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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors (October 26, 2021)

Statement

The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors

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Oct. 26, 2021

Introduction[1]

As we mark the upcoming twentieth anniversary of the enactment of the Sarbanes-Oxley Act of 2002 (“SOX”),[2] it is critical for all gatekeepers in the financial reporting ecosystem (auditors, management, and their audit committees) to maintain constant vigilance in the faithful implementation of the requirements of SOX by fulfilling their shared responsibilities to continue to produce high quality financial disclosures that are decision-useful to investors and maintain the public trust in our capital markets. An integral part of the faithful implementation of SOX is for audit firms to remain independent of their audit clients and for audit committees to take ownership of their oversight responsibilities with respect to the independent auditor.

While all gatekeeper roles in producing high quality financial disclosures are critical, it is undisputed that assurance provided by *independent* public accountants improves the quality of financial disclosures and, in turn, such assurance is a critical component of our capital markets.[3] Academic studies demonstrate that assurance provided by an independent auditor reduces the risk that an entity provides materially inaccurate information to external parties, including investors, by facilitating the dissemination of transparent and reliable financial information.[4] Research also shows that an independent, high quality audit improves the credibility of financial statements reducing risk to investors, thereby lowering the cost of debt[5] and the cost of equity[6] for the company.[7] Additionally, companies often benefit in other ways from the services of an independent auditor. In a recent survey, 77% of public company respondents stated that their independent auditor provided important insights about the company.[8]

Because of these benefits, historically even absent requirements for audited financials, many publicly-traded companies voluntarily released audited financial statements.[9] Similarly, external stakeholders for many other types of entities also require assurance over financial information because of the desire for increased confidence in the reliability and quality of the information. Research shows, similar to public companies, U.S. private companies that voluntarily release audited financial statements experience lower costs of debt than unaudited companies.[10] Apart from debt-related benefits, an audit may also help a private company prevent fraud[11] and aid in the evaluation of management.[12]

Notwithstanding the importance of assurance to all stakeholders, not all audits are created equal. In order for an audit to effectively protect investors, an objective, impartial, and skilled professional must perform the audit in accordance with an appropriate framework. The U.S. capital markets’ disclosure regime is designed to promote high quality audits through the adherence of accountants to rigorous independence, quality control, and auditing standards performed under the oversight of an effective audit committee and subject to Public Company Accounting Oversight Board (“PCAOB”) inspections.[13] The PCAOB’s inspections program has successfully led to significant improvements in audit quality since it was first created by SOX nearly twenty years ago.[14]

The Importance of Auditor Independence

The independence of the auditor, in both fact and appearance, is foundational to the credibility of the financial statements.[15] While sourcing a high quality independent auditor is a key responsibility of the audit committee,[16] compliance with auditor independence rules is a shared responsibility of the issuer, its audit committee, and the auditor.

As we near the twentieth anniversary of SOX, it is critical for all gatekeepers to continue to vigilantly maintain the independence of auditors, in both fact and appearance. In this regard, auditors and audit clients must carefully consider the scope of their audit and any permissible non-audit engagements that have been pre-approved by the audit committee to guard against impairments of independence. As part of this responsibility, all gatekeepers in the financial reporting ecosystem should be especially mindful of the nature and the scope of any other services provided by the independent auditor. For instance, an auditor that provides extensive non-audit services to an entity that has an active mergers and acquisitions business model must continually monitor the impacts of all such transactions, and potential transactions, on its audit engagements to ensure that the auditor remains, in fact and appearance, independent of all of its audit clients.

Responsibility of Audit Committees and Management

We continue to encourage audit committees to consider the sufficiency of the auditor's and the issuer's monitoring processes, including those that address corporate changes or other events that potentially affect auditor independence.[17] This is particularly relevant in the current environment as companies seek to access public markets through new and innovative transactions, and audit firms continue to expand business relationships and non-audit services.

Management, the audit committee and the independent auditor should proactively seek to inform themselves of any potential impact to auditor independence, in fact and appearance, as companies negotiate potential transactions with third parties. This requires all parties to potential transactions to understand the filings that could be required by such transactions, the existing auditors' relationship with counterparties, and the potential impact of transactions and the auditor's relationships with the counterparty on the existing auditor's ability to continue to comply with the Commission's auditor independence rule applicable to such filings. This proactive monitoring requires management, the audit committee, and the independent auditor to each consider the potential effects of the auditor's existing business and service relationships with other companies on the auditor's ability to remain independent of the issuer if a contemplated transaction is consummated.

For example, it is important to understand what business relationships exist, including non-audit service relationships, between the audit firm and other entities that will, or in the future could, require an audit, become the existing audit entity's affiliates, or result in other companies that have significant influence over the entity.[18] Given the importance of independence as it relates to the audit of financial statements, these relationships and services and their implications to auditor independence should be carefully considered when management is negotiating the timing and substance of a transaction with third parties.

Responsibility of Audit Firms

Audit firms should carefully consider the impact of business relationships and non-audit services on existing and prospective audit relationships. Entering into significant, multi-year non-audit service contracts or business relationship arrangements with non-audit clients can impact the auditor's ability to remain independent of its existing audit clients in certain future circumstances. For example, prohibited business or service arrangements can be independence-impairing for the audit firm if an existing audit client merges with, acquires or sells a significant equity position to the non-audit client. Audit firms' risk management processes should use a firm-wide perspective to understanding the potential future consequences of such arrangements on their ability to remain independent of their existing audit clients. Ultimately, because an audit client is required to retain an independent auditor, audit firms should always consider the potential impacts of all their business relationships on their audit clients.

General Standard of Independence

Audit committees, issuers, and audit firms need to understand not only the specifically prohibited services and relationships, but also the application of the general standard of independence to all applicable reporting periods.[19]

The text of Rule 2-01(b) together with the four guiding principles laid out in the Introductory Text of Rule 2-01 serve as a framework to be applied when considering matters that are not directly addressed in other parts of Rule 2-01. The guiding principles refer to whether a relationship or a provision of a service:

- Creates a mutual or conflicting interest between the accountant and the audit client;
- Places the accountant in the position of auditing his or her own work;
- Results in the accountant acting as management or an employee of the audit client; or

- Places the accountant in a position of being an advocate for the audit client.[20]

We believe it would be a high hurdle to reach a conclusion that the accountant could remain objective and impartial when an auditor has provided services in any of the periods included in the filing that is contrary to any one of these guiding principles.

Importance of Audit Committee Oversight of the Independent Auditor

Audit committees play a vital role in the financial reporting systems of public companies through their oversight of financial reporting, including internal controls over financial reporting, and over the external, independent audit process.[21] Effective oversight by strong, active, knowledgeable and independent audit committees significantly furthers the collective goal of providing high quality, reliable financial information to investors.

An effective audit committee enhances the accountant's independence by, among other things, providing a forum apart from management where the accountants may discuss their concerns.[22] It facilitates communications among the board of directors, management, internal auditors and independent auditors. An effective audit committee also enhances auditor independence from management by exercising its responsibilities in appointing, compensating and overseeing the work of the independent auditors. Because audit committees have financial reporting and audit oversight authority and responsibility, they also are instrumental in setting the tone at the top for the quality of the issuer’s financial reporting to investors. In selecting, retaining, and evaluating the independent auditor, the audit committee always should be focused, in the first instance, on audit quality.

Closing

Investors benefit to the extent that they have access to high quality financial information when making capital allocation decisions. The independent audit overseen by an active and effective audit committee is a critical step in providing that information to the capital markets. OCA staff continue to emphasize the importance of auditor independence in contributing to the credibility of audited financial statements. The staff also recognize the important role the regulatory framework plays in promoting audit quality. When the gatekeepers in the financial reporting ecosystem work together to promote trust and transparency in the quality of information reported for the benefit of investors, our public markets benefit as well.

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[1] This statement represents the views of the staff of the Office of the Chief Accountant (“OCA”). It is not a rule, regulation, or statement of the Securities and Exchange Commission (“SEC” or the “Commission”). The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. “Our” and “we” are used throughout this statement to refer to OCA staff.

[2] *See* Sarbanes-Oxley Act of 2002, 15 U.S.C. 7211, *Pub. L. 107-204. 750 Stat. 116. 30 July 2002*, available at https://www.congress.gov/bill/107th-congress/house-bill/3763/text.

[3] The terms “accountants” and “auditors” are used interchangeably throughout this statement.

[4] Mark Defond & Jieying Zhang, *A Review of Archival Auditing Research*, Journal of Accounting and Economics*,* 58, 275–326 (2014).

[5] Jeffrey A. Pittman & Steve Fortin, *Auditor Choice and the Cost of Debt Capital for Newly Public Firms*, Journal of Accounting and Economics*,* 37, 113–136 (2004).

[6] W. Robert Knechel, Gopal V. Krishnan, Mikhail Pevzner, Lori B. Shefchik &Uma K. Velury, *Audit Quality: Insights from the Academic Literature*, Auditing: A Journal of Practice and Theory*,* 32, 385–421 (2013).

[7] Risk determines an entity’s costs of raising capital from investors. *See* Christine A. Botosan, *Disclosure Level and the Cost of Equity Capital*, The Accounting Review, 72, 323–349 (1997).

[8] *11th Annual Public Company Audit Fee Study, Financial Education & Research Foundation* (February 25, 2021), *available at* https://www.financialexecutives.org/Research/Publications/2021/11th-Annual-Public-Company-Audit-Fee-Study.aspx.

[9] S. A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part I*, Accounting Horizons 17, no. 3 (2003): 189–205.

[10] David W. Blackwell, Thomas R. Noland, & Drew B. Winters, *The Value of Auditor Assurance: Evidence from Loan Pricing*, Journal of Accounting Research, 36, 57–70 (1998). Michael Minnis & Nemit Shroff, *Why regulate private firm disclosure and auditing?* Accounting and Business Research, 47, 473–502 (2017).

[11] Gavin Cassar, *Discussion of the Value of Financial Statement Verification in Debt Financing: Evidence from U.S. Firms,* Journal of Accounting Research, 49, 507–528 (2011).

[12] Ann Vanstraelen & Caren Schelleman, *Auditing private companies: What do we know?* Accounting and Business Research, 47, 565–584 (2017).

[13] *See* U.S. Department of Treasury, Final Report of the Advisory Committee on the Auditing Profession D:2 (2008), https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf and Phillip T. Lamoreaux, *Does PCAOB Inspection Access Improve Audit Quality? An Examination of Foreign Firms Listed in the United States,* 61 J. Account. Econ.

[14] *See* Phillip T. Lamoreaux, *Does PCAOB inspection access improve audit quality? An examination of foreign firms listed in the United States*, 61 J. Acct. Econ. 313 (2016), https://reader.elsevier.com/reader/sd/pii/S0165410116000161?token=CDE756302B19F26FA11DB98DD24F6F6E1D3068762AD8EB3ED9DE9C954CDE6F011D1DF9761860E0711F3B5A329C5EE7C3 ("The positive effect of PCAOB inspection access on audit quality is observed in jurisdictions with, and without, a local audit regulator. Overall, the results are consistent with PCAOB inspection access being positively associated with audit quality"); *see also* Phillip T. Lamoreaux et al., *Audit Regulation and The Cost of Equity Capital: Evidence From the PCAOB's International Inspection Regime*, Contemp. Acct. Res. (2020), https://onlinelibrary.wiley.com/doi/epdf/10.1111/1911-3846.12599 (finding "that foreign SEC registrants with auditors from countries that allow PCAOB inspections enjoy a lower cost of capital, relative to foreign SEC registrants with auditors from countries that prohibit inspections").

[15] *See* SEC Release No. 33-7919, *Revision of the Commission's Auditor Independence Requirements* (November 21, 2000).

[16] The Sarbanes-Oxley Act requires that audit committees be directly responsible for the oversight of the engagement of the company's independent auditor. *See* Section 10A(m) of the Exchange Act [15 USC 78j-1(m)].

[17] *See* discussion of monitoring activities in COSO, *Internal Control – Integrated Framework*, 2013, available at www.coso.org.

[18] *See* 17 CFR 210.2-01(c)(3).

[19] The Commission adopted amendments to the independence requirements in Rule 2-01 of Regulation S-X (the "Rule") in October 2020, including amending the definition of the "audit and professional engagement period." See *SEC Updates Auditor Independence Rules*, Release No. 2020-261 (October 16, 2020).

[20] *See* Introductory Text to 17 CFR 210.2-01.

[21] *See* SEC Release No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence* (January 28, 2003).

[22] *Id*.

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