December 7, 2010

European Commission
Via email to markt-greenpaper-audit@ec.europa.eu

RE: GREEN PAPER Audit Policy: Lessons from the Crisis

Dear Commission Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the GREEN PAPER Audit Policy: Lessons from the Crisis.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Commission. If the Commission has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Committee Members and Contributors:
Chair – Joseph Brazel, North Carolina State University
Past Chair – James Bierstaker, Villanova University
Jong-Hag Choi, Seoul National University
Steve Glover, Brigham Young University
Linda Myers, University of Arkansas

Responses to Specific Questions in Part II of the Release

Question #1

Do you have general remarks on the approach and purposes of this Green Paper?

Some of the committee believes that the Big 4 Accounting Firms are already too big to fail. For example, the U.S. Government Accountability Office rejected firm rotation because it was not feasible. Clearly, if a Big 4 firm failed it would be a very complex and costly transition. In addition, both liability caps and protocols for transition are needed.
Question #4

Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?

Currently U.S. auditors comment on the financial health of the company when they issue going concern opinions. Perhaps they could be allowed to comment on situations where financial health is deteriorating, but has not reached a going concern status.

Question #5

To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?

Yes, members of the committee currently think users have a very difficult time understanding the audit process.

Furthermore, without revisions to the audit report and the financial reporting models, the gap seemingly will keep increasing. The complexity and estimation uncertainty inherent in financial statements have changed dramatically over the past few decades; however, the format of financial statements, the nature of assurance provided for accounting estimates, and content in the auditor’s report have changed very little. In a recent study (Christensen et al. 2010) considers whether accounting standards requiring fair value estimates may have outstripped the auditor’s ability to support the level of assurance required by auditing standards. The study examines estimates reported by public companies and finds that the level of estimation uncertainty or imprecision in reported fair value measurements (and net income) can be many times (50 to 100 times) greater than materiality. This suggests that auditors properly applying both accounting and auditing standards will increasingly be required by standards to provide what may be impossible: high assurance that financial statements including estimates with extreme measurement uncertainty are materially correct. Users continue to behave as if specific values reported are precise. The study discussed the limitations of current footnote disclosures and recommends changes to auditing standards, auditor reports, and the financial reporting framework. The nature of audit assurance provided to users with respect to extremely uncertain fair value estimates may need to be different than the assurance provided on accounts that can be precisely measured.

Question #6

Should "professional scepticism" be reinforced? How could this be achieved?
Professional scepticism can be reinforced through training, but most importantly through observing the actions of superiors in the field (i.e., superiors on the audit engagement team).

**Question #8**

*What additional information should be provided to external stakeholders and how?*

More non-financial lead indicators, such as customer and employee satisfaction, should be included in financial reports and audited.

A recent study (Brazel et al. 2009) examines whether auditors can effectively use nonfinancial measures (e.g., employee headcount, production space, number of retail outlets) to assess the reasonableness of financial performance and, thereby, help detect financial statement fraud (hereafter, fraud). If auditors or other interested parties (e.g., directors, lenders, investors, or regulators) can identify nonfinancial measures (e.g., facilities growth) that are correlated with financial measures (e.g., revenue growth), inconsistent patterns between the nonfinancial and financial measures can be used to detect firms with high fraud risk. The authors find that the difference between financial and nonfinancial performance is significantly greater for firms that committed fraud than for their non-fraud competitors. The researchers also find that this difference is a significant fraud indicator when included in a model containing variables that have previously been linked to the likelihood of fraud. Overall, the study’s results provide empirical evidence suggesting that nonfinancial measures can be effectively used to assess the likelihood of fraud.

In a separate study, Brazel et al. (2010) conducted an experiment to determine if and how nonprofessional investors react to red flags related to fraudulent financial reporting. The researchers also examined if making red flag data more transparent affects investor judgments. Investors reviewed information related to a hypothetical company and decided whether to increase or decrease their investment. The authors manipulated the presence of two specific red flags between investors: (1) a large difference in sales growth and growth in related nonfinancial measures (e.g., number of employees, size of production space), and (2) a large difference between net income and cash flow from operations (i.e., high accruals). In general, the study did not find that investors reacted uniformly to red flags. The researchers found making a large difference in sales growth and growth in corresponding nonfinancial measures (NFM) transparent led to lower investment levels. Conversely, they did not observe investors decreasing investment levels when the accrual red flag was present, even when it is made more transparent. Analyses revealed that investors perceived the NFM red flag to be more intuitive and this difference likely drives their conflicting results. Interestingly, if the NFM red flag is not made transparent to investors, investors
appear to interpret the abnormal inconsistency as a positive signal regarding operational efficiency and, in turn, increase their investment levels.

In light of these findings, we suggest that the commission consider the disclosure of key financial measures (e.g., revenue, total assets, net income) and related nonfinancial measures (e.g., number of retail outlets, distribution centers). This disclosure should be comparative (current year and prior year) and provide percentage changes for these measures. Last, requiring such disclosure in a footnote would require the nonfinancial measures to be audited, thus increasing the reliability of the disclosure to financial statement users.

Question #9

*Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?*

The audit committee should have some meetings with internal and external auditors without management present.

Question #11

*Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?*

It might be difficult to reduce the time gap until companies have dealt with the IFRS transition.

With regard to accelerating filings of audited financial statement information, the U.S. Security Exchange Commission (SEC) rules 33-8128 and 33-8644 substantially reduce the 10-K filing period for large accelerated filers and accelerated filers from 90 days to 60 and 75 days, respectively. Large accelerated filers are firms with a market value of equity greater than $700M and accelerated filers have a market value of equity between $75M and $700M. The SEC has twice reduced filing periods by 15 days. For many firms and their auditors, these rules have led to mandatory reductions in audit delay (i.e., the length of time from a company’s fiscal year-end to the date of the auditor’s report). A recent study by Lambert et al. (2010) investigates the potential effects of this regulation by examining under what contexts these mandatory reductions have been associated with changes in earnings quality. The authors use discretionary accruals and other measures to proxy for earnings quality. The researchers find that larger mandatory reductions in audit delay (≥ 15 days) more negatively impact earnings quality than smaller mandatory reductions. This result suggests an unintended consequence of the SEC’s two separate 15-day reductions in filing deadlines (i.e., lower earnings quality). The relation between audit delay reductions and earnings quality also appears to be more acute for both “busy-season” audits (vs. non-busy season
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Audits) and accelerated filers (vs. large accelerated filers). Overall, these findings support claims by auditors and preparers that accelerated filings would lead to reductions in the quality of financial information supplied to external users.

**Question #12**

*What other measures could be envisaged to enhance the value of audits?*

We suggest the disclosure (in a footnote) and auditing of nonfinancial measures that correlate with the financial performance depicted by financial statements. See our response to Question 8 above.

**Question #16**

*Is there a conflict in the auditor being appointed and remunerated by the audited entity?  
What alternative arrangements would you recommend in this context?*

Audit committees (as a subcommittee of the board of directors consisting solely of outside directors) should appoint (and if needed fire) the auditor, as well as approve all fees for audit and non-audit services. The audit committee should seek to avoid situations where auditors are auditing their own work (via the provision of non-audit services).

**Question #18**

*Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?*

Several empirical studies explore how auditor tenure affects financial statement quality and/or audit quality (or perceptions of quality) and suggest that these relations provide evidence on auditor independence. Regulators and some investor groups suggest that mandatory auditor rotation will strengthen auditor independence, leading to higher quality audits and higher quality earnings.

Some papers use abnormal accruals to proxy for the quality of financial reports. Myers et al. (2003) find that abnormal accruals are lower when the auditor-client relationship is longer. They suggest that auditors with longer tenure more effectively constrain earnings management, suggesting higher earnings and audit quality with longer auditor tenure. Similarly, Johnson et al. (2002) find that financial reporting quality is lower when auditor tenure is short (e.g., two to three years in length) versus when it is longer (e.g., four to eight years in length). Moreover, they find no evidence of reduced financial reporting quality for clients with auditor tenures of nine or more years. In addition, using a sample of former Arthur Andersen clients, Blouin et al. (2007) investigate the effect of a forced auditor change on financial statement quality; they find no significant
improvement in earnings quality for companies that did not follow the former Andersen audit team, suggesting that mandatory auditor rotation may not improve earnings quality.

Other papers study the relation between auditor tenure and conservatism. For example, Jenkins and Velury (2008) find that conservatism increases as the auditor-client relationship lengthens. They document an increase in conservatism between short and medium tenure and find that conservatism does not deteriorate over long tenure. They suggest that mandating auditor rotation may have an adverse effect on the conservatism in reported earnings.

Still other papers use fraud to proxy for earnings quality. Carcello and Nagy (2004) find that fraudulent financial reporting is more likely to occur in the first three years of the auditor client relationship, further suggesting that mandatory auditor rotation may have adverse effects on audit quality. Geiger and Raghunandan (2002) report similar findings.

Some recent studies have examined other facets of earnings quality and auditor tenure. Gul et al. (2009) examine whether industry specialization of auditors and discounting initial fees affect the association between auditor tenure and earnings quality and find that the association between shorter auditor tenure and lower earnings quality is weaker for firms audited by industry specialists compared to non-specialists.

With respect to perceptions, Ghosh and Moon (2005) find a positive association between investor perceptions of earnings quality and auditor tenure. They also find that the influence of reported earnings on analyst stock rankings is larger with longer tenure, and that the influence of past earnings on analyst earnings forecasts increases with tenure. Overall, their results suggest that investors and information intermediaries perceive auditor tenure as improving audit quality.

Last, some international studies explore the relation between earnings or audit quality and audit partner tenure. For example, Chen and Lin (2008) investigate the relation between earnings quality (using discretionary accruals as a proxy) and audit partner tenure using a sample of Taiwanese companies for which the audit report is signed by two audit partners. They find that accruals are decreasing in audit partner tenure, suggesting that earnings quality is higher when audit partner tenure is longer.

Overall, the empirical evidence to date overwhelmingly suggests that earnings quality (and therefore audit quality) does not decrease as the length of the auditor-client relation lengthens.
Question #19

*Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?*

See our response above to Question #16 regarding non-audit services.

Question #20

*Should the maximum level of fees an audit firm can receive from a single client be regulated?*

At some point the commission may consider regulating fees as follows: the fees that an office (or firm) receives from one client as a percentage off all fees received from all clients (for the office or the entire firm). It is possible that, as this percentage increases, auditor independence could diminish (because the office or the firm is more dependent on the client’s fees). However, we would like to highlight that Craswell et al. (2002) examined this issue and found no empirical evidence that such fee dependence impacts auditor independence.
References


Lambert, T., J. Brazel, and K. Jones. 2010. Unintended consequences of accelerated filings: Are mandatory reductions in audit delay associated with reductions in