Accounting Horizons
Vol. 27, No. 4
2013
pp. 775–798

American Accounting Association
DOI: 10.2308/acch-10363

COMMENTARY

PCAOB Audit Regulation a Decade after SOX: Where It Stands and What the Future Holds

Zoe-Vonna Palmrose

SYNOPSIS: This commentary assesses the status of audit regulation under the Public Company Accounting Oversight Board (PCAOB) and explores what the future might hold. The commentary discusses how discretionary choices in implementing the PCAOB's legislative mandates under the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and the 2012 Jumpstart Our Business Startups Act have shaped the Board and the PCAOB's inspection, standard-setting, and enforcement activities over its first decade. The commentary suggests that the importance of discretionary choices gives rise to a necessity to develop, articulate, and adhere to core principles of audit regulation. The commentary uses the PCAOB's articulated principles to explore what appear to be some of the key determinants of the future of audit regulation under the PCAOB.

Keywords: PCAOB; audit regulation; audit quality; SOX; cost benefit analysis.

INTRODUCTION

It has been more than ten years since the Sarbanes-Oxley Act of 2002 (SOX) created the Public Company Accounting Oversight Board (PCAOB) to regulate public company auditing. Because a decade provides sufficient time for the contours of this new audit regulatory landscape to emerge, this commentary uses this milestone as motivation to assess the status of public company audit regulation, consider what is working and what is not, and explore what the future might hold.

Assessing the regulatory structure is important because SOX took the giant step of transferring public company audit regulation from the private sector to the federal govern-

Zoe-Vonna Palmrose is a Professor at the University of Washington.

This commentary has benefited from discussions with a number of people, especially Bill Kinney. In addition, I very much appreciate the comments and suggestions on various drafts by Bill Kinney, Joe Carcello, and the participants in the LSU Regional Accounting Conference.

Submitted: March 2013
Accepted: August 2013
Published Online: December 2013
Corresponding author: Zoe-Vonna Palmrose
Email: palmrose@uw.edu

ment.[1] This transfer occurred under a "fire-alarm" approach to regulation (Kinney 2005), whereby major instances of fraudulent financial reporting propelled congressional action without first trying alternate private sector regulatory structures (e.g., see Panel on Audit Effectiveness 2000), including one proposed by the Securities and Exchange Commission (SEC) (SEC 2002) just prior to the enactment of SOX.

Even so, this commentary does not represent a call to return to self-regulation. Congress did not choose to sunset the PCAOB, and the organization has withstood a constitutional challenge. The commentary generally does not quibble with the provisions of SOX. However, there is great scope for discretion in implementing SOX and the commentary provides perspective on the efficacy of this implementation. As such, the discussion extends prior assessments of the PCAOB and the regulation of public company auditing post-SOX (e.g., Kinney 2005; Palmrose 2006, 2010a, 2010b; Glover et al. 2009).

Taking its own stock as part of strategic planning, the Board identified the PCAOB's current strengths, weaknesses, opportunities, and threats (PCAOB 2011c).[2] For example, the Board concluded the PCAOB's strengths include that it "has institutional credibility in confronting the realities of the global audit" and has "developed a robust auditor oversight program," which it "knows has been effective in improving the quality and credibility of audits" (PCAOB 2011c, 8). This commentary provides an outside perspective on these matters.

It is important to acknowledge that a great deal has been accomplished during the last decade. To its credit, the PCAOB has evolved and continues to do so. In the spirit of continuous regulatory improvement, this commentary proceeds in three parts. The first part assesses selected portions of the PCAOB's legislative mandate under SOX and how discretionary choices in the implementation of this mandate have shaped the PCAOB during its first decade. The second part of the commentary expands on this theme and describes the additional PCAOB mandates under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) and the 2012 Jumpstart Our Business Startups Act (JOBS). The third part explains that the importance of discretionary choices gives rise to a necessity to develop, articulate, and adhere to core principles of audit regulation. This part goes on to use the PCAOB's articulated principles to explore what appear to be some of the key determinants of the future of audit regulation under the PCAOB. These key determinants center on how the PCAOB chooses to define itself over the next decade; and the commentary makes some suggestions to build on the PCAOB's articulated vision in this regard.

SOX: ASSESSING THE CHOICES MADE IN IMPLEMENTING THE PCAOB'S MANDATE

Overview

SOX establishes the PCAOB, defines its authority, and outlines the legal requirements by which it must abide. Although the PCAOB received additional legislative mandates and constraints under Dodd-Frank and JOBS, as described in the next section, working to implement SOX dominated much of the PCAOB's first decade. This section discusses the PCAOB's legislative mandate under SOX, including areas where the PCAOB has been unable to meet its mandate or is still in the process of doing so. The discussion also includes selected examples of a theme in this commentary—namely that the PCAOB's legislative mandates allow for much discretion in their implementation. The exercise of this discretion via critical implementation choices represents the

[1] This is a statement on substance rather than form. SOX designates the PCAOB as a nonprofit organization and not an agency or establishment of the U.S. government.

[2] The PCAOB reaffirmed these strengths, weaknesses, opportunities, and threats in its Strategic Plan for 2012–2016 (PCAOB 2012d).

key to assessing audit regulation by the PCAOB over the last decade, as discussed in this section and the next, and determining what the future might hold, as discussed in the last section.

Background

SOX established the PCAOB "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors" (Section 101(a)). This mission focuses the PCAOB on maintaining and improving public company audit quality through its statutory authority under SOX for registration, inspection, standard-setting, and enforcement.[3]

Reinforcing the elemental shift to government regulation of public company auditing, SOX gives the SEC oversight of the PCAOB. SEC oversight includes the authority to appoint PCAOB board members; to approve PCAOB budgets, rules, and standards before they can take effect; to inspect PCAOB operations; and to consider audit firm requests for interim review of PCAOB inspection reports and Board remediation determinations, and hear appeals of PCAOB enforcement findings.[4] Based on the June 2010 Supreme Court decision in *Free Enterprise Fund et al v. PCAOB* (2010), SEC oversight allowed the PCAOB to withstand the constitutional challenge to the regulatory framework created by SOX.

It is easy to overlook the impact of this constitutional challenge. Actually the challenge represents one of the defining events in the PCAOB's first decade. For a significant period before the Supreme Court decision, uncertainty existed about whether the PCAOB would even survive. This uncertainty undermined the PCAOB's ability to attract new Board members and to retain and attract staff at all levels, which, in turn, slowed the organization's initiatives. Moreover, with the Supreme Court decision, any resistance to the exercise of SEC oversight lost standing and faded away. Essentially, the decision empowered the SEC in its dealings with the PCAOB and reinforced the necessity of a substantive day-to-day working relationship between the PCAOB on K Street and the SEC at Station Place.

As an aside, SOX also formalizes the responsibilities of issuer systems of corporate governance for oversight of the audit and the relationship with the audit firm. SOX Section 301 gives the audit committee direct responsibility for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer for the purpose of preparing or issuing an audit report or related work. Further, SOX specifies that the accounting firm shall report directly to the

---

[3] The commentary uses the term "public companies." More precisely, SOX gives the PCAOB authority over accounting firms that audit issuers. PCAOB Rule 1001 states that the term "issuer" means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn. Under this definition, issuers include companies with public equity securities and private companies with public debt, among others. In addition, PCAOB rules implementing SOX and Dodd-Frank specify accounting firms that play a substantial role in the audit of any issuer, broker, and dealer are also subject to PCAOB authority, including inspections.

[4] Although SOX does not prescribe an SEC standard of review for PCAOB inspection reports and remediation determinations, SEC Rule 140 establishes a high threshold for these interim reviews—namely an "arbitrary and capricious" standard of review. In contrast, SOX Section 107(c) specifies that the provisions of sections 19(d)(2) and 19(e)(1) of the Securities Exchange Act of 1934 govern the review by the Commission of final disciplinary sanctions imposed by the Board. Further, SOX provides that the Commission may enhance, modify, cancel, reduce, or require the remission of a sanction imposed by the Board for disciplinary actions if the Commission determines, among other factors, that the sanction is not necessary or appropriate in furtherance of SOX or the securities laws or is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed.

American Accounting Association

audit committee. While the PCAOB has no authority over audit committees and audit committees are not the focus of this commentary,[5] some consider the legislative requirement for audit committees to "step up to the plate" as one of the major influences on audit services post-SOX.

Board Appointments

The Board is central to the way the PCAOB implements SOX. SOX specifies a five-member Board "appointed from among prominent individuals of integrity and reputation." SOX gives the Commission, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, responsibility for appointment of PCAOB Board members. But unlike SEC commissioners, SOX allows PCAOB Board members to be well paid, at least by Washington, DC standards for the public sector, which somewhat diminishes the public service aspect of the position.

SOX also requires the Board have two members that shall be or have been certified public accountants (CPAs) and a CPA chairperson may not have practiced for at least five years prior to Board appointment. Moreover, SOX restricts the number of CPAs on the Board to these two members. In this regard, we can all appreciate the objective of not giving "regulated parties" the ability to dominate the Board and, thereby, the organization. SOX allows for a Board that balances objectivity and audit expertise.

Nonetheless, given the large number and variety of prominent and eligible people from outside public accounting that are or have once been CPAs, the SOX restriction on CPAs has facilitated the appointment of "non-expert" members to all five board positions. The politics of Board appointments are complicated (e.g., see Palmrose 2010a, 2010b). As a result, the Board has largely consisted of prominent individuals, such as securities lawyers and other Washington, DC insiders, without relevant experience in the actual practice of auditing. This has impacted the PCAOB's activities in large and small ways.

It is not clear if a current or former audit partner from one of the four largest global audit firms (B4) has been asked and willing to serve, but none has yet been appointed to the Board. Indeed, my students are taken aback to learn that only recently has someone with *any* experience as an audit partner been appointed to the Board. This appointment represents an important turning point in the evolution of the PCAOB. However, all things considered, including the politics of Board appointments, restricting the appointment of only two CPAs to the Board does not appear necessary. Admittedly, there has been no discussion of eliminating this restriction and the prospects for accomplishing a legislative change would be dim. On the other hand, eliminating this SOX provision could risk losing the congressional signal that audit expertise matters at the Board level, so perhaps it would be best to leave well enough alone.

PCAOB Funding

The PCAOB has a ready source of funding to carry out its legislative mandates. In accordance with SOX and Dodd-Frank as subsequently discussed, issuers and broker-dealers provide the vast majority of the PCAOB's funding, with the rest coming through registration and more recently

[5] Actually, the PCAOB has no authority over accounting matters or issuers and their audit committees. However, PCAOB inspections, auditing standards, and other initiatives certainly provide feedback into and, therefore, impact issuers and their financial reporting and internal control over financial reporting (ICFR). Certain auditing standards require and some PCAOB releases contemplate dialogue between auditors and audit committees. In addition, the PCAOB includes as a priority project for 2013 "enhancing outreach to and interaction with audit committees to constructively engage in areas of common interest, including auditor independence and audit quality" (PCAOB 2012d, 5).

annual fees from accounting firms.[6] The PCAOB considers the funding authority provided by SOX, whereby the PCAOB does not rely on the accounting firms it regulates to fund its activities, as among its strengths (PCAOB 2011c, 8).

However, the non-voluntary nature of the funding and the process by which it occurs are perhaps more important strengths for the PCAOB, rather than the sources per se. The SEC collects fees from market participants on securities transactions, which offset the SEC's appropriations. A key aspect of PCAOB funding is that, unlike other regulatory agencies such as the SEC, the PCAOB does not have to "compete" for resource allocations from Congress or otherwise navigate the politics and vagaries of the congressional budget process. Essentially, SOX and Dodd-Frank allow the PCAOB the luxury of obtaining the resources that the Board believes are needed to support a broad array of activities under its regulatory authority.[7]

During the ten-year period from 2003–2012, issuers, broker-dealers, and registered audit firms paid more than $1.4 billion to support the PCAOB's activities. Appendix A discusses the PCAOB's responsibilities and resources compared to those of the SEC. A review of the PCAOB's spending can provide important insights on areas of priority, among other matters. For example, the data summarized in Appendix A reveal that the majority of the PCAOB's resources are devoted to activities involving inspections (including registration) and that enforcement's budget is three times that of standards. The information in Appendix A also reveals that the SEC is asked to do much more with its resources than the PCAOB. The SEC has a broader mandate that involves overseeing a very large number of entities of many different types, while an important focus for the PCAOB is annually inspecting less than a dozen large global audit firms.

In addition, unlike other government agencies, over the last decade the PCAOB has not been resource constrained. Reinforcing this point, a review of budgets and annual reports posted on the PCAOB's website (while sorting out differences between cash flow and GAAP reporting) finds that the PCAOB's actual spending each year often falls well short of its approved budgets. For example, the annual spending shortfall during 2005–2011 ranges from 6 to 21 percent and averages about 10 percent.

The SEC reviews and approves the PCAOB's budget and has developed a process for doing so. The Commission and staff take their PCAOB budgetary oversight responsibilities very seriously. Nonetheless, the SEC does not treat the PCAOB as Congress treats the SEC. Importantly from the standpoint of transparency, the PCAOB budget process now typically culminates in an open Commission meeting with "testimony" by the PCAOB chairman (Palmrose 2010b). Commissioner's statements and questions during the open meeting, along with SEC annual PCAOB budget orders, provide insight into areas of concern for the Commission. Notwithstanding that the budget approval process provides a lever for the Commission to exercise some influence over the PCAOB, as a practical matter, the Board has a good deal of leeway on its priorities and initiatives as long as the spending choices comply with SOX and SEC approved budget guidelines.

Furthermore, few outside the SEC and PCAOB appear to pay much attention to the PCAOB's spending. For example, the media does not generally probe PCAOB spending or otherwise challenge it—unlike what often occurs for other government agencies. Perhaps the PCAOB

[6] Due to problems with its information technology (IT) systems, the PCAOB was delayed in getting an annual reporting system for registered accounting firms up and running, which in turn delayed implementing the SOX requirement for the payment of annual fees by such firms. Certain SEC budget orders and reports from the PCAOB Office of Internal Oversight and Performance Assurance (IOPA) reflect concerns over the efficacy of IT spending and various IT system challenges. The PCAOB includes "information technology, governance, and enterprise architecture" among its weaknesses in the 2011 Strategic Plan (PCAOB 2011c, 9).

[7] Given these factors and its nonprofit status as specified by SOX, it is a surprise that the PCAOB appears as a line item in the Office of Management and Budget's (OMB) congressionally mandated report pursuant to the Sequestration Transparency Act of 2012 (published in September 2012). If maintained, this may represent at least a short-term resource challenge for the PCAOB and necessitate some reprioritization.

initiative on mandatory audit firm rotation (PCAOB 2011b) provides one exception, as some commenters have questioned the wisdom of the Board's spending resources on this activity, including the Board's decision to hold multiple roundtables. This situation illustrates that controversial initiatives may shine a spotlight on PCAOB spending, especially where any eventual rules would impose significant, additional costs on issuers (and registered audit firms) that are already compelled to fund the PCAOB.

Standard-Setting

SOX gives the PCAOB authority to establish quality control, auditor independence, and auditor performance standards by promulgating its own standards and adopting or adapting the standards of others. The PCAOB is planning to revise the quality control standards (adopted in 2003 from the American Institute of Certified Public Accountants [AICPA] as interim standards)—an effort that is long overdue. The PCAOB has promulgated few new auditor independence rules, choosing instead to mostly rely on SEC auditor independence rules. I have previously written about the wisdom of this decision (Palmrose 2010b), in part, because it recognizes that any such rules affect issuer filings, which are the SEC's jurisdiction. And this issue comes to the forefront with the concept release on mandatory audit firm rotation (PCAOB 2011b). Even though the concept release is premised on the PCAOB's authority to set auditor independence rules, it is not settled that this PCAOB authority would extend to mandating audit firm rotation. For example, some commenters on the concept release suggested that this is the SEC's jurisdiction.

In regards to audit standard-setting, a decade ago the PCAOB adopted generally accepted auditing standards (GAAS) as promulgated by the Auditing Standards Board (ASB) of the AICPA as interim standards. However, it also made the critical decision to rewrite and replace GAAS with its own auditing standards and set new standards using a permanent staff—rather than delegate these activities to other authoritative bodies as allowed by SOX. Problematic elements of this approach are well recognized (e.g., Kinney 2005; Palmrose 2006, 2010b; Glover et al. 2009). These include assuming a small staff removed from practice is, nonetheless, well informed and up-to-date on *all* aspects of auditing as necessary to develop and draft auditing standards. As this approach plays out, it has likely contributed to the PCAOB's lengthy standard-setting process and minimal output over the last decade.[8] On the other hand, to its credit, the PCAOB has shown a willingness to use concept releases, several rounds of exposure drafts, and the comment letter process to better calibrate and otherwise improve its proposals before adopting them.

Likewise affected by the choice to set its own auditing standards, the PCAOB has also chosen not to commit to the convergence of its auditing standards with those of the International Auditing and Assurance Standards Board (IAASB) and ASB (while the IAASB and ASB have agreed to converge their standards). Again, convergence would be allowed under SOX. Although the current auditor reporting initiative indicates some improvement in the working relationship among these standard-setters, the PCAOB continues to resist convergence, in large part because the IAASB and ASB include practicing auditors.[9] Thus, the complexities from having multiple sets of auditing standards continue to vex audit education and practice alike.

---

[8] Based on Commissioners' questions and comments at the SEC Open Meeting on February 13, 2013 for the PCAOB's 2013 budget, the PCAOB's minimal standard-setting output is a concern at the SEC (SEC archives).

[9] For example, half of the members of the IAASB are practitioners. The other half that consists of members not practicing within an audit firm includes public interest members. There is an expectation that all non-practitioners on the IAASB will have the knowledge and experience to participate fully in the standard-setting process. See PCAOB (2004) for additional insights regarding the PCAOB's emphasis on audit regulatory processes being independent from the auditing profession.

Congress appreciated the need for current relevant expertise to inform auditing standards and intended that the PCAOB involve practicing auditors in its standard-setting process (U.S. Senate 2002[10]). Such involvement includes service on advisory groups, committees, and task forces. However, unlike other audit standard-setting bodies such as the IAASB and ASB, the PCAOB generally does not use task forces or advisory committees for its individual standard-setting projects to assist in developing and drafting standards.[11] Such work is done by PCAOB staff with some input along the way from SEC staff.

Last, the PCAOB of course has discretion in the way it writes auditing standards. In this regard, it is noteworthy that in revising interim standards and setting new ones, the PCAOB now promulgates more prescriptive auditing standards. In the main, the debate over moving accounting standards from "rules-based to principles-based" has not given the PCAOB pause when it comes to auditing standards. To illustrate, the PCAOB appears to be embedding presumptively mandatory procedures (i.e., the auditor "should"), while working to remove the word "judgment" from its auditing standards. For example, I searched the risk suite of eight PCAOB auditing standards (AS 8 through 15) and found that the word "judgment," as it relates to auditor judgment, appears in only two paragraphs.[12] Otherwise, the term "judgment" is used in reference to judgments of management and investors.

This move seems even more curious given the PCAOB is emphasizing auditor skepticism, through initiatives such as the one on mandatory audit firm rotation, and skepticism relates to judgment.[13] Perhaps the rationale for moving towards more prescriptive auditing standards is to serve a particular type of "bright-line" inspection process. Nonetheless, the impact of more prescriptive standards on audit quality is an open question and one ripe for research.

DODD-FRANK AND JOBS: COMPLICATIONS ENDING THE FIRST DECADE

Dodd-Frank

Broker-Dealers

As previously noted, the PCAOB's legislative mandates have not been static since SOX. The Madoff scandal in late 2008, in conjunction with the 2008 financial crisis and ensuing severe economic downturn, again drove regulatory reforms via Dodd-Frank. Selected provisions of Dodd-Frank impact the PCAOB. For example, Madoff's audit firm was not registered with or inspected

---

10 The Senate Report stated: "The Board's standard-setting authority, however, is neither intended nor structured to exclude practicing accountants from participation in the standard-setting process" (U.S. Senate 2002, 8).

11 The standard-setting project on confirmations may be an exception as the PCAOB received input from a task force, although this long-standing project is still not finalized.

12 The term "judgment" appears twice in the bullet-point list in AS 9.7, to acknowledge auditors make preliminary judgments on materiality, risk, and (in integrated audits) factors related to the determinations of material weaknesses and the effectiveness of ICFR. It also appeared once in a note in AS 13.5(d), in reference to auditor's judgments about the quality of a company's accounting principles as articulated in AU 380, but this note has now been deleted with the adoption of AS 16.

13 Recognizing that judgment is pervasive in accounting and auditing, the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR) recommended that the PCAOB articulate a framework for how the PCAOB considers the reasonableness of auditing judgments in its inspection and enforcement processes. The PCAOB has declined to adopt this recommendation, instead demurring until the SEC first adopts a CIFiR recommendation on articulating the components of a framework for accounting judgments as a policy statement (Palmrose 2010b). On the other hand, a number of firms have developed their own audit judgment frameworks.

by the PCAOB. To remedy this "regulatory gap," Dodd-Frank gives the PCAOB inspection authority over certain broker-dealer auditors.[14]

Over 500 accounting firms registered with the PCAOB as auditors of broker-dealers and are now subject to PCAOB inspections. At the time of initial registration, these firms audited about 5,000 broker-dealers. Most of these broker-dealers are small (e.g., 70 percent had tentative net capital under $1 million) and have much diversity in the types of services they offer. Recognizing this diversity, one aspect of the Board's interim inspection program is to determine whether auditors of some types of broker-dealers can safely be exempted from PCAOB oversight without compromising investor protection (Goelzer 2010).

The PCAOB describes "building a new broker-dealer auditor oversight program" as among the PCAOB's opportunities (PCAOB 2011c, 10). On the other hand, considering the collapse of Peregrine Financial Group (PFGBest) in July 2012 under allegations of fraud, plus the relatively troubling early results from the PCAOB's interim inspection program for broker-dealers (PCAOB 2012c), developing a meaningful broker-dealer inspection program might be better characterized as a challenge for the PCAOB.

Inspection of Registered Foreign Audit Firms

In addition, the PCAOB has faced challenges meeting its SOX mandate for the inspection of registered foreign accounting firms. To help address these challenges and facilitate the ability of the PCAOB to interact with foreign regulators, Dodd-Frank now permits the PCAOB to share information, such as inspection findings, in certain circumstances with foreign auditor oversight authorities. Nonetheless, the PCAOB continues to be denied access to conduct inspections in certain countries, such as China, Hong Kong, Greece, Italy, and Sweden, among others.

Post-Dodd-Frank, the PCAOB still finds itself in a difficult political situation, which it must continue to work deftly with other regulators in both the U.S. and abroad to try and resolve. The PCAOB has not taken the extreme step of deregistering existing audit firms from jurisdictions where it cannot inspect, which would result in denying issuers from such jurisdictions access to the U.S. capital markets—a consequence with implications well beyond matters of auditing.

Instead, the PCAOB website lists the issuers audited by registered accounting firms in non-U.S. jurisdictions where the PCAOB is being denied access to conduct inspections. Thus, the PCAOB provides transparency on this matter to investors and others. Meanwhile, new accounting firm registrations with the PCAOB from such jurisdictions are effectively halted.[15] Further, the SEC filed administrative proceedings against the Chinese affiliates of five of the largest global audit firms for refusing to produce audit work papers and other documents related to China-based companies

[14] As previously discussed, SOX requires public accounting firms that audit *issuers* to register with the PCAOB. A number of entities registered with the SEC, such as broker-dealers and investment advisers, are not "issuers." After Madoff, the SEC let expire an exemption for nonpublic broker-dealers to file financial statements audited by a PCAOB-registered public accounting firm. Thus, beginning in 2009, audit firms for such entities had to register with the PCAOB, but they were not subject to PCAOB inspections (because they did not audit issuers) until Dodd-Frank gave the PCAOB inspection authority in 2010 (Palmrose 2010b).

[15] In light of the continuing inability to inspect registered firms in some jurisdictions, the PCAOB now asks for additional information from firms in such jurisdictions that apply to register with the PCAOB. Specifically, the PCAOB asks them to provide written confirmation from the appropriate local regulatory authority that a PCAOB inspection of the firm would be allowed. The PCAOB will not approve applications that fail to provide this information (PCAOB 2010). This provision could take on new meaning as Chinese affiliates of global accounting firms convert from a joint venture to a local business with a majority of Chinese partners, as mandated by the Chinese government. Rather than seek a new registration, which would require the additional information, at least one firm sought to transfer its PCAOB registration instead (Reilly 2012).

under investigation by the SEC (SEC 2012c).[16] Then in May 2013, the PCAOB announced that it had entered into an enforcement cooperation agreement with Chinese regulators. The PCAOB chairman added: "We look forward to continued progress with our Chinese counterparts to reach an agreement on cross-border inspections of PCAOB-registered firms as well" (PCAOB 2013).

Exemption from SOX Section 404(b)

Much of the PCAOB's first decade was defined by SOX Section 404. Until at least 2008, the PCAOB's standard-setting process was consumed by promulgating, explaining, defending, and then replacing PCAOB Auditing Standard No. 2 for auditor attestation on ICFR (Palmrose 2010a). Even though the replacement standard (AS 5) responded to the cost concerns of smaller issuers with risk-based and scalable audit requirements, and the PCAOB committed to inspecting for efficiencies in ICFR audits, these actions did not eliminate concerns.

Thus, Dodd-Frank reflects the lingering perceptions of burdensome ICFR audit costs for smaller companies and simply exempts non-accelerated filers from auditor attestation on ICFR under SOX Section 404(b).[17] In turn, the PCAOB refocused inspections from efficiency to the effectiveness of ICFR audits and expected the largest annually inspected audit firms to quickly adjust audit performance to accommodate this change in the political winds.

SEC Approval Deadlines

Finally, a little noticed provision of Dodd-Frank amended Section 19 of the Exchange Act of 1934 to shorten deadlines for the SEC in publishing and acting upon proposed rule changes submitted by supervised organizations, including the PCAOB. This amendment prompted the Commission to delegate authority to the Chief Accountant with respect to proposed PCAOB rule changes (pursuant to SOX Section 107 and Section 19(b) of the Securities Exchange Act of 1934) and extending time periods (SEC 2011). Delegated authority does not apply to determinations required of the SEC under JOBS, as subsequently discussed. Even so, this change is important because delegated authority elevates the role of the Chief Accountant and staff in the Office of the Chief Accountant (OCA), including the Deputy for Professional Practice, and reinforces the necessity for the PCAOB Board and staff to work with SEC staff day-to-day from the inception of each PCAOB initiative.

---

[16] Because SOX provides that the PCAOB disciplinary process is non-public until finalized in favor of the PCAOB, it is not known if the PCAOB likewise has enforcement proceedings underway against any audit firm(s) related to these matters. The PCAOB considers this SOX confidentiality provision as a "structural weakness" to the detriment of auditors and the public generally. The PCAOB is campaigning for a legislative change to eliminate it. However, confidentiality on PCAOB enforcement matters likely facilitated the negotiation of the cooperation agreement with China. Moreover, the situation illustrates that the SOX provision is not really a fatal flaw since the SEC can always undertake enforcement proceedings that are public instead of (in conjunction with) the PCAOB. Further, PCAOB enforcement remains a work in progress and the PCAOB may apply lower legal thresholds in bringing enforcement actions than the SEC. Given these considerations and consistent with a supervisory (prudential) approach to regulation as subsequently discussed, confidentiality seems important to maintain, at least until the PCAOB has developed a more robust and reasonably calibrated track record in enforcement. Finally, research on "trial versus settlement" suggests that seeking to eliminate confidentiality may be less about transparency and more about enhancing the PCAOB's advantages in resolving disciplinary allegations (Palmrose 1991).

[17] Non-accelerated filers are companies with less than $75 million of public float.

JOBS

Exemptions from SOX Section 404(b) and Certain Future PCAOB Rule-Making

Prior to the 2012 presidential election, perceptions that regulation hinders U.S. competitiveness, economic growth, and access to the public capital markets resurfaced on the forefront of public policy debates. In response to these perceptions, and reflecting the economic and political environments at the time, JOBS provides a legislative recalibration targeted at reducing the regulatory burden on smaller companies. JOBS includes provisions that not only exempt emerging growth companies (EGCs) from SOX Section 404(b), but from any future PCAOB rules requiring mandatory audit firm rotation or auditor discussion and analysis.[18] The latter provisions represent an important cautionary "shot across the bow" for the Board. They signal congressional sentiments on these particular issues. And, they signal the willingness of Congress to step in and constrain the PCAOB—even early on at the concept release stage during public dialogue and well before, if ever, the PCAOB formalizes any specific proposal.

Economic Analysis

Another far-reaching provision in JOBS exempts EGCs from PCAOB rules adopted after the enactment of JOBS—unless the SEC determines those rules are necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation. In turn, this means the PCAOB needs to engage in economic analysis to consider these factors before adopting any rule and to document that consideration when submitting its rule approval requests to the SEC (Croteau 2012). Since all PCAOB auditing, quality control, and independence standards fall under the heading of rules, this provision of JOBS has important implications for the PCAOB and the future of audit regulation.

The PCAOB now expects "to devote significant time and resources to preparing analyses to assist the SEC in making JOBS determinations, as well as continuing to explore ways to further incorporate economic analysis into its rulemaking processes" (PCAOB 2012d, 4). As discussed in the next section, doing so will be one of the challenges that will determine the future of audit regulation.

DETERMINANTS OF THE FUTURE

Introduction: The Importance of Developing, Articulating, and Adhering to Core Principles for Audit Regulation

This section looks to the future of PCAOB audit regulation. Certainly the future will depend on who holds the key positions at the SEC (i.e., chairman, other commissioners, and key staffers) and at the PCAOB (i.e., chairman, other Board members, and key staffers). It will likewise depend on what environmental shocks occur (such as major audit failures).[19] But these

[18] The JOBS Act defines EGCs as issuers with less than $1 billion in total annual gross revenues during their most recently completed fiscal year and that first sold common equity securities in a registered offering after December 8, 2011. An issuer would continue to be considered an EGC until the earliest of: the last day of the fiscal year during which it had total annual gross revenues of $1 billion or more; the last day of the fiscal year following the fifth anniversary of the equity IPO; the date on which it has, during the previous three-year period, issued more than $1 billion in non-convertible debt; or the date on which such issuer becomes a large accelerated filer (generally an issuer with public float of $700 million or more).

[19] The PCAOB recognizes this potential as a threat. However, during the last decade, the PCAOB was largely unscathed even though inspections failed to detect both the fraud at Satyam Computer Services and the sham audits of a small firm before it grew to become the seventh largest public company audit firm in the U.S. (based on number of audited companies) (Palmrose 2010b).

factors are difficult to predict, so the discussion focuses instead on the PCAOB's core principles. For example, changes in leadership can involve "regime shifts" with which public company auditors and other stakeholders must contend. And this potential for regime shifts reinforces the importance of developing, articulating, and adhering to core principles for audit regulation that transcend any particular regime.[20] This section uses the PCAOB's core principles to identify issues and offer suggestions for balancing the competing demands of the world it lives in as an audit regulator.

SOX reflects the application of a supervisory or prudential model of regulation for the PCAOB. Indeed, the PCAOB has acknowledged congressional intent in this regard. For example, the PCAOB's 2006 Annual Report states that "Our primary goal is to promote investor confidence in audited financial statements of public companies through effective use of a supervisory model of oversight of registered public accounting firms" (PCAOB 2006a, 2). A supervisory model intends to encourage cooperation and constructive dialogue between the PCAOB and the audit firms it regulates, and discourage adversarial confrontation (Center for Audit Quality [CAQ] 2010, 2 and 6; PCAOB 2006b, 2). A supervisory approach means that "the Board endeavors to address many auditing problems through a combination of inspections and standards-setting," rather than through enforcement (PCAOB 2008, 3). Although the reason is unstated, since 2009, references to the supervisory approach have been dropped from PCAOB strategic plans, annual reports, and speeches.

Nonetheless, the PCAOB has core principles, which are articulated in its vision statement as follows:

> The PCAOB seeks to be a model regulatory organization. Using innovative and cost-effective tools, the PCAOB aims to improve audit quality, reduce the risks of auditing failures in the U.S public securities market and promote public trust in both the financial reporting process and auditing profession. (*Our Vision* from the PCAOB website)

Thus, this vision statement provides a framework for considering the future of audit regulation. In the spirit of continuous regulatory improvement, the commentary suggests steps for enhancing the implementation of the PCAOB's vision through:

- Voluntarily adopting traditional regulatory provisions for accountability and transparency—consistent with the objective of being a model regulatory organization;
- Applying comprehensive and rigorous cost-benefit analysis, and analyzing, understanding, and reporting the PCAOB's unique data—consistent with the objectives of being a model regulatory organization that uses innovative and cost-effective tools;
- Judiciously choosing initiatives, appropriately balancing stakeholder views, while bringing expertise to inform audit regulation, and using carefully crafted messaging—consistent with the objectives to improve audit quality, reduce the risks of auditing failures, and promote public trust in both the financial reporting process and auditing profession.

Adopting Traditional Regulatory Provisions for Accountability and Transparency

According to its vision, the PCAOB seeks to be a model regulatory organization. To do so, it cannot simply abide by its legislative mandates. Moreover, as previously discussed, the PCAOB's legislative mandates leave much room for discretion in their implementation. Thus, the PCAOB

[20] This is consistent with the spirit of Professor Bill Kinney's advice to academics that "when all else fails, try theory."

needs to consider other factors that characterize model regulatory organizations and, where appropriate, voluntarily adhere to these factors, including voluntarily complying with legislation that embodies them.

For example, several key acts apply to the SEC and other government agencies, although neither SOX nor subsequent legislation extend their reach to the PCAOB. These acts include the Federal Advisory Committee Act, which provides transparency, accountability, and other safeguards in the use of advisory groups such as the PCAOB's Standing Advisory Group (SAG) and Investor Advisory Group (IAG), as well as the Administrative Procedure Act and the Government in Sunshine Act, which provide transparency and accountability on process, such as in developing rules and standards.

Notwithstanding that the PCAOB voluntarily complies with selected portions of these acts, it does not comply with them all. As an illustration, the PCAOB does not comply with the requirement under the Sunshine Act for public meetings when more than two Board members discuss substantive matters that are other than confidential; and Board meetings on confidential matters would still need to be disclosed as taking place (such as Board meetings on certain enforcement and inspection matters). The Financial Accounting Standard Board (FASB) voluntarily complies with this requirement and holds open board meetings.

Admittedly, as a member of the SEC staff I found the requirements of these acts added complexity to the rule-making process (Palmrose 2010a). Nonetheless, I have come to appreciate their import and, for example, the essential nature of the transparency and accountability that open standard-setting (rule-making) meetings provide. They give credibility to process. The PCAOB has an opportunity to embrace the provisions of these acts, consistent with its vision of being a model regulatory agency. An important determinant of the future of audit regulation will be whether it voluntarily decides to do so.

Applying Comprehensive and Rigorous Cost-Benefit Analysis

Background

In addition to being a model regulatory organization, the PCAOB's vision includes using innovative and cost-effective tools. Both of these elements would seem to include cost-benefit analysis. Yet, over the last decade, stakeholder views on costs and benefits have been the proverbial "elephant in the room" regarding some of the PCAOB's initiatives, in particular the implementation of SOX Section 404(b) (Palmrose 2010a).

Like other government agencies, the SEC has long considered the costs and benefits of its rules before promulgating them. Each of the four major securities laws administered by the SEC (the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act) contain the same review standard whereby the Commission shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation (Cox and Baucom 2012). While no statute expressly requires the Commission to conduct formal cost-benefit analysis as part of its rulemaking activities, "SEC chairmen have informed Congress since at least the early 1980s, and rulemaking releases since that time reflect, the Commission considers potential costs and benefits as a matter of good regulatory practice whenever it adopts rules" (SEC 2012b, 3).

SOX and Dodd-Frank contain no such legislative requirement for economic (cost-benefit) analysis *per se* by the PCAOB. Even so, many thought the PCAOB should have been doing cost-benefit analysis all along. In the past, Board members assured that they implicitly considered the costs and benefits of PCAOB proposals (Palmrose 2010a). With JOBS, the PCAOB's consideration of costs and benefits now moves from implicit to explicit.

Implementing Economic Analysis

One Board member reported that the PCAOB's first application of the requirements of JOBS to a proposed auditing standard (i.e., AS 16 on audit committee communications) was a challenging learning experience and revealed that the PCAOB has "much work to do to assess the economic consequences of other pending standard-setting projects." He added that the PCAOB confronts a significant task "to evaluate how to incorporate more robust economic analysis in our standard-setting process more generally, including how we begin with a clear articulation of each problem, how we prioritize the problem, and how we assess possible solutions" (Hanson 2012). In addition, members of a congressional oversight committee expressed concern that the PCAOB is "taking insufficient action to comply with the broad consensus that economic analysis is a critical element of credible regulatory policy" (Lynch 2013).

The SEC approved AS 16, including for audits of EGCs. The SEC order granting approval contains a discussion of economic considerations and comments received on the PCAOB analysis of these considerations (SEC 2012d). Nonetheless, the SEC order demonstrates that there are different world views on what it takes to meet the JOBS mandate for economic analysis. How these different views will get reconciled is an open question.

Regardless, the PCAOB's process will be informed by a March 16, 2012 Memorandum from the SEC's Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel to SEC rule-writing Divisions and Offices (SEC 2012b), which provides guidance on the substantive requirements for economic analysis in SEC rule-making. The Memorandum states that it is widely recognized that the basic elements of a good regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis. The Memorandum goes on to give guidance on addressing ways to strengthen these aspects of the SEC's economic analysis.

Future Implications

All things considered, getting to an appropriate approach on the essentials of cost-benefit analysis will be a substantial challenge for the PCAOB. As a consequence, the JOBS mandate may not only delay the PCAOB's standard-setting and other rule-based initiatives, but the substance of these initiatives will likely be altered through the economic analysis process as well. As a result, initiatives such as that on mandatory audit firm rotation may be dropped altogether. For example, one Board member expressed skepticism that the Board would "ever get there" with all the hurdles in front of them, including the need to consider statistical evidence that firm tenure is linked to audit failures and deficiencies and to have a complete analysis showing that the benefits of mandatory audit firm rotation would outweigh the costs (Hanson 2013).[21] Importantly and by necessity, cost-benefit analysis, if done appropriately, should inform the PCAOB's initiatives *both* before and after implementation. Thus, its impact on future audit regulation will likely be great.

Furthermore, consistent with the PCAOB's vision for being a model regulatory organization and using innovative and cost-effective tools, economic analysis should be applied widely by the PCAOB. At the February 13, 2013 Open Commission Meeting, one SEC Commissioner emphasized his view that the PCAOB's cost-benefit analysis should not just be confined to EGCs

[21] Inconsistent with evidence on the former, the Director of Inspections reported at the PCAOB's Academic Symposium in April 2012 based on the PCAOB's internal analysis that one "red flag" for finding inspection deficiencies, at least in small firm inspections, is auditor change and initial year(s) engagements.

(in accordance with JOBS) and mandatory audit firm rotation (in accordance with Chairman Doty's testimony at hearings on March 28, 2012 by the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises), but applied to all initiatives; and, the PCAOB Chairman agreed.

Finally, from the standpoint of scholarship, the JOBS requirement for economic analysis also provides an opportunity for research to help illuminate the costs and benefits of PCAOB proposals and, thereby, inform audit regulation generally. The PCAOB is looking to hire several economists in the Office of the Chief Auditor to assist with economic analysis on audit standard-setting projects, to supplement the work of economists in the Office of Research and Analysis (ORA). The PCAOB is also working on forming a network of academic economists from around the country.[22] But, quite frankly, it is not obvious that economists have a comparative advantage here. While I advocate the benefits of considering research from an inter-disciplinary perspective (Palmrose 2009), analyzing the costs and benefits of auditing standards and rules requires auditing expertise, accounting expertise, and knowledge of the institutional setting for auditing and accounting. Thus, auditing and accounting academics, not just economists, should "have a seat at the table, too" for the PCAOB's economic analysis efforts.

Analyzing, Understanding, and Reporting Its Unique Data

Data are another dimension of using innovative and cost-effective tools. The PCAOB views its "unique data and analysis" (from its inspection authority) as among its strengths. Notwithstanding this strength, the PCAOB also acknowledges its weaknesses include the public and timely reporting of inspection results for both initial findings and determinations of the failure to remediate quality control criticisms.[23] In 2013, the PCAOB is giving priority to improving the timeliness, content, and readability of inspection reports. Thus, the PCAOB is engaging in discussions with its advisory groups and outreach to stakeholders, including audit committee members, with the objective of improving the usefulness of inspection reports (PCAOB 2012d, 5).

As to timeliness of the initial inspection findings, the PCAOB largely attributes the lack of timely public reporting to SOX constraints. However, even though engagement inspections can only proceed once audits (reviews) are completed, such inspections are also subject to practical considerations. For example, the inspection schedule must consider the continuing work-a-day requirements of the auditors on engagements selected for inspection; inspections take a good deal of time for the larger and more complex engagements of annually inspected audit firms; and the PCAOB must allow for adequate internal review and due process before public disclosure. Thus, the timeliness of public reporting will always be a challenge. That said, the realities that delay public reporting of inspection results do not have to delay the commencement of a feedback loop to audit practice within each inspected firm itself. In concept, this feedback loop could likewise be expanded to include a dialogue at the completion of each inspection that involves members of the

[22] See comments at the SEC Open Meeting on February 13, 2013 for the PCAOB's 2013 budget (SEC archives).

[23] SOX Section 104 states that the PCAOB should make available inspection findings in appropriate detail to the public, subject to confidentiality and protection provisions, except that no portions of an inspection report that deal with criticisms of or potential defects in the quality control systems of the inspected firm shall be made public if such criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report. Implementing SOX, the PCAOB has designed audit firm inspection reports in which Part I publicly discloses deficiencies that exceed a certain significance threshold. [Inspected audits are labeled alphabetically (i.e., for issuer A, issuer B, and so on) in order of severity in Part I from most (issuer A) to least severe in the PCAOB's view.] Further, any lesser inspection deficiencies that fall short of the PCAOB's Part I significance threshold are included in the non-public Part II of an inspection report as confidential findings related to quality control criticisms and potential defects.

inspection team, the auditors, and the audit committee of the inspected issuer. In other words, the inspection process serves several masters. Public reporting is not necessarily the end game, but rather one element of the inspection process.

On the "back-end" of the inspection process, nothing is publicly known about the PCAOB's remediation determination process, including the criteria used by the PCAOB in making remediation decisions. Some transparency here would likely benefit auditors, audit committees, and other stakeholders such as auditing educators and students. Even so, reaching timely conclusions on the efficacy of audit firm remediation does not face similar issues of process as inspections, with the exception of appeals. The SOX framework intends to provide incentives for remediation. Meanwhile, delays in the process contribute to disclosing stale information. Given the long delays observed in the release of Part II findings because the PCAOB finally determined firm progress on remediation was not satisfactory, this area seems ripe for PCAOB improvement. The PCAOB recognizes this and includes it among the near term priorities for 2013 (PCAOB 2012d, 5).

Turning to *public* reporting of inspection findings, developing *meaningful* individual audit firm inspection reports and reporting the analysis of aggregated inspection findings (which can involve findings from both Parts I and II of audit firm inspection reports), while recognizing the delayed nature of such reporting, are both areas for improvement. The overarching question that the PCAOB has not yet come to grips with is: "What is usefully learned from the inspection process and how do the findings inform audit practice, audit committees and other stakeholders, and PCAOB regulation of auditing?"

An important consideration here is determining how to use inspection data to provide a substantive and transparent feedback loop into both audit practice and standard-setting (Croteau 2012). Such a feedback loop will have the added benefit of informing auditing scholarship and education, too. Based on that foundation, the next question becomes what and how to best publicly communicate inspection information within the guidelines of SOX, while maintaining confidence in public company audits, as subsequently discussed. From public discussions it appears that the PCAOB is engaged in robust brainstorming on these issues. For example, one Board member has suggested that the PCAOB could consider an annual "state of the profession-type report" that discusses such things as historical trends in inspection data, PCAOB views on root causes of inspection deficiencies, what audit firms are "doing right," best practices, and the like.[24]

Academics tend to be sensitive to data limitations. And, in analyzing, understanding, and reporting its unique data, the PCAOB likewise faces similar issues. Although the inspection process lacks transparency, we do know that these limitations include the non-representative sampling of audit engagements and inspections that involve only certain areas of selected engagements. In particular, the PCAOB discloses that its inspections focus on engagements and areas of the selected engagements with a heightened possibility of audit deficiencies. Other potential (unobservable) considerations include changes in selection criteria and inspection approach over time, cross-sectional and time-series differences in inspection teams (including their expertise), and changes in the criteria for and other factors that influence decisions on comments and, in turn, impact the number and nature of comments included in inspection reports and the thresholds for classifying comments as Part I versus Part II or excluding them altogether.

[24] See comments of Lewis Ferguson during the March 28, 2012 IAG meeting (PCAOB archives) and suggestions made during the May 15–16, 2013 SAG meeting (PCAOB archives). A potential source of best practices could be root cause analysis of audits without inspection deficiencies. Otherwise, discussion of root causes could include more explicit linkage between inspection deficiencies and specific auditing standards, as discussed at the February 13, 2013 SEC Open Meeting on the PCAOB's 2013 budget (SEC archives).

The PCAOB (2012d, 3) has recently expressed concern about "a continuing trend of a high number of deficiencies identified in inspections."[25] In conjunction with this concern, the PCAOB started disclosing the number of engagements inspected for the largest firms, which has facilitated computing audit firm "inspection deficiency rates."[26] However, essential for this type of exercise is an understanding of the nature of the limitations of the PCAOB's inspection data—including from issues related to endogeneity, as illustrated by the considerations noted above—and the extent to which such limitations might undermine the use of inspection data for cross-sectional and time-series comparisons, regardless of metric or count. This is important because the PCAOB is giving priority in 2013 to enhancing its processes and systems to improve the analysis and usefulness of PCAOB inspections findings, including comparative analyses across firms and over time, in order to better understand audit quality in firms and better inform the PCAOB's standard-setting and other regulatory activities (PCAOB 2012d, 5).

Judiciously Choosing Initiatives for Improving Audit Quality and Reducing the Risks of Auditing Failures

Improving Audit Quality

The PCAOB's vision states that the PCAOB aims to improve audit quality and reduce the risks of auditing failures in the U.S. public securities market. Consistent with the overall theme that the PCAOB has considerable discretion in implementing its legislative mandates, from a standard-setting or rule-making perspective, the PCAOB has great scope in choosing its initiatives to improve audit quality and reduce the risks of auditing failures, and these choices should be informed by analyzing, understanding, and reporting its unique data, as just discussed.

Currently, the PCAOB is considering a number of concept releases and proposals that have the potential for large effects on audit practice in the future. Depending on which ones advance to adoption and the details of those that do, substantive changes in the role and responsibilities of auditors could occur. For example, in addition to planning to revise a number of extant auditing standards, the list of current outstanding initiatives includes such things as partner naming, mandatory audit firm rotation, auditor reporting, and audit quality indicators.[27]

Viewing the judiciousness of the PCAOB's choices of initiatives from the standpoint of improving audit quality, and exercising global leadership in regards to improving audit quality, several comments are in order. First, just by taking up an issue especially using formal mechanisms such as concept releases, even if the objective is to engage in public dialogue, the PCAOB creates an expectation that some regulatory action will ensue. This expectation adds noise to the system, so priorities are important and caution is required.

---

[25] This trend in Part I deficiencies appears to partly reflect the shift in inspection focus from efficiencies to effectiveness in ICFR attestations on integrated audits, as previously noted, and to inspecting for internal control reliance issues generally.

[26] The PCAOB cautions against making such computations or otherwise extrapolating inspection results because audit work selected for inspection is not a representative sample, which begs the question of why change and begin disclosing this information for each individual annually inspected audit firm.

[27] Additional changes are possible through more subtle channels. For example, the PCAOB's strategic plan states: "As the audit profession continues to evolve its business models, firms large, medium and small confront choices on profitability, mergers and consolidations, partner productivity, promotions and compensation, practice growth, and marketing emphasis. Through our inspection and enforcement arms we do have insight into the operative consequences of such developments, and we will spend substantial time in working on our 'root cause' analytical tools to gain a deeper understanding of such persistent shortcomings as we may see in audit practice from time to time. In particular, the growth of consulting practices at the largest firms merits careful monitoring through our inspection program. We will examine the firms' approach to selling consulting and other business services and how those initiatives may affect audit quality. We will also continue to address this topic with large firm leadership" (PCAOB 2011c, 15).

For example, mandatory audit firm rotation is an old idea that has resurfaced in a few jurisdictions around the world. Yet, the PCAOB need not have formally taken up the issue with a concept release to exercise global leadership or monitor developments around the world. The U.S. institutional setting has a number of elements not found in many contemporary foreign settings (including those related to corporate governance, regulation, and enforcement). Importantly, the PCAOB's mission focuses on audit quality, while a number of foreign jurisdictions, including several in Europe, are focused on competition and concentration. Otherwise, the U.S. institutional setting post-SOX vastly differs from the U.S. setting pre-SOX, when previous public dialogue on mandatory audit firm rotation occurred in the U.S. An essential point is that leadership involves the wisdom of knowing what not to pursue. This point was stressed by one Commissioner at the SEC's February 13, 2013 Open Meeting. The Commissioner wondered if moving forward on the concept release (PCAOB 2011b) had Board support and, if not, expressed the hope that "we're not sitting here next year having the same discussion" on mandatory audit firm rotation (see Holzer 2013).[28]

Setting aside that specific issue, the PCAOB's concept release (PCAOB 2011b) encompassed auditor skepticism and much of the public dialogue over mandatory audit firm rotation in the U.S. has revolved around this topic. As such, it has reinforced the importance of focusing attention on this element of audit quality and how it might be improved, which is laudable. This attention extends to motivating audit research and stimulating changes in audit education.

On the education front, for example, I recently revised my masters of accounting courses (on current issues in auditing and financial statement analysis) to better incorporate auditor skepticism. In financial statement analysis, I now build in "moments of reflection" to remind my students to pause and consider "connecting the dots" or addressing disconfirming evidence.[29] During these "moments of reflection," we discuss the types of analyses and reasoning that "skeptical" auditors might use in each particular circumstance to meet the difficult challenge of decision-making under uncertainty. My hope is that students will internalize these "moments of reflection" and likewise apply them in practice. In addition, this year, at the University of Washington, where we have a winter quarter internship component in our masters of accounting program, we asked our students to write an essay on their experiences with auditor skepticism during their internship. We learned that this assignment helped our interning students engage in some useful discussions in the field with audit team members on the exercise of professional skepticism.

Finally, highlighting the PCAOB's objective to improve audit quality raises the essential question: Has audit quality improved over the last decade with the move to PCAOB regulation of public company auditing? As noted in the introductory section of this commentary, the PCAOB maintains that it has been effective in improving the quality and credibility of audits. Surveys provide some evidence in support of this assertion. For example, a CAQ survey of audit committee members reports that more than 75 percent rate overall audit quality "very good" or "excellent," and 82 percent say it has improved in recent years (CAQ 2008).

It is beyond the scope of this commentary to tackle whether audit quality has improved post-SOX. Academics appreciate the challenges in defining and measuring audit quality and, therefore, in using empirical evidence to assess cross-sectional and time-series differences in audit quality (e.g., see Palmrose 2012). Even so, a large number of academic studies examine issues related to audit quality and evidence from these studies may provide insights on changes in audit quality under the PCAOB. So, assessing whether audit quality has improved over the last decade with the move from private-sector to government regulation of auditing is left to future research. That said,

---

[28] In April 2013, legislation was introduced in the House of Representatives as the Audit Integrity and Job Protection Act (H.R. 1564) that would amend SOX to prohibit the PCAOB from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis.

[29] I thank Ken Bouyer at Ernst & Young for naming these "moments of reflection."

the issue takes on added importance as the PCAOB has announced that a priority for 2013 is "initiating a project to identify audit quality measures, with a longer-term goal of tracking such measures with respect to domestic global network firms and reporting collective measures over time" (PCAOB 2012d, 5; Franzel 2013).[30]

Reducing the Risk of Audit Failures

The initiative to identify and track audit quality metrics also relates to the objective of reducing audit failures, which is likewise an element of the PCAOB's vision. This inclusion moves the definition of an audit failure to center stage. The widely used and long-standing definition of an audit failure, which involves a meaningful departure from auditing standards that fails to appropriately detect a material misstatement of the financial statements, has been articulated by the GAO (GAO 2003).[31] However, in 2011 the PCAOB began using its own definition of audit failure in large firm inspection reports (Franzel 2013). That is, the PCAOB began using the term "audit failure" instead of "significant deficiency" to describe each audit engagement with Part I inspection findings for the largest audit firms. This occurs even though such reports likewise reveal that Part I findings are rarely associated, for example, with any restatements. Further, it has not gone unnoticed that equating Part I inspection findings (such as lacking an appropriate understanding of methods and assumptions used by pricing services or other third-parties in fair valuing certain financial instruments [which are apparently not misstated]) to "audit failures" conflates such findings with failing to detect material misrepresentations, as in cases like the management fraud at WorldCom.

Frankly, the objective here is a puzzle. Thus, it is difficult to assess the judiciousness of this move. Perhaps using the term "audit failure" is designed to elevate the importance of inspection findings. Or, maybe the intent is to somehow spur improvements in audit quality. Regardless, Franzel (2013) suggests that these issues will get sorted out with the PCAOB's project on audit quality indicators. Meanwhile, some caution is in order from a cost-benefit perspective.

Since the PCAOB's vision includes reducing the risk of audit failures, characterizing Part I inspection findings as audit failures has subtle but non-trivial implications. For example, while we can all agree that fewer Part I inspection findings are preferable to more, *ceteris paribus*, it is an open question whether a regulatory structure *based* on a discretionary decision by the PCAOB to minimize the risk of Part I inspection findings (with no investor losses) could be cost-benefit effective as compared to a structure focused on minimizing the risk of audit failures as commonly defined (where the potential for investor losses would be a first-order concern). In addition, another potential concern is that, while the PCAOB is now doing economic analysis as part of its rule-making process, any audit quality measures developed and applied through mechanisms other than PCAOB rules or standards would bypass the SEC approval process and, therefore, could avoid the requirement for economic analysis.

[30] For example, the May 15–16, 2013 SAG meeting solicited feedback from SAG members on the PCAOB's preliminary thinking on audit quality indicators (see PCAOB archives).

[31] The GAO (2003, 6) uses the term "audit failure" to refer to "audits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud, and reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was not conducted in accordance with generally accepted auditing standards, and, therefore, the auditor failed to appropriately detect and/or deal with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC."

Appropriately Balancing Stakeholder Views and Bringing Expertise to Inform Audit Regulation

The PCAOB's articulated vision includes promoting public confidence and trust in both the financial reporting process and auditing profession. How the PCAOB calibrates its approach to doing so will be an important determinant of the future of audit regulation. Part of the "trust and confidence" challenge for the PCAOB is how to obtain appropriately balanced stakeholder views to inform its regulation of auditing. Here, the PCAOB might proceed on two fronts: (1) to extract itself from having become a tool of selected investor advocates and (2) to bring the expertise of currently practicing auditors to inform its processes—while avoiding the appearance of regulatory capture. The former problem was exacerbated with the formation of IAG, as subsequently discussed. IAG also gave a handful of voices additional sway through continuing appointments to seats on both IAG and the SAG.[32] In a positive development, some of the 2013 appointments to SAG break with this tradition, although SAG and IAG continue to have a few "permanent-type" members and a few people continue to serve on both.

An overarching issue here involves reconsidering the long-standing PCAOB mindset that intends to distance itself from those it regulates. This mindset is behind the PCAOB's decade-old decision to set its own standards and to demur on the convergence of auditing standards, as previously discussed. It has had a pervasive impact on the regulation of public company auditing over the last decade. While the PCAOB *permanently hires* former public company auditors, by design, the PCAOB keeps *currently practicing* auditors from substantive involvement in its initiatives, including standard-setting.[33] As a result, audit firm input appears largely confined to writing comment letters on concept releases and exposure drafts as part of the PCAOB's formal due process available to all stakeholders.

As noted, the PCAOB formed two major advisory groups—only one of which includes practicing auditors.[34] But setting aside membership, the PCAOB has not yet figured out how to effectively use either SAG or IAG to inform its activities, including standard-setting. For example, regardless of who is appointed to SAG, this cannot possibly be a group that optimally informs the development and drafting of PCAOB auditing standards or other rules and initiatives. This is because SAG currently consists of 40 or so members, meets twice a year for four days or less in total, and discusses a variety of topics at each meeting based on an agenda largely controlled by the PCAOB. Further, while the PCAOB references SAG input to support various Board and staff positions, these references run the risk of being seen as "cherry-picking" because nearly every point of view is heard from SAG, regardless of topic, without any explicit (or often discernible) consensus reached.

---

[32] The PCAOB specifies that both IAG and SAG membership is personal to the member. This means that individuals, not their affiliated companies, firms, organization, or institutions, are members of IAG and SAG. Further, IAG members serve three-year terms and no one can be an IAG member for more than nine consecutive years.

[33] In this regard, the PCAOB is unlike the SEC. For example, the SEC's Professional Accounting Fellow (PAF) Program is one mechanism for bringing current accounting and auditing expertise into the Agency, while maintaining objectivity. In spite of recommendations to do so in the Final Report of the Treasury Advisory Committee on the Auditing Profession (ACAP 2008) and by others (Palmrose 2010b), the PCAOB has declined to institute a PAF-type program.

[34] Of the 40 members of SAG for 2013, only nine are from audit firms. Nonetheless, in all fairness, while another 16 or so are not currently with audit firms and may not have practiced auditing for some time, they did spend time in public accounting. The PCAOB also has a Pricing Sources Task Force, which has eight out of 24 members from audit firms. IAG includes no practicing auditors. Any other currently active PCAOB committees or advisory groups are unknown, as they have no transparency, an issue previously discussed.

In contrast, the PCAOB uses subcommittees on IAG (but not SAG). IAG subcommittees meet privately and appear to have free reign on topics. They draft subcommittee reports, too. Indeed, these reports tend to develop consensus positions that seem intended to help drive the PCAOB's agenda. In this regard, it is concerning that some IAG subcommittees have taken to surveying themselves and others and presenting the results as if the individual views represent the views of organizations with trillions of investment dollars and, therefore, investors generally.

To summarize, all things considered, a ten-year milestone presents a perfect opportunity to re-evaluate how the PCAOB seeks stakeholder input to inform its processes, including the use of advisory-type groups. Suggestions have been made for expanding the use of advisory groups, including, for example, forming an issuer/audit committee advisory group.[35] And perhaps the PCAOB could even experiment with forming traditional project specific standard-setting task forces. Regardless, it appears that the future of audit regulation will be shaped in a positive way if the PCAOB can abandon the status quo and re-craft a vision for optimally eliciting balanced views on the issues at hand—during all stages of the process. Such a vision should encompass obtaining the wisdom and expertise of all stakeholders, including those that understand audit quality and the drivers of audit quality, especially the expertise that resides with practicing auditors.

Using Carefully Crafted Messaging to Promote Confidence and Trust

Finally, an additional challenge for the PCAOB in achieving its vision of promoting confidence and trust in both the financial reporting process and auditing profession is how to maintain confidence in both itself as the audit regulator *and* in the auditors it regulates. Certainly the PCAOB's role encompasses being a critic. But, with carefully crafted messaging, it is possible to be a critic without undermining confidence and trust. For example, based on my experience, one approach that the SEC uses is to generally avoid indicting the many when using anecdotes about problems with the few.

Even in regard to inspection findings, balanced messaging is possible. To illustrate, the overview section of each audit firm report on the PCAOB's 2003 initial limited inspections for the large firms included the following:

> [F]rom the Board's perspective, the inspection reports are not intended to serve as balanced report cards, rating tools, or potential marketing aids for any firm. The reports are intended principally to focus our inspection-related dialogue with a firm on those areas where improvement is either required for compliance with relevant standards and rules, or is likely to enhance the quality of the firm's audit practice.
>
> The reports' emphasis on these criticisms, however, should not be understood to reflect any broad negative assessment. The four firms inspected in 2003 are made up of thousands of audit professionals, have developed multiple volumes of quality control policies, and perform audits for a combined total of more than 10,000 public companies. It would be a mistake to construe the Board's 2003 inspection findings as suggesting that any of these firms is incapable of providing high quality audit services.

Although this and related text was subsequently dropped from inspection reports, it provides one example of using carefully crafted messaging to promote confidence and trust, while likewise performing the function of a critic, as Part I of each report went on to describe inspection deficiencies.

Further on the inspection front, reasonable differences can exist between judgments of PCAOB inspectors and those of auditors on accounting and auditing matters, including the requisite nature,

[35] See discussion of audit committee outreach at the May 15–16, 2013 SAG meeting (PCAOB archives).

timing, extent, and documentation of audit evidence. It is important for all stakeholders to take PCAOB inspection findings seriously. However, the point is not to silence alternative perspectives, but to encourage a robust dialogue about the issues, including among regulators, auditors, and audit committees (e.g., see PCAOB 2012b).

To summarize, a key for the future of audit regulation is whether the PCAOB can navigate to an effective and balanced approach to messaging. Such messaging would be characterized by candor, while maintaining confidence and trust in public company audits and the auditing profession—consistent with the PCAOB's vision. Such messaging would also provide appropriate incentives for and encouragement to audit firms and their individual auditors to maintain and continually strive to improve audit quality.

REFERENCES

Advisory Committee on the Auditing Profession (ACAP). 2008. *Final Report*. (October 6). Washington, DC: U.S. Department of the Treasury.

Center for Audit Quality (CAQ). 2008. Report on the Survey of Audit Committee Members Conducted By the CAQ. (March). Washington, DC: CAQ.

Center for Audit Quality (CAQ). 2010. Brief of *Amicus Curiae* Center for Audit Quality in Support of KPMG LLP. (May 12). Washington, DC: CAQ.

Cox, J. D., and B. J. C. Baucom. 2012. *The Emperor Has No Clothes: Confronting the DC Circuit's Usurpation of SEC Rulemaking Authorit*y. Working paper, Duke University.

Croteau, B. T. 2012. *Policy Choices Informed by Root Cause Analysis and the Audit Performance Feedback Loop—Investors are Counting on All of Us*. Remarks before the 2012 American Accounting Association Annual Meeting, August 6. Available at: http://www.sec.gov/news/speech/2012/spch080612btc.htm

Franzel, J. M. 2013. *Protecting Investors by Seizing the Opportunity to Strengthen Audit Quality*. Speech at the American Accounting Association Midyear Conference and Doctoral Consortium, January 18. Available at: http://pcaobus.org

Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board and United States of America. 130 S. Ct. 3138, 177 L. Ed. 2d 706. 2010.

General Accounting (Accountability) Office (GAO). 2003. *Public Accounting Firms Required Study on the Potential Effects of Mandatory Audit Firm Rotation*. (GAO 04-217). Washington, DC: Government Printing Office.

Glover, S. M., D. F. Prawitt, and M. H. Taylor. 2009. Audit standard setting and inspection for U.S. public companies: A critical assessment and recommendations for fundamental change. *Accounting Horizons* 23 (2): 221–237.

Goelzer, D. L. 2010. *Statement on Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Broker Dealers*. (December 14). Available at: http://pcaobus.org

Hanson, J. D. 2012. *Statement on Auditing Standard Related to Communications with Audit Committees*. PCAOB Open Board Meeting. (August 15). Available at: http://pcaobus.org

Hanson, J. D. 2013. News Digest highlights: PCAOB member Jay Hanson said that he struggles to see how the board would ever be able to create a mandatory audit firm rotation requirement. *Journal of Accountancy* (February): 11, 13.

Holzer, J. 2013. Oversight board chairman pressed on auditor rotation plan. *CFO Journal/ Wall Street Journal* (February 13). Available at: http://blogs.wsj.com/cfo/2013/02/13/oversight-board-chairman-pressed-on-auditor-rotation-plan/

Kinney, W. R., Jr. 2005. Twenty-five years of audit deregulation and re-regulation: What does it mean for 2005 and beyond. *Auditing: A Journal of Practice & Theory* 24 (Supplement): 89–109.

Lynch, S. N. 2013. U.S. House panel probes audit watchdog's economic analyses. *Thomson Reuters* (January 14). Available at: http://www.reuters.com/assets/print?aid=USBRE90D14I20130114

Palmrose, Z.-V. 1991. Trials of legal disputes involving independent auditors: Some empirical evidence. *Journal of Accounting Research* 29 (Supplement): 54–71.

Palmrose, Z.-V. 2006. Maintaining the value and viability of auditors as gatekeepers under SOX: An auditing master proposal. In *Financial Gatekeepers: Can They Protect Investor*, edited by U. Fuchita, and R. Litan, 103–135. Baltimore, MD: The Brookings Institute.

Palmrose, Z.-V. 2009. Science, politics, and accounting: A view from the Potomac. *The Accounting Review* 84 (2): 281–297.

Palmrose, Z.-V. 2010a. Balancing the costs and benefits of auditing and financial reporting regulation post-SOX, Part I: Perspectives from the nexus at the SEC. *Accounting Horizons* 24 (2): 313–326.

Palmrose, Z.-V. 2010b. Balancing the costs and benefits of auditing and financial reporting regulation post-SOX, Part II: Perspectives from the nexus at the SEC. *Accounting Horizons* 24 (3): 487–507.

Palmrose, Z.-V. 2012. *Public Policy Perspectives on Audit Quality Research*. Working paper, University of Washington.

Panel on Audit Effectiveness. 2000. *Report and Recommendations*. (August 31). Stamford, CT: Public Oversight Board.

Public Company Accounting Oversight Board (PCAOB). 2004. *Rule 4012 Inspections of Foreign Registered Public Accounting Firms*. PCAOB File No. 2004-04; Sec Release No. 34-50291. (August 30). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2006a. *PCAOB Annual Report: Strengthening Investor Confidence*. Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2006b. *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms In Inspection Reports*. PCAOB Release No. 104-2006-077. (March 21). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2008. *PCAOB Strategic Plan 2008–2013*. (March 31). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2010. *Consideration of Registration Applications from Public Accounting Firms in Non-U.S. Jurisdictions where There are Unresolved Obstacles to PCAOB Inspections*. PCAOB Release No. 2010-007. (October 7). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2011a. *PCAOB Annual Report: Protecting the Public Interest Through Audit Oversight*. Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2011b. *Concept Release on Auditor Independence and Audit Firm Rotation and Notice of Roundtable*. PCAOB Release No. 2011-006. (August 16). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2011c. *PCAOB Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2011–2015*. (November 30). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2012a. *PCAOB Budget 2010–2012*. Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2012b. *Information for Audit Committees about the PCAOB Inspection Process*. PCAOB Release No. 2012-003. (August 1). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2012c. *Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers*. PCAOB Release No. 2012-005. (August 20). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2012d. *PCAOB Strategic Plan: Improving the Relevance and Quality of the Audit for the Protection and Benefit of Investors 2012–2016*. (November 30). Available at: http://pcaobus.org

Public Company Accounting Oversight Board (PCAOB). 2013. *News Release: PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators*. (May 24). Available at: http://pcaobus.org/News/Releases/Pages/05202013_ChinaMOU.aspx

Reilly, D. 2012. Playing peekaboo with audit watchdog. *Wall Street Journal* (August 25-26).

Schapiro, M. L. 2012. *Testimony before the Subcommittee on Financial Services and General Government Committee on Appropriations United States House of Representatives*. (March 6). Available at: http://www.sec.gov/news/testimony/2012/ts030612mls.htm

Securities and Exchange Commission (SEC). 2002. *Commission Formally Proposes Framework For a Public Accountability Board*. (June 20). Available at: http://www.sec.gov/news/press/2002-91.htm

Securities and Exchange Commission (SEC). 2011. *Delegation of Authority to Chief Accountant*. SEC Release No. 34-63699. (January 11). Available at: http://www.sec.gov

Securities and Exchange Commission (SEC). 2012a. *In Brief: FY 2013 Congressional Justification*. (February). Available at: http://www.sec.gov

Securities and Exchange Commission (SEC). 2012b. *SEC Memorandum Regarding Current Guidance on Economic Analysis in SEC Rulemakings*. (March 16). Available at: http://www.sec.gov

Securities and Exchange Commission (SEC). 2012c. *Press Release: SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Reusing To Produce Documents*. (December 3). Available at: http://www.sec.gov

Securities and Exchange Commission (SEC). 2012d. *Order Granting Approval of Proposed Rules on Auditing Standard No. 16, Communications with Audit Committees, and Related Transitional Amendments to PCAOB Standards*. Release No. 34-6845 3. (December 17).

U.S. Senate Committee on Banking, Housing, and Urban Affairs (U.S. Senate). 2002. *Report on Public Company Accounting Reform and Investor Protection Act of 2002*. Report 107-205. (July 3). Washington, DC: Government Printing Office.

APPENDIX A

Comparison of PCAOB and SEC Responsibilities and Resources

As subsequently discussed, the PCAOB's annual budget is about 17.5 percent of the SEC's and its staffing is about 20.5 percent. The heart of the PCAOB's activities focuses on annually inspecting nine large U.S. firms, with about 272 additional audit firm inspections planned during 2012. A small amount of PCAOB resources are devoted to standard-setting; and enforcement gets almost three times the amount of resources as standard-setting.

To explain, the PCAOB's budget for 2012 provides for total outlays of $227.7 million. The breakdown is as follows:

- 50 percent for the Division of Registration and Inspections;
- 25 percent for administration (of which IT is nearly half);
- About 9 percent for the Division of Enforcement and Investigations;
- Slightly more than 3 percent for the Office of the Chief Auditor (Standards), 10 percent for other offices, and 3 percent for the Board and executive staff (PCAOB 2012a).

As of December 31, 2011 (and used for planning 2012 inspections), 2,388 audit firms were registered with the PCAOB. However, 72 percent of these firms issued no audit reports (1,004 U.S. and 708 non-US for a total of 1,712 firms). Otherwise, 28 percent issued one to 100 audit reports (467 U.S. and 200 non-US for a total of 667 firms), which would make them subject to tri-annual inspections. Less than 0.5 percent issued more than 100 audit reports (nine U.S. and no non-US firms) and are, therefore, subject to annual inspection (PCAOB 2011a). During 2012, the PCAOB planned to inspect a total of 281 audit firms (90 of which are non-US) (PCAOB 2011c).

By way of comparison, the SEC's appropriation for fiscal year 2012 was about $1.3 billion, which was offset by collections of fees on securities transactions. As of March 2012:

- The SEC has responsibility for approximately 35,000 entities, including direct oversight of about 11,700 investment advisers, 9,700 mutual funds and exchange traded funds (ETFs), and close to 4,500 broker-dealers with more than 160,000 branch offices;

- The SEC also has responsibility for reviewing the disclosures and financial statements of more than 9,100 reporting companies;
- The SEC oversees approximately 450 transfer agents, 15 national securities exchanges, eight active clearing agencies, and nine nationally recognized statistical rating organizations (NRSROs), as well as the PCAOB, Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC);
- Due to recent changes in the law, smaller investment advisers will transition from SEC to state oversight during 2012, but with the corresponding addition of advisers to private funds, the SEC estimates that the agency will still oversee approximately 10,000 investment advisers with about $44 trillion in assets under management.
- Over FY 2012 and FY 2013, the SEC expects to fully implement its new oversight responsibilities with respect to municipal advisors and entities registering with it in connection with the security-based swap regulatory regime (Schapiro 2012).

In terms of staffing, by the end of 2012, the PCAOB plans to have 810 staff in place (PCAOB 2012a). The SEC estimates 3,946 full-time equivalent employees for 2012 (SEC 2012a).

One final comparison on resources devoted to standard-setting, the Financial Accounting Foundation (FAF) budget for accounting-related standard-setting activities by the Financial Accounting Standard Board (FASB) and Governmental Accounting Standards Board (GASB) called for total outlays of $54.8 million during 2012 (of which $39.1 million involved the FASB and advisory groups). The PCAOB 2012 budget for audit standard-setting totaled $8.3 million.