of other information about governance, including the organizational structure, beyond what is currently provided may also help in this regard. One way to group governance disclosures is by the following: (1) network, governance structure, and management of audit firms; (2) quality control systems; (3) human resource policies and procedures, including training; and (4) independence and ethics.

Network, Governance Structure, and Management of Audit Firms[27]

Some audit firms belong to a network of member firms. The design of network firms may have an impact on audit quality by promoting a certain degree of consistency in audits conducted by members of a network. Network firms generally share quality control systems, audit methodologies, firm names, logos, and technical resources. Transparency related to these arrangements and how they are structured and managed may allow for stakeholders to evaluate and compare how audit firms manage audit quality and to understand options regarding auditor

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[25] See Section VII:20-23 of the U.S. Treasury Advisory Committee Report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

[26] For example, see the UK transparency reports from Deloitte & Touche LLP Audit Transparency Report 2008 available at http://annualreport.deloitte.co.uk/audit-transparency-2008/, Ernst & Young Transparency Report 2008 available at http://www.ey.com/Global/assets.nsf/UK/EY_Transparency_Report_2008/$file/UK_ Transparency_Report_61008.pdf, KPMG LLP September 2007 has disclosed its listing of public interest entities at http://www.kpmg.co.uk/about/annualreport/documents/kpmgar_2007_public_interest_entities.pdf, and PricewaterhouseCoopers LLP Annual Report 2007 at http://www.pwc.co.uk/pdf/annual_report07.pdf.

[27] Article 1, paragraph 7 of the EU 8th Company Law Directive, *Definitions,* states, "network means the larger structure: which is aimed at cooperation and to which a statutory auditor or an audit firm belongs, and which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality-control policies and procedures, a common business strategy, the use of a common brand-name or a significant part of professional resources." The term "network" is used with the same meaning in this report.

choice.[28] Additional transparency about an audit firm's network may also allow investors and audit committees to better understand decision making at the network level as compared to the country-wide firm level. Similarly, how an audit firm's separate legal entities are structured and managed may also be important in understanding how a firm manages audit quality. For example, disclosure of the organizational structure could allow stakeholders to identify who the leader of an audit firm's risk management practice reports to within that individual audit firm structure. Examples of disclosures about networks, governance structure, and management of audit firms may include descriptions of the following:

a. The network and the legal and structural arrangement in the network;

b. The governance structure of the entire network and of the operations within a country, including a description of the board or committees in charge of managing the network or the country-wide firm and whether any members are independent. These disclosures could also include information about the balance between audit and non-audit board or committee members;[29]

c. The voting rights given to each audit firm within a network;

d. The liability and insurance arrangements within the network;

e. How global networks ensure compliance with standards in all jurisdictions in which the audit firm operates and what happens if an affiliate audit firm does not act in accordance with those standards, such as descriptions related to global management of quality assurance and risk management; and

f. The balance of power between the entire network compared to the country-wide firm level.

Quality Control Systems

Audit firms have legal and professional requirements to maintain quality control systems. Quality control systems are intended to provide reasonable assurance that the audit firm and its personnel comply with professional, regulatory, and legal requirements and that reports issued by the audit firm or engagement partners are appropriate in the circumstances.[30] The manner in which audit firms implement and monitor their quality control systems can directly impact audit quality. Transparency of audit firms' quality control systems and how audit firms implement and monitor these systems may provide additional information to stakeholders when comparing audit firms and considering how a firm focuses on audit quality. Examples of disclosures may include a description of the following:

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[28] See Section V:11 of the U.S. Treasury Advisory Committee's Report that discusses smaller audit firms which also belong to a network, available at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

[29] See Section V:15-16 of the U.S. Treasury Advisory Committee's Report that provides an overview of some of the network firms and the committees that manage the networks at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

[30] See International Standard on Quality Control 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements."

a. Internal quality control system of the audit firm and a statement by the administrative or management body on the operating effectiveness of the system;

b. Policies and results of internal quality control reviews and the audit firm's monitoring of quality controls, including client acceptance and continuance;

c. National office and other technical groups' resources and authority (*e.g.*, the experience, structure, reporting lines, and qualifications of the group); and

d. Risk management policies and procedures, including those related to managing litigation exposure.

HR Policies and Procedures, Including Training

Focusing on education of partners and staff, providing incentives for performing high quality audits, and proactively managing individual workloads are factors that may contribute to a culture that promotes audit quality. Human resource policies and procedures that give the highest priority to the performance of high quality audits in the evaluation, compensation, training, and retention of partners and staff are also factors that may have an impact on audit quality. For example, while compensation by itself may not be an indicator of audit quality, compensation policies and procedures that are linked to audit quality may create incentives for behaviors that lead to improved audit quality. Transparency related to these policies and procedures may allow stakeholders to evaluate which audit firms create environments conducive to the performance of high quality audits and for retention of strong performers. Examples of disclosures may include descriptions of policies and procedures for the following:

a. Continuing education and training;

b. Hiring and promotions;

c. How partners and staff are assigned to engagements and how their workloads are managed; and

d. How an audit firm's appraisal process and compensation relates to the performance of quality audits and to internal and/or external inspection findings.

Ethics and Independence

How an audit firm establishes, implements, trains, and monitors ethical policies and practices, including those related to independence, may have an impact on audit quality. For example, an audit firm that does not have formal policies on monitoring and educating ethical practices and requirements may be more at risk because certain members of an engagement are not independent. Transparency of how audit firms implement and monitor these policies and procedures provides investors and audit committees additional information when considering how a firm manages audit quality. Examples of such disclosures may include the following:

a. A description of the audit firm's independence policies and procedures;

b. Resources the audit firm devotes to ensuring the audit firm's independence is maintained;

c. A statement that confirms that an internal review of partner and staff compliance with independence policies and procedures has been conducted;

d. Code of conduct for employees; and

e. Disciplinary actions for violations of these policies.

Limitations of Additional Disclosures

In considering whether to require disclosure of elements of audit firms' governance, securities regulators may want to consider limitations, including negative consequences, of the disclosures and evaluate whether such limitations could be minimized. For example, governance disclosures are generally narrative and subjective in nature. As a result, evaluating or measuring audit quality on a consistent basis may be difficult. Also, audit firms may have flexibility in formulating their disclosures with a positive bias and over time disclosures may become boilerplate, which may reduce the ability of market participants to distinguish audit quality among firms. Further, stakeholders may find the disclosures difficult to understand without also providing additional information that facilitates an understanding of the auditing process.[31] To minimize these limitations, securities regulators may need to clearly define what should be disclosed and recognize the limitations of the disclosures chosen and consider whether oversight is necessary.

Request for Consultation:

3. Are there other areas of governance for which additional transparency should be considered?

4. Would the proposed disclosures mentioned above be useful in improving audit quality and availability and delivery of audit services to public companies?

5. Could other limitations arise if such disclosures were required?

[31] For example, see the *Auditor Communications*, Consultation Report, Report of the Technical Committee of IOSCO published in September 2009, which describes the "expectation gap" and identifies ways in which this expectation gap may be minimized. This is available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD303.pdf.

IV. TRANSPARENCY OF AUDIT FIRMS' AUDIT QUALITY INDICATORS

Transparency of governance may provide insights into how an audit firm manages audit quality through narrative disclosures but, as discussed above, these narrative disclosures are subjective. Therefore, the development of specific audit quality indicators may provide investors and other stakeholders with objective information that may help evaluate audit quality. Audit quality indicators should be factual measures, either quantitative or qualitative, that provide useful information when considering the evaluation of audit quality. Since audit firms can be expected to focus on the behaviors that influence the measures that are required to be disclosed, securities regulators and audit oversight bodies may want to consider disclosures relevant to audit quality or the availability and delivery of audit services. The scope and findings of audit firms' inspections may also be considered in developing relevant audit quality indicators.

The U.S. Treasury Advisory Committee discussed the issue of transparency of audit quality indicators,[32] and recommended that the PCAOB determine the feasibility of developing key indicators of audit quality and effectiveness for public disclosure. The PCAOB's Standard Advisory Group (SAG) publicly debated the issue during its October 2008 meeting.[33] Other jurisdictions already have legal disclosure requirements and audit firms have voluntarily disclosed certain information that could provide an indication of audit quality or availability and delivery of audit services.

For example, Article 42 of the EU 8th Directive requires auditors to annually confirm to audit committees, in writing, their independence and to disclose any additional services provided to the audited entity, threats to independence, and the safeguards applied to mitigate those threats. Additionally, PCAOB Rule 3526 requires audit firms to describe in writing to the audit committee all relationships that may reasonably be thought to bear on independence and confirm their independence on an annual basis.[34] Also, certain jurisdictions require disclosure of revenue or ratios of revenue for audit and non-audit services and information on disciplinary and criminal actions.[35]

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32 See Section VIII:14-17 of the U.S. Treasury Advisory Committee's Report discusses examples of input and output measures that could be quantified when measuring audit quality. These examples were discussed during testimony provided by various panellists and submissions of comment letters and include, but are not limited, to the nature and reason for restatements, average experience level of audit firm staff, and annual staff retention. See the report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

33 See the SAG paper issued by the PCAOB discussing the issue at http://www.pcaobus.org/Standards/Standing_ Advisory_Group/Meetings/2008/10-22/BP_Feasability_ AQI.pdf and the webcast at http://www.pcaobus.org/News_and_Events/Webcasts.aspx#57.

34 Details of the rule are available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Section_3.pdf. Also, the Japan CPA Act requires governance disclosure of "policy-setting and implementation of quality control management," including disclosure relating to maintaining independence.

35 Such countries include EU member states (pursuant to the Article 40 Transparency Report) and Japan (pursuant to the Japan CPA Act). Other countries are considering such requirements, including in the United States where the PCAOB has issued rules on *Periodic Reporting by Registered Public Accounting Firms*.

Some audit firms currently provide information about indicators of audit quality on a voluntary basis. For example, some audit firms disclose information about personnel, including the number of personnel by level (partner, client support, and practice support staff), geographic region, and average turnover rates by service line. Additionally, some audit firms voluntarily disclose information about their global revenues by service line, geography, and industry.

Possible Examples of Audit Quality Indicator Disclosures

The disclosure of each audit quality indicator has benefits and limitations, including potential negative consequences, which need to be assessed. When considering audit quality indicators, input and output measures should be considered.[36] The U.S. Treasury Advisory Committee defined input measures as indicators of what the audit firm puts into its audit work to achieve a certain result, and output measures as indicators determined by what the audit firm has produced in terms of its audit work.[37] As discussed in greater detail below, even if the inputs into the process are of a high quality, the resulting output of the process will not always be of a high quality, and the description of such indicators is subjective by its nature. Recognizing such inherent limitations, input measures, however, may still provide useful information of audit quality to market participants. Output measures, on the other hand, can provide objective information; however, they may not accurately reflect the quality of an audit, due to the subjective nature of audit quality itself. The following discussion identifies various input and output measures that could be used as audit quality indicators.

Input Measures

A. Experience, Competency, and Technical Resources

A key driver of audit quality could be the education, experience, and competency of the professionals delivering audit services. Competition among audit firms to recruit and retain human capital is intense, and audit committees and companies value the proficiency and knowledge of an audit firm and of an individual engagement team when making auditor choice decisions.

Examples of measures related to the education, experience, and competency of professionals within an audit firm may include average training hours, the percentage of an audit firm's revenues spent on training, headcount, employee turnover ratios, and average years of service. Also, narrative disclosures regarding educational background, competency, and experience, including industry experience, may be considered. Disclosure of these measures may provide users with information about an audit firm's commitment and ability to build the knowledge base and technical skills of its employees as well as retaining those skills, thereby increasing the likelihood of providing higher quality audit services.

Further, an example of a measure related to an audit firm's technical resources may include, if applicable, the ratio of national office staff and partners to the firm's total audit staff and

[36] See Section VIII:14-17 of the U.S. Treasury Advisory Committee's Report discussing input and output measures at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

[37] See Section VIII:16 of the U.S. Treasury Advisory Committee report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

partners. Disclosure of this measure may provide valuable information for users to assess the ability of an audit firm to address complex and technical accounting and auditing matters that may arise on an audit. This ratio might also provide an indication about an audit firm's infrastructure and ability to monitor and encourage audit quality.

B. Workload

Another driver of audit quality could be employee workloads. Providing high quality audit services requires diligence and a thorough execution of audit procedures necessary in the circumstances to meet professional responsibilities and requirements. The complexity of business and financial reporting and the extent of the requirements contained in the auditing standards of most jurisdictions place high demands on audit firm professionals. Further, audit firms are motivated by economic incentives to maximize the leverage of their human capital. If left unchecked, these pressures can result in unrealistic performance expectations and workloads on professional staff, particularly for more experienced members of an audit firm who are ultimately responsible for delivering high quality audit services.

Measures that may provide indications of employee workloads include average hours worked per week, average hours managed by partners, average number of clients per partner, and utilization percentages (the ratio of average professional hours provided by employees during a period to the number of hours available during that period based upon standard working conditions). Transparency of measures about the workloads of an audit firm's employees may provide incentive for audit firms to manage these workloads in a manner that would result in improvements to audit quality. An additional measure specifically applicable at the engagement team level is the percentage of a company's audit fee to the total audit fees managed by the engagement partner, which can provide indications about both the partner's workload and the relative level of economic incentive.

C. Leverage

A direct relationship may also exist between audit quality and the extent of involvement in an audit by more experienced members of an audit team. Audit firms that desire to provide high quality audit services manage constraints on the availability of human capital by using less experienced members of the engagement team to perform audit procedures in lower risk areas. Further, economic incentives could cause audit firms to leverage resources beyond a level that allows for high quality audits.

Measures that may provide indications of leverage include staff-to-partner ratios and the percentage of senior engagement team member time spent on an audit to the total audit time for all team members. Narrative disclosures could also be considered, such as descriptions of the roles of the engagement team members and the number of clients an audit partner and manager serve. Transparency of measures related to leverage may provide market incentives for audit firms to avoid excessive leverage, which could result in improved audit quality.

Output Measures

A. Revenue Information

Disclosure by audit firms of certain revenue information, such as revenues by service line (*e.g.,* audit, tax, consulting, and other), geographic region, and industry, may allow investors and other stakeholders to better understand an audit firm's relative strengths and potential conflicts. For example, an audit firm in which most revenues are generated from non-audit services may suggest greater potential for conflicts of interest if not managed through other safeguards. Further, revenue data by geography or industry could provide investors and other stakeholders with information about an audit firm's geographic reach and industry expertise.

B. Independence Matters

Investors must be able to rely on issuers' financial statements, which require the auditor to be independent from its client to avoid conflicts of interest that may affect the auditor's objectivity. Therefore, information about the number and nature of an audit firm's independence violations may provide a measure about a firm's audit quality and ability to deliver audit services.

C. Disciplinary Proceedings and Legal Matters

Audit firms' disclosures of information about its disciplinary proceedings, pending litigation, legal settlements, and insurance coverage may improve both audit quality and the availability and delivery of audit services. Disclosure of disciplinary proceedings may benefit audit quality by providing public information that could be used by investors and other stakeholders to identify potential weaknesses in an audit firm's audit quality. Although the existence of disciplinary proceedings or litigation claims does not automatically indicate that an audit firm has poor audit quality, this information could be useful as investors monitor an audit firm's performance and frequency of proceedings or litigation over time to identify potential trends. Further, since legal matters pose risks to the viability of audit firms, information about litigation and insurance may allow regulators and other market participants to better monitor the liquidity and viability of audit firms and take actions, if necessary, to prevent the compromise of audit-service availability if another audit firm's existence is threatened.

D. Restatement and Inspection Results

Additional output measures that may assist investors and other stakeholders in evaluating a firm's audit quality include the percentage of financial statements of a firm's audits that are restated (due to fraud or error) and the percentage of audits that require the performance of additional procedures resulting from regulatory or other outside inspection. Although a restatement of a company's financial statements does not automatically indicate the audit opinion was not supported by a quality audit that complied with all relevant auditing standards, information about the frequency with which financial statements audited by a firm are restated could influence investors and other stakeholders' confidence in a firm's audit quality.

Additionally, jurisdictions may differ on whether auditor oversight is performed by the profession or by an independent audit oversight body, but either way, it typically requires inspection of a firm's audit engagements for compliance with professional standards. In certain

instances, the audit firm inspections identify areas where the audit team failed to perform procedures that the inspection team deemed necessary to meet all relevant professional standards. In these circumstances, audit firms may perform additional procedures to determine whether their respective auditors' report remains appropriate. Accordingly, disclosure of the percentage of engagements inspected that resulted in the performance of additional audit procedures may also influence investors and other stakeholders' perception about a firm's audit quality.

E. Client Acceptance and Dismissal

Other output measures that may provide an indication about a firm's audit quality include trends related to new clients and audit-firm resignations and dismissals which may provide information that can be used to monitor a firm's audit activity over time. Information about an audit firm's new clients or dismissals may provide an indication to investors and others about the profile of companies for which an audit firm provides audit services. Also, trends that indicate an audit firm has gained or lost a significant portion of audit business in a particular geographic region may provide an indication to the market about the quality of that firm's audit services in that area.

Limitations of Additional Disclosures

While audit quality indicators may provide insight into audit quality, various limitations may need to be considered when evaluating whether disclosure of certain measures would be helpful. These limitations include the subjective nature of the concept of audit quality, the potential for negative consequences, and other implementation issues.

Subjective Nature

As previously discussed, because the definition of audit quality is subjective, any required disclosure of measures may need to be accompanied by contextual language or other qualitative information to aid users' understanding. This information could include an acknowledgement of the subjectivity involved in defining audit quality as well as a statement cautioning users that the measures may provide indications of audit quality but that audit quality cannot be determined solely by reference to one or more of the disclosed measures.

In addition, output measures may provide more objective information than input measures, but none of the possible indicators may be thoroughly suited to mirror adequately audit quality. For example, a restatement of financial statements could imply that the prior audit was not reliable, but it also could suggest that—if the restatement was the result of fraudulent financial reporting—the fraud was discovered due to a more robust audit procedure.

Negative Consequences

Although the intent of requiring audit firms to disclose certain audit quality indicators would be to improve audit quality, disclosure of such measures may also have negative consequences. Academic studies show a lack of conclusive evidence about whether many input-based factors have a direct positive relationship with audit quality. Industry experience of the engagement team and professional competence, however, may be two factors that appear to more consistently

support an association with improved audit quality, although these factors are difficult to measure in an objective manner.[38] As a result, audit firms may manage their resources to show improvements in input measures without producing a concurrent positive impact on audit quality. For example, an audit firm may have incentives to improve its ratio of senior engagement team members' time spent on the audit compared against total time spent on the audit by assigning more areas to the senior members of the audit team. However, in making this assignment, the senior members of the audit team may then have less time to spend in supervision; the higher-risk areas of the audit and the lower-level staff may not be receiving, respectively, sufficient attention or the right opportunities to develop proper skills as they advance in their career within the firm. Therefore, the audit firm may have improved its ratio but may have reduced audit quality in the short- and long-term.

Output measures also have limitations because the outcome of an audit is not immediately observable. Information about poor audit quality usually emerges in the context of certain business failures, such as instances involving restatements or those where the auditor failed to adequately consider an entity's ability to continue as a going concern. Or, it may never be known. Simplistic indicators, such as the size of an audit firm and the size of audit fees, arguably cannot be viewed as true measures of higher audit quality.[39]

Additionally, transparency may cause bias when audit firms make decisions about matters that may provide an indication of poor audit quality. For example, disclosure about the frequency with which financial statements audited by a firm are restated or the frequency with which an audit firm's inspection results in the performance of additional audit procedures could create an inappropriate bias when an audit firm evaluates whether a restatement or the performance of additional audit procedures is necessary. The consequence of these actions may be less confidence in the audit process, which results in less confidence in financial reporting overall. The potential selective use of audit quality indicators may also increase litigation risk for audit firms, which could have negative consequences on an audit firm's viability in certain jurisdictions because of the exposure within the legal system.

As further discussed in the *Parameters of Enhanced Disclosure for Audit Firms* section of this report, securities regulators may need to consider whether other mechanisms exist to mitigate these risks. For example, oversight of the reporting by audit firms may be needed to promote accurate reporting. Narrative disclosures may need to supplement the calculations to explain how an audit firm manages or is addressing less favorable measures. Also, expectations and education about various measures may need to be developed and communicated. For example, an expectation that an audit firm should have no inspection findings or restatements may be unreasonable relative to the costs, and educating market participants about this unrealistic expectation may be necessary. In time, the market may then develop benchmarks of acceptability.

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[38] See page 9 of the PCAOB SAG paper at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Feasability_AQI.pdf.

[39] For example, see page 9 of the PCAOB SAG paper at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/BP_Feasability_AQI.pdf.

Implementation Issues

A variety of other implementation issues also would need to be considered when deciding whether audit firms should disclose audit quality indicators, including what information is most useful in evaluating audit quality. Many potential audit quality indicators include variables related to "audit" professionals, "audit" services, "audit" clients, and "audit" firms. Consequently, in determining which audit quality indicators would be most useful in evaluating audit quality, it is important to consider (i) the definition of audit professional, (ii) the nature of services to be included in the calculations, such as whether measures should include a firm's total audit client base or only its public company audit base, and (iii) the identification of which types of audit firms are required to make requisite disclosures.

For example, although measures of audit quality will necessarily focus on a firm's audit practice, many audit firms utilize other specialists, such as tax or information technology professionals, to provide support for audit teams. Requiring these specialists to be included in certain of the audit quality indicator metrics, such as headcount, may provide the most complete information about a firm's audit practice, but determining how they should be included could be difficult. Similarly, consideration may need to be given to which services provided by an audit firm should be included in an audit firm's measure of audit quality. For example, most audit firms that audit publicly listed companies also audit non-public companies. Therefore, regulators would need to consider whether audit quality indicators should be based upon a firm's total audit portfolio or only its publicly-listed audit portfolio. Information about an audit firm's publicly listed audit portfolio may be more relevant to capital market participants, but may not provide a complete view of a firm's audit quality since many of the input measures, such as those relating to headcount and training, are based on factors affecting audit quality equally across an audit firm's entire business. Making a distinction between public and non-public activities, therefore, may not be possible.

Issues concerning identification of which audit firms would be required to make the disclosures and how such disclosures could be implemented are discussed further below.

Request for Consultation:

6. Can audit quality indicators provide objective information when evaluating a firm's audit quality? If so, do the ones identified in this report accomplish that goal?

7. In addition to the indicators identified in this report, are there any other audit quality indicators that should be considered for disclosure? Would disclosure of the audit quality indicators described above be helpful in evaluating audit quality?

8. In addition to the benefits or limitations identified in this report, are there any other benefits or limitations about disclosing audit quality indicators that need to be considered?

V. TRANSPARENCY OF AUDIT FIRMS' FINANCIAL STATEMENTS

Currently, certain countries require audited financial statements of audit firms to be publicly disclosed in specified circumstances,[40] and the U.S. Treasury Advisory Committee recently recommended that, beginning in 2011, the larger audit firms file audited financial statements with the PCAOB on a confidential basis.[41]

Benefits and Limitations

Financial statements of audit firms would benefit stakeholders in a number of ways. For example, financial statements would allow stakeholders to understand the financial condition and results of operations of an audit firm, which may be beneficial in determining the availability and delivery of audit services. Securities regulators could also consider this information in monitoring the viability of an audit firm, which may allow for actions to be taken, if necessary, to prevent companies from facing a shortage in audit services. Nevertheless, financial statements by themselves may only provide indirect evidence of audit quality. For example, if an audit firm's financial condition is strong, this may provide evidence that the audit firm has the ability to invest in improving audit quality, yet having such financial ability does not guarantee that future investments will be made or that improvements are not needed.

As with all disclosures, the benefits have to be compared against any limitations defined in the report, including any negative consequences that may arise. In addition to the benefits described above, some have also asserted that audited financial statements provide greater transparency, increase discipline, and help build accountability and trust. Others have expressed concern that audited financial statements could increase litigation settlements, which would harm competition among smaller and mid-size audit firms, and potentially threaten the viability of larger audit firms.[42]

Request for Consultation:

9. Can audited financial statements of audit firms provide useful or objective information regarding audit quality? If so, how?

10. If disclosure to the public or regulators of an audit firm's own audited financial statements is warranted, who should audit the auditors? Are firms other than the Big Four equipped to audit the Big Four? If not, does having the Big Four firms audit each other raise concerns? If so, how could any such concerns be addressed?

11. Can disclosing certain financial information instead of audited financial statements achieve the same objective of improving audit quality and the

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[40] Examples include the UK, Netherlands, and Japan.

[41] See Section VII:20-23 of the U.S. Treasury Advisory Committee Report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf. The Report noted that some believed the audited financial statement should be made public.

[42] See Section II:9, VII:22-23, and IX:1 of the U.S. Treasury Advisory Committee Report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

availability and delivery of audit services? If so, what financial information should be disclosed?

VI. PARAMETERS OF ENHANCED DISCLOSURE FOR AUDIT FIRMS

Additional considerations securities regulators may need to consider when determining whether to require additional disclosures by audit firms include:

- Whether the information should be publicly disclosed, provided to audit committees, or filed with a regulator;
- Whether and how regulators should be involved in ensuring the reliability of the disclosures;
- At what levels of the audit firm disclosures should be provided (*i.e.,* network level, country level, regional level, office level, or engagement level) and whether the disclosures should only be provided for the audit practice or for the entire operations of the audit firm;
- Whether the disclosures should be required for all audit firms, larger audit firms, or whether other criteria should be developed to determine which audit firms should provide the disclosures;
- How often the disclosures should be reported; and
- Whether the disclosures should be mandatory or encouraged.

The answers to these questions may not be the same for each disclosure item and one answer may not be exclusive to each question. For example, certain disclosures might be applicable at both the firm-wide and engagement level, and certain disclosures might be applicable for both an audit committee and regulator. When evaluating these questions, the purpose of the disclosure and potential limitations, including negative consequences, if any, may need to be considered.

Public vs. Confidential Disclosure

Additional transparency does not necessarily mean that everything has to be publicly disclosed. Investors, audit committees, and regulators each have distinct roles; therefore, certain information may be more relevant to one group as compared to others. For example, even if investors are ratifying the audit committee's decision on the appointment of an audit firm, they may rely on the audit committee to drive the process and recommend an audit firm. A regulator's role is to protect investors and ensure markets are fair, efficient, and transparent. As a result, this may indicate that more information should be given to audit committees and regulators than to the general public.

Certain information regarding the viability of an audit firm may be more relevant to regulators in their role of oversight as they are concerned about the availability and delivery of audit services as a profession compared to audit committees' concerns about whether their current audit firm or local engagement team has the capability of serving their company. Also, public disclosure of all information related to an audit firm's governance, audit quality indicators, or audited financial statements may have additional negative consequences. For example, having detailed public information regarding pending litigation cases may be seen as detrimental to the defense of the case, but the information might be relevant to regulators in considering the availability and delivery of audit services. Also, in certain jurisdictions, an independence violation occurs

regardless of materiality to the overall client relationship or financial statements; therefore, a requirement to disclose all independence violations may be more meaningful to audit committees and regulators than investors.

Monitoring the Reliability of the Disclosure

Limitations and potential biases that arise when certain information is disclosed may require regulators to monitor the reliability of the disclosures. Regulators' involvement may mitigate the risk that disclosures may be biased or inconsistent.[43] Regulators could decide initially to not regulate the disclosures, but instead, to monitor the implementation of the effectiveness of the disclosures and, if needed, begin to regulate the disclosures at a future date. Regulators could require amendments to the disclosure or initiate disciplinary actions if the disclosure is found to be inaccurate or misleading.

Extent of the Disclosure

The content of disclosures may determine whether information should be disclosed at a network, country, regional, office, or engagement level because certain information may be more relevant at one level than another. For example, quality control procedures that are applied on a network or country-wide level would only be applicable at that level. Disclosure of other information at various levels may be limited by practical considerations, and negative consequences could arise as a result of disclosure of information across multiple levels.

Who should Disclose

Requiring audit firms to expand their disclosures will necessarily result in incremental costs. Therefore, the costs and benefits of disclosure may influence whether certain disclosures should be required or which audit firms should be required to disclose the information.[44] Failure to do so could result in smaller and mid-size audit firms concluding that the additional disclosures are too costly and elect not to enter or choose to exit the market of serving large public companies. On the other hand, if mid-size or smaller audit firms are not required to disclose information, competition may be hindered as investors and audit committees will continue to lack information necessary to consider smaller and mid-size audit firms as potential alternatives to larger audit firms.

Moreover, if disclosures are required for all audit firms, consideration of the structure and complexity of audit clients may need to be considered. Large audit firms are structured differently than mid-size and small audit firms; therefore, securities regulators may need to consider how the disclosures can be comparable and scalable. For example, a small audit firm

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[43] The U.S. Treasury Advisory Committee recommended that the PCAOB monitor the audit quality indicators. See Section VIII:14-17 of the report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

[44] For example, Japan requires all audit firms to publicly disclose revenue from audit and non-audit services for the last two years as part of the explanatory document. For limited liability audit firms, they must also file financial statements for the past two years based upon Article 34-16-3 of the Japan CPA Act, and if their revenues exceed one billion yen, then the financial statements are required to be audited in accordance with Article 34-32 of the Japan CPA Act.

may not have central resources to assist with technical accounting and auditing matters due to their size. The disclosure may therefore need to be flexible to allow an audit firm without national or central resources to demonstrate how they manage technical accounting and auditing matters. By allowing this flexibility, investors, audit committees, and other stakeholders may make an informed decision about whether a specific audit firm can adequately service their client. Also, criteria other than the size of an audit firm might be considered, such as a criterion based on the types of companies a firm audits (*i.e.*, firms that audit companies with a market capitalization above a certain amount may need to publicly disclose more information than other audit firms).

Frequency of Disclosure

Consideration should be given to how often an audit firm may need to update these disclosures. Some disclosures, such as certain audit quality indicators and financial statements, might be more meaningful if updated annually. On the other hand, regulators should consider whether certain governance disclosures should be updated less often and only when significant changes have occurred.

Voluntary vs. Mandatory Disclosure

Regulators should also consider whether disclosure of information should be mandatory or encouraged. In certain jurisdictions, securities regulators may not have the authority to require disclosures of audit firms; yet if a securities regulator believes that additional disclosures are warranted, they could provide input to such legislators or other regulators who oversee the audit profession and/or standard setters for the auditing profession. In addition, securities regulators can also encourage "best practice" disclosures for audit firms.

If a decision is made by any regulator to encourage disclosure but not require it, then some audit firms could choose not to disclose anything or to disclose only what they believe is beneficial to themselves. In addition, voluntary disclosure may result in inconsistent disclosures among audit firms, which may make comparisons difficult. However, mandating disclosures may be costly, which might serve as a barrier to entry or as an incentive to exit the public company audit market. Alternatively, regulators may consider—instead of prescribing detailed disclosure requirements— establishing an audit quality framework which encourages disclosures as part of the audit firm's reporting obligations, similar to the approach developed in the United Kingdom.[45]

Request for Consultation:

12. Are there other parameters that should be considered?

13. Should certain disclosures not be publicly available and if so, what criteria should be considered when determining what disclosures should be publicly available?

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[45] See the FRC paper entitled, *The Audit Quality Framework* at http://www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web.pdf.

14. Should certain disclosures be made at the network, firm, and/or, engagement level?

15. Should there be different disclosure requirements for large, mid-size, and small audit firms?

16. Should the disclosures be mandatory and if so, should they be subject to regulatory oversight? Would a similar impact to the markets occur if the disclosures were encouraged instead of being mandatory? Should consideration be given to a framework of audit quality and allow for flexibility in the types of disclosures?

VII. SUMMARY

Transparency may improve audit quality, yet transparency of audit firms alone may not exclusively improve audit quality. Audit quality is difficult to define, and evaluating audit quality is subjective; therefore, disclosure of more information is not a guarantee that behavior will change. Nevertheless, additional disclosures may provide significant benefits and more objective information to investors, audit committees, regulators, and other stakeholders when evaluating audit quality among audit firms and engagement teams while making decisions.

Transparency may improve the availability and delivery of audit services, but other factors exist that transparency alone may not resolve. For example, other barriers to entry may prevent audit firms from acquiring the human resources and expertise necessary to offer the wide geographical reach, as well as the technical competence, required by larger public companies. As a result, additional transparency may confirm that larger audit firms are best suited to serve large public companies. Stakeholders may also continue to select larger audit firms because of past relationships and established reputations. Certain small and mid-size audit firms may then elect not to compete in serving larger companies for a variety of reasons, including litigation risk and their business strategy.[46]

Certain jurisdictions have already or are in process of requiring transparency of audit firms. To date, these disclosures have principally been focused on narrative disclosures and certain financial information but not on audit quality indicators. Some jurisdictions are starting to analyze the benefits and limitations of disclosing audit quality indicators. This report is intended to facilitate consideration of the issues surrounding transparency of audit firms.

Request for Consultation:

The Task Force seeks public input on the following additional matters to facilitate its consideration of the issues surrounding transparency of firms that audit public companies:

17. Would transparency of audit firms improve audit quality and the availability and delivery of audit services? What negative effects, including costs, of increased transparency should regulators consider?

18. Would investors have increased confidence in financial reporting as a result of increased audit firm transparency?

19. Are there significant benefits to investors of increased audit firm transparency, since they invest in companies and not audit firms?

20. Should regulators consider areas outside of audit firms' governance, audit quality indicators, and financial statements for potential disclosures?

[46] See Section VIII:4 of the U.S. Treasury Advisory Committee Report at http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

APPENDIX I

IOSCO TASK FORCE ON AUDIT SERVICES

Consultation Report on the Transparency of Firms that Audit Public Companies

Interim Chairman: Mr. Ethiopis Tafara
US Securities and Exchange Commission

Comisión Nacional de Valores (Argentina)	Mr. Emilio Ferre
Austrialian Securities and Investments Commission (Australia)	Mr. Mark Adams Mr. Lee White
Comissão de Valores Mobiliários (Brazil)	Mr. Eduardo Manhães
Ontario Securities Commission (Ontario, Canada)	Mr. Cameron McInnis Mr. James Turner Ms. Ilana Singer
Autorité des marches financiers (Quebec, Canada)	Mr. Jean Lorrain Mr. Louis Morisset
Autorité des marches financiers (France)	Ms. Sophie Baranger Ms. Marion Bougel-Bomtemps
Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	Dr. Christian Schindler Mr. Philipp Sudeck
Securities and Futures Commission (Hong Kong)	Mr. Charles Grieve Ms. Susan Lau
Commissione Nazionale per le Società e la Borsa (Italy)	Ms. Nicoletta Giusto
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Comisión Nacional del Mercado de Valores (Spain)	Mr. Eduardo Manso

	Mr. Antonio Mas
Eidgenössische Finanzmarktaufsicht FINMA (Switzerland)	Mr. Jehle Bernhard Mr. Heinz Meier
Financial Services Authority (United Kingdom)	Ms. Patricia Sucher Mr. Richard Thorpe
Securities and Exchange Commission (United States)	Mr. Ethiopis Tafara Ms. Julie Erhardt