

CHAPTER 4 – AUDIT FIRMS

4.1 Approximately 15,000¹ entities file financial statements with the Securities and Exchange Commission (SEC); about 1,200 of those entities are foreign registrants.² Those financial statements are audited by international, national, regional and local accounting firms, most of which are members of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA).³ The Panel studied, among other things, the overall “tone at the top” in the firms, their hiring and employee retention policies, the professional development of auditors, the assignment of personnel to audits, the performance measures used by the firms to evaluate audit personnel, and time pressures on auditors.⁴ The Panel focused primarily, but not exclusively, on the eight largest firms.⁵

PROFESSIONAL LEADERSHIP – THE TONE AT THE TOP

4.2 The “tone at the top” of an audit firm is a major influence on its culture. It determines, for example, whether the culture is quality-oriented or sales-oriented, and whether top management extols the important role audits play in the capital markets or acts as if audits are little more than minimum-value commodities.

4.3 Audit personnel constantly receive messages from firm management on such topics as audit efficiency and effectiveness, client service, client relationships, profitability, marketing of services and development of personnel. Often these messages only indirectly imply that quality audit work is an integral part of quality client service. They often do not focus directly on audit quality in the context of a service provided to protect the interests of the investing public.

Findings

4.4 Focus group participants often indicated that not only clients, but also engagement partners and firm leaders, treat the audit negatively – as a commodity. Some respondents to the Panel’s survey and some engagement teams interviewed in the QPR process expressed a similar view, in some cases implying, by the more positive comments made about the firms’ other service lines and their perceived higher levels of growth and profitability, that the audit was viewed as a commodity. The emphasis on providing profit-enhancing ideas to the client’s management, so the audit would appear to have value

¹ Internal SEC staff estimates as of March 2000.

² 1999 annual report of the Securities and Exchange Commission, *SEC Annual Report 99*, p. 76 (U.S. Government Printing Office).

³ The SECPS has approximately 1,300 member firms; however, only approximately 800 of them audit SEC registrants. There are approximately 50 U.S. accounting firms that audit U.S. domiciled registrants but are not SECPS members.

⁴ The Panel makes no recommendations on firms’ hiring and retention policies and the assignment of personnel, and accordingly they are not discussed in this chapter.

⁵ Appendix B provides information about the firms.

beyond meeting statutory requirements, also contributed to the perception that the audit itself had little value. All of the firms represent that they are placing significant emphasis on their audit practices. Furthermore, some firms have indicated that, following the divestiture of their consulting practices, they will place even more emphasis on their audit practices. The Panel views this as a positive development.

Recommendations

To audit firms:

4.5 The Panel recommends that audit firms:

- Emphasize to all audit personnel the importance of performing high-quality professional work. This message should be delivered frequently by the CEO, COO, leaders at the firm's regional and office levels, and the head of the assurance practice, as well as by the firm's top technical partners. It should stand out above all other messages.

The message should be a positive, constructive message that is refreshed frequently so it commands attention, rather than becoming a tired slogan that is ignored. For example, it might reference specific situations where client management, audit committees or others recognized and applauded audit quality. In addition, situations could be recognized in which individuals or engagement teams took difficult stands on earnings management issues, issues involving possible management fraud or illegal acts, or contentious accounting issues. Other messages might cover important developments in the profession that affect the quality of accounting and auditing.

- Address the importance of the role and responsibility of audit professionals, as well as the concepts of integrity and objectivity, independence, professional skepticism and accountability to the public. These concepts should be introduced on or near the day professionals, both experienced and inexperienced, are hired. They should be reinforced regularly and be integral to the firm's training efforts.
- Develop marketing and advertising messages targeted to users of audited financial statements, coordinated with similar AICPA messages, which promote the importance of audits.

To the SECPS Peer Review Committee:

4.6 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess the timeliness, frequency and appropriateness of internal messages from firm leaders about audit quality

- Include their findings in this area in their reports to the SECPS Peer Review Committee

To the AICPA:

4.7 The Panel recommends that the AICPA develop messages targeted to both audit professionals and users of audited financial statements that promote the importance of audits.

PROFESSIONAL DEVELOPMENT

4.8 Audit firms have faced major challenges in recent years in maintaining the necessary level of professional competence on the part of their audit personnel. The challenges include increased business complexities and risks, the rapid pace of technological change, changes in audit methodologies, the globalization of business, significant regulatory developments, new and often complex accounting and auditing standards and a decreasing number of university graduates who intend to enter the accounting profession.

Findings

4.9 Participants in the focus groups, respondents to the Panel's survey, presenters at the Panel's public hearings, personnel in the offices visited in the QPRs and others expressed their views regarding both continuing professional education and collegiate education. In addition, the Panel reviewed the eight largest firms' instructor-led and self-study course catalogs and selected course content, coaching and mentoring programs, and average training hours per auditor by experience level.

Continuing Professional Education

4.10 Average continuing professional education (CPE) hours per audit professional, across all levels of experience in the large firms, are well above professional and regulatory requirements, and have changed little in recent years. Formal CPE is in addition to on-the-job training, which is the primary vehicle for the professional development of auditors. The firms also have invested heavily in new technology-driven, information-sharing systems, which include extensive databases of technical, industry and other resource materials. These systems serve as a means of delivering training programs and as important sources of professional self-development.

4.11 The firms support an impressive array of instructor-led and self-study programs directed at developing broad-based business professionals and skilled auditors. Professional development programs typically are standardized for less experienced personnel and focus on technical accounting knowledge and audit skills, industry knowledge, interpersonal skills and administration of work assignments. Programs for more experienced professionals generally are more tailored to the individual's needs and most often include technical topics, industry programs, and skills related to personnel development (including coaching and mentoring), relationship building and practice development. Formal training at all levels also includes using technology to deliver internal

communications, research resources and individual learning. The Panel supports the emphasis on coaching and mentoring and the use of high-quality, technology-based delivery tools as supplements to traditional instructor-led programs.

4.12 Participants in focus groups and other Panel activities indicated that partners and other supervisory personnel, and sometimes the firms themselves, do not always view professional development as a high priority. This negatively affects on-the-job learning, and at times interferes with attendance at scheduled formal training programs and the effective use of self-study programs. The participants also noted that auditors need improved knowledge and skills to respond to the increased audit demands called for by the Panel's recommendations in Chapters 2 and 3. The participants indicated that current professional and regulatory CPE requirements are focused on the attainment of a specified number of training hours and are, in general, less than effective in providing auditors with the necessary levels of skills and competence. The Panel believes that outcome measures, such as assessments of performance against agreed-upon knowledge and competency criteria, would be more effective in developing auditors' skills and improving audit quality.

4.13 The profession's approach to professional development has started to move toward self-directed, competency-based learning. Several firms have developed "competency models" that reflect the firms' skills and competency expectations for each experience level, which are then incorporated into their performance management processes. The AICPA, working cooperatively with the National Association of State Boards of Accountancy, has issued an exposure draft of a *Statement on Standards for Continuing Professional Education* that incorporates the core competency concept. The Panel supports these steps to improve the focus, relevance and effectiveness of CPE.

Collegiate Education

4.14 The Panel did not study the extent to which entry-level audit personnel bring to the firms the necessary knowledge and skills to respond to the increased audit demands called for by the Panel's recommendations in Chapters 2 and 3. As indicated above, however, improved knowledge and skills are required, whether they are brought to the firms by newly hired personnel or are obtained afterward by formal CPE or on-the-job training. Numerous participants in the focus groups stated that collegiate accounting programs do not always adequately prepare entry-level personnel for auditing.

4.15 Throughout the project, the Panel has listened to concerns about the decline in the number of accounting majors. Perceptions that other careers are more attractive along with negative perceptions or misperceptions about the work of accountants and auditors, compensation, workloads, family or lifestyle, and increased educational requirements⁶ are often included among the factors contributing to this decline.⁷ While the larger firms generally believe that they have been able to hire sufficient numbers

⁶ According to the AICPA website (August 2000), 48 of the 54 jurisdictions that issue CPA licenses have adopted the 150-hour education requirement as a prerequisite to sit for the Uniform CPA Examination. However, the requirement is not yet effective in 15 of the 48 jurisdictions.

⁷ A report commissioned by the AICPA and conducted by The Taylor Research & Consulting Group, Inc., *Student & Academic Research Study Final Quantitative Report* (July 2000), discusses a number of these issues.

of qualified people to meet their needs, they too have expressed concerns about the future. These concerns led the Big 5 firms along with the American Accounting Association (AAA), AICPA, and Institute of Management Accountants (IMA) to sponsor a project to reconsider and transform accounting education. In August 2000, the sponsors published a monograph that discusses a number of issues and makes recommendations for improving accounting education.⁸ The Panel applauds this step and encourages firms (both large and small), the AAA, AICPA, IMA and other interested parties to work together to address this crucial challenge.

Recommendations

To audit firms:

4.16 The Panel recommends that audit firms:

- Support and adopt the competency-based learning concepts in the AICPA exposure draft, *Statement on Standards for Continuing Professional Education*, and use a core competency model that is similar in design to the AICPA model as a basis for career planning and self-assessing whether individual performance and competency goals are being achieved
- Make increased knowledge and skills a high priority for all experience levels, with a particular focus on meeting the increased audit demands called for by the Panel's recommendations in Chapters 2 and 3

To the SECPS Peer Review Committee:

4.17 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess whether engagement teams have the requisite knowledge and skills for the particular engagements
- Make qualitative assessments of the audit firm's policies and performance related to professional development
- Include their findings in this area in their reports to the SECPS Peer Review Committee

⁸ W. Steve Albrecht and Robert J. Sack, "Accounting Education: Charting the Course through a Perilous Future," *Accounting Education Series*, Volume No. 16 (August 2000).

To the AICPA:

4.18 The Panel recommends that the AICPA assist firms in adopting the competency-based learning concepts in the AICPA exposure draft, *Statement on Standards for Continuing Professional Education*, and in using a core competency model that is similar in design to the AICPA model as a basis for career planning and self-assessing whether individual performance and competency goals are being achieved.

PERSONNEL MANAGEMENT

4.19 Audit firms devote significant time and resources to personnel management. Although each firm has unique policies and procedures, their evaluation criteria all generally encompass industry knowledge, client relationship building, practice development activities (including cross-marketing), and interpersonal, administrative and technical skills. Incentive compensation programs exist in most firms. Quantifiable incentive measures typically are related to practice development, revenue growth and practice profitability. Measures related to technical skills and the quality of professional work – which are considered in firms’ internal inspection programs and in peer reviews – typically are more subjective and consequently not consistently as influential in their incentive compensation programs.

Findings

4.20 The Panel found that generally there is an appropriate focus on technical skills and the quality of professional work, and a reasonable balance of these items with other criteria. Focus group and QPR participants expressed few concerns about the attention firms give to personnel evaluations and rewards or about their overall effectiveness. Participants at all levels spoke positively about the benefits of mentoring programs. Some audit managers believed that their firms sometimes overemphasize new business development in measuring performance. Other participants commented about the need for firms to develop innovative compensation plans that would add to the attractiveness of auditing as a profession.

Recommendations

To audit firms:

4.21 The Panel recommends that audit firms:

- Review performance measures for all experience levels, and ensure that performing high-quality audits is appropriately recognized as the highest priority in performance evaluations and in compensation, promotion and retention decisions for all personnel. The measures should focus on such matters as (1) the depth and substance of understanding of the client’s business and risks, (2) responsiveness to unexpected or unplanned conditions encountered in audits, (3) development of innovative audit approaches, (4) professional skepticism and

persistence, and (5) knowledge of accounting principles and practices.

- Work cooperatively with the SECPS in developing effective measures of audit quality and incorporate those measures into their internal inspection processes. (See the Panel's recommendations to the SEC Practice Section in the section "Enhancing Peer Reviews" in Chapter 6.)

To the SECPS Peer Review Committee:

4.22 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess the role that performing high-quality professional work plays in performance reviews and in compensation, promotion and retention decisions at all levels of audit personnel
- Include their findings in this area in their reports to the SECPS Peer Review Committee

TIME PRESSURES ON AUDITORS

4.23 Time pressures on auditors have been a pervasive and long-standing issue within the profession. The Commission on Auditors' Responsibilities initially raised the issue of time and budget pressures as a factor in substandard audits.⁹ In addition to having an immediate potential effect on the quality of audit work, over time, these pressures may reflect negatively on job satisfaction, on the desirability of choosing a career in auditing and ultimately on the profession's ability to attract and retain high-quality personnel.

4.24 The Panel believes that time and fee budgets, unexpected turnover of engagement personnel, and sometimes unrealistic client-imposed or internally imposed deadlines can place significant pressures on engagement teams. These pressures can create an environment in which audit quality might be compromised if engagement team members, at any level, perceive that their individual performance is measured primarily by meeting time deadlines and budget estimates. These threats to audit quality frequently appear at or near the completion of the engagement in the form of client pressures on the engagement team to "finalize the audit" and hurry the issue-resolution process.

Findings

4.25 No focus group participant indicated any personal involvement in either self-imposed, firm-imposed or client-imposed time pressures that resulted in compromised audit quality, and this generally was confirmed by the QPR process. Focus group participants, however, suggested that time pressures can and often do place stress on the audit process and have the potential to affect audit quality

⁹ Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations*, 1978. This commission often is referred to as "the Cohen Commission."

adversely. The study of SEC Accounting and Auditing Enforcement Releases indicated that, in a limited number of instances, succumbing to time pressures may have contributed to the auditors' failure to detect material misstatements.¹⁰ Conversely, in other situations the auditors' resistance to time pressures may have facilitated the detection of material misstatements.

4.26 The Panel recognizes that client deadlines and engagement budgets are a necessary part of the audit process. It also recognizes that many firms have controls built into their audit processes that are designed to help detect and correct quality issues arising from time pressures. Nonetheless, managing the potential risks from excessive time pressures on engagement teams must be a high priority. Performance measures need to be balanced and clearly and carefully communicated to all professionals to ensure that all personnel understand that quality work, not meeting time deadlines and budget estimates, is the ultimate priority.

Recommendations

To audit firms:

4.27 The Panel recommends that audit firms:

- Expand the client acceptance and continuance assessment processes to include inquiries about possible time pressures on specific engagements that could create an environment in which audit quality might be compromised
- Provide guidance and training on actions that engagement partners and other supervisory personnel should consider in managing time pressures
- Incorporate appropriate measures of partners' and other supervisory personnel's abilities to manage time pressures in upward evaluations or other similar feedback processes
- Reaffirm periodically with partners and managers the importance of establishing realistic time budgets and work loads

To the SECPS Peer Review Committee:

4.28 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess the extent of time pressures on audit engagements and the firm's success in managing those pressures
- Include their findings in this area in their reports to the SECPS Peer Review Committee

¹⁰ See Appendix F.

SMALLER FIRM CONSIDERATIONS

Findings

4.29 The Panel staff met with several partners from smaller firms, each of whom had extensive experience performing peer reviews of firms of similar size. Discussions with these and others indicated that smaller firms generally have a strong commitment to quality audit work. The focus group members also thought that the professionalism of people working in these firms is very high.

4.30 Some concerns were expressed, however, about the limited resources available in smaller firms for consultation on technical accounting and auditing issues, difficulties in obtaining concurring partners with the appropriate technical and industry skills, and difficulties in assessing engagement risk (client acceptance and continuance), especially when considering whether to accept a new audit client that previously had been served by a large firm.

4.31 The findings and related recommendations in each of the preceding subsections generally apply to smaller firms as well as the large firms.

Recommendations

To the AICPA:

4.32 The Panel recommends that the AICPA:

- Provide greater audit-related assistance to smaller firms, particularly technical and industry accounting and auditing support and consultation
- Consider additional means by which smaller firms can meet the SECPS concurring partner requirement
- Develop software and other tools to assist smaller firms in assessing engagement risk (client acceptance and continuance)

