

Investor Advisory Group of the
Public Company Accounting Oversight Board

Summary of May 4, 2010 Meeting

A [full recording of the meeting](#) is available on the Public Company Accounting Oversight Board (PCAOB) Web site. For a complete record of the Investor Advisory Group (IAG) members' views, interested parties are encouraged to listen to the recording rather than rely on the summary below, which includes only selected highlights from the meeting. The views expressed in this summary do not necessarily reflect the views of the PCAOB, the members of the Board, or the Board's staff.

The meeting consisted of six panel discussions. Each of the first five panels focused on a specific topic, and the last panel invited a discussion of additional views and recommendations not expressed during the previous panels.

***Panel 1 – Lessons Learned From the Financial Crisis and
the Establishment of a Fraud Center***

Some IAG members noted that there should be some method, short of enforcement, to target for resolution, systemic problem areas identified during the financial crisis. One such area could be how auditors assess the quality of a company's earnings and the "tail risk" associated with certain financial instruments. Some members indicated that auditors should ask if a deal or transaction makes economic sense.

Some members noted that a national center focused on the prevention and detection of financial fraud ("Fraud Center"), as currently being developed by the Board, could be involved in assessing lessons learned from the financial crisis. In addition to examining instances of possible fraud and bad actors, the center also should look for systemic risks beyond fraud. It was noted that the Fraud Center could be a good vehicle for making nonpublic information about fraud detections and preventions (in an anonymous form) available to auditors and others.

Some members indicated that calling it a "Fraud Center" may not make sense because it needs to look at the bigger picture and at situations that do not rise to the level of fraud.

It was noted that the Fraud Center may find that deficient disclosures played more of a role in the current crisis than misstated financial statements, and that auditors were not paying enough attention to those disclosures. It was suggested that auditors should place themselves in investors' shoes and ask what information, if they were investing in the company, they would want to know.

Some suggested that the Fraud Center could emulate the National Transportation Safety Board and arrive on the scene soon after an audit failure, find the cause of that failure, and issue a public statement regarding relevant issues and how those issues would be addressed. Other members noted that the PCAOB already may inspect audit failures on a timely basis.

Some members noted that the Fraud Center could provide advice to and tools for boards of directors as well as auditors, as board members continually are trying to look forward to find where the next fraud might be. Some also suggested that the Fraud Center could address expectation gaps between auditors and investors through long-term educational efforts.

While most agreed that the Fraud Center would need to be forward-looking, they also noted that certain fraudulent conduct does tend to be repeated (such as improper revenue recognition and CEO or CFO participation in frauds). It was indicated that one lesson to be learned is for auditors to consider tips from whistleblowers in finding frauds. Serial restatements were identified as another potential indication of fraud. Another lesson to be learned is that auditors need to look for poor judgment on the part of management as well as fraud.

A suggestion was made that in drafting new standards the PCAOB should consider closer coordination with the standards issued by the Institute of Internal Auditors. Other suggestions were that the PCAOB issue timely guidance on “hot issues” and that the PCAOB oversee audits of brokers and dealers.

Some IAG members indicated that the PCAOB needs to turn to the 2008 recommendations of the Treasury Advisory Committee on the Auditing Profession for ways to improve the transparency and accountability of the auditor.

Some IAG members contrasted audit reports with management certifications under section 302 of the Sarbanes-Oxley Act of 2002. They indicated that 302 certifications are not limited to whether financial statements comply with generally accepted accounting principles. They also indicated that auditors spend very little time with management disclosures regarding enterprise risk management and similar measures. Other members indicated that when safeguarding assets is an issue, auditors should examine a company’s operational controls and compliance procedures. They indicated that such procedures could resemble the procedures for issuance of a type II, SAS 70 report.

Finally, some members emphasized that auditors need to change their attitude away from avoiding liability and to an attitude of serving the public, which is a long-term project. It was observed that the PCAOB should strive to change auditors’ ethics, culture, and behavior by considering incentives, prophylactic measures, and punishments.

Overall, suggestions made by IAG members included that the PCAOB report on the lessons learned from the financial crisis, continue with its efforts to create a national

fraud center that broadly examines risks to financial reporting and publishes public reports, and address the recommendations from the Treasury Advisory Committee on the Auditing Profession.

Panel 2 – Foreign Inspections

PCAOB Acting Chairman Goelzer began the panel by noting that approximately 930 foreign public accounting firms are registered with the PCAOB, but that only a segment of those firms issue audit reports on issuers' financial statements or play a substantial role in the preparation of such audit reports and, therefore, are subject to PCAOB inspections. He stated that over the last six years the PCAOB has conducted over 200 international inspections in 33 jurisdictions. He also noted, however, that the Board currently is unable to inspect firms in the European Union, China and Switzerland. Acting Chairman Goelzer described the Board's efforts to inspect firms in those jurisdictions and, pending agreement on access to those jurisdictions, the activities the Board has taken and is considering taking in order to inform investors of the firms, and the firms' audit clients, that are not subject to PCAOB inspections.

Some IAG members then presented specific information regarding the foreign public accounting firms registered with the PCAOB, and described the Board's statutory mandate to inspect firms that audit issuers (or that play a substantial role in the audits of issuers). Some IAG members estimated that approximately 200 of the 930 registered foreign public accounting firms are subject to the Board's inspection process.

Some IAG members emphasized that the PCAOB has been denied access to certain countries for the purpose of conducting inspections due to legal conflicts with home country laws or national sovereignty issues. They stated that PCAOB inspections have been blocked in countries with the third through sixth largest economies in the world based on gross domestic product (3-China, 4-Germany, 5-France, 6-United Kingdom). These IAG members indicated that the PCAOB's response has been to postpone certain inspections, disclose the names of firms not yet inspected, and disclose jurisdictions that have denied the PCAOB access. Other members suggested that the PCAOB pursue disciplinary actions against firms that fail to cooperate with PCAOB inspection requests.

Some IAG members discussed alternatives to inform investors when auditors have not been subject to PCAOB inspections. Members generally agreed that it is important to inform investors when parts of the financial statements are audited by an uninspected firm.¹ Other members noted that boards of directors and companies are aware of the use of other accounting firms during the audit, as the company may send its employees to other locations to assist those auditors.

¹ Subsequent to the meeting, on May 18, 2010, the PCAOB posted to its Web site, at <http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>, the names of issuer clients of PCAOB-registered firms in jurisdictions where the PCAOB is denied access to conduct inspections.

Some members discussed the branding and quality control efforts of the major international firms. Some members suggested that investors are unaware of the fact that, despite the use of a common brand around the world, there can be significant differences in quality controls between U.S. firms and their foreign affiliates. Other members suggested that the major international firms devote considerable resources to quality control matters connected with their foreign affiliates and that disclosure of firms' global quality controls would help investors.

It was observed by some members that the major international firms often use international auditing standards as their base standards and then add on additional PCAOB requirements when performing audits subject to PCAOB oversight. The point was made, however, that if the base international standards or performance of those standards are deficient, then adding on incremental PCAOB requirements will not cure those deficiencies. It was urged that audits be performed entirely under PCAOB standards.

Some IAG members noted that PCAOB reliance on, or convergence with, international auditing standards would not be appropriate because those standards are set by the profession (through the International Auditing and Assurance Standards Board) and Congress rejected allowing the profession to set its own standards. It was noted that it may be possible for PCAOB standard setters and international standard setters to agree, but that reaching agreement should not be an end in itself.

Other members noted that even with uniform standards, there may not be uniform audits due to cultural and other differences. The point also was made that the goal should be high standards, not convergence. The example was cited where International Financial Reporting Standards had to be made less stringent and provide investors with less information because certain small countries could not assure compliance with more demanding standards.

Finally, some IAG members noted that investors do not have the resources to call audit partners all over the world, and to review all of the thousands of elements that may enter the auditor's analysis of whether to issue a clean audit opinion. Instead, investors rely on PCAOB inspections to provide assurance that audits have been conducted in accordance with the applicable standards.

Suggestions made by IAG members therefore included that the PCAOB continue efforts to obtain access to foreign registered accounting firms for the purpose of conducting inspections and, in the interim, increase disclosures when auditors are not inspected by the PCAOB.

Panel 3 – Greater Transparency and Governance of Audit Firms

Some IAG members indicated that transparency in three areas would be especially helpful: (1) a firm's client acceptance procedures (how does the firm decide

which clients to accept and then which ones to keep), (2) a firm's global network (who is in the network and who are their clients), and (3) available audit liability insurance (which some IAG members indicated mostly is hidden from trial lawyers but does exist).

Some members also noted that the market for audit services for large companies is concentrated among four firms. They indicated that the possibility of one or more of those firms failing is a systemic risk that should be managed by the PCAOB and others. To manage that risk, some IAG members suggested that the PCAOB should gather information from the firms regarding their quality controls, governance, and financial conditions, including obtaining the firms' financial statements.

The systemic risk of one of the four largest firms failing was described by one member as "too few to fail" (as opposed to "too big to fail"). Some IAG members noted that if the Board does not obtain the information it needs to understand the vulnerability of each firm to failure and dissolution, then the Board "would have nowhere to hide" if a firm failed and the PCAOB was asked why it had not taken steps to protect investors from any resulting disruption in the securities markets.

Some IAG members noted that the large accounting firms, as limited liability professional partnerships, typically manage their finances, and therefore their financial statements, for tax purposes. This means that they may pay out virtually all of their earnings to partners and, because they may not receive tax deductions for pension contributions, they may carry large unfunded pension liabilities. Other members noted, however, that a firm's financial statements still would provide the Board with important information related to a firm's expenditures on IT and personnel (including training), on the firm's liquidity, and "calls on cash."

The discussion of liability insurance led to a discussion of auditor liability. Some members noted that no major firm had been "brought down" as a result of shareholder litigation and that, with few exceptions, the largest payments by the firms resulted from actions initiated by the government.

Some members suggested auditors should be allowed to form corporations in order to be able to obtain capital for expansion. Others noted the importance of removing the barriers to small firms' growth. Still other members, however, opposed allowing auditors to form corporations due to concerns that incentives to maximize profits would supplant professional ethics and reduce audit quality. It was noted that several firms experimented with "alternative firm structures" in the past, and that those that implemented alternative structures eventually regretted it.

Other efforts related to firm transparency discussed by the IAG members included having each firm disclose "audit quality indicators" and having firm engagement partners sign their names (as opposed to the firm name) to audit reports. Several members who had experience signing both audit reports and management certifications or other personal documents noted that there is a "different feeling" when signing their own name as opposed to the firm name.

The use of firm advisory boards, composed of individuals who are independent from the firm, also was discussed, with some members indicating that such boards could provide helpful, outside advice to the firm.

Another possible initiative discussed by some IAG members was to have the Board issue clear statements regarding conflicts of interest and auditor independence. Some IAG members discussed increasing transparency regarding how firms address conflicts of interest that arise. Other members indicated that there will not be true independence until firms stop being paid directly by their audit clients. Additional IAG members indicated that there should be a requirement that companies rotate auditing firms (as opposed to audit partners) every five years. These members noted that a requirement to change firms periodically could increase competition in the market for audit services and because the change would be required by the PCAOB it would not have a negative implication for the company. Other members indicated that changing firms every five years would be disruptive to a company's finance and accounting teams and would not be easy in large international companies that undergo continual, year-round audit procedures.

Suggestions made by IAG members therefore included that the PCAOB require registered firms to disclose to the public information related to their audit practices, require engagement partners to sign audit reports in their own names (as opposed to firm names), and consider requiring or encouraging each firm to have an advisory board composed of individuals who are independent from the firm.

Panel 4 – Greater Transparency of the Audit Process

According to some IAG members, the auditor's report should be written in plain English and expanded to discuss the auditor's responsibilities for detecting fraud and the quantitative and qualitative tests the auditor uses to evaluate what information would be material to a reasonable investor.

Other members indicated that firms should disclose how the firm staffed the audit, the use of subject matter experts during the audit, the audit plan, and the principal risks taken into account in planning and performing the audit. Other items that some members indicated could be disclosed included trends in the company's internal control over financial reporting, regulatory risks facing the company, and auditor independence.

Some members indicated that there might be two reports – one for large investors who understand accounting terminology and one for smaller, retail investors who would prefer a plain English report.

Some members wanted the auditor's report to give an indication of "how close the company is to the edge of the cliff." It was noted that accounting often deals with selecting amounts within ranges of possible valuations, and investors should know the

risks resulting from that selection process. One member indicated that investors want to know how hard the company is pushing to get numbers at one end of the range.

Other IAG members like the current pass/fail auditor report because it requires the auditor to make a definitive and clear decision about the financial statements. They indicated that a multi-page audit opinion could be confusing for investors. Many of these members, however, support a supplemental “auditors’ discussion and analysis” that would describe many of the items currently included in firms’ summary memoranda. A summary memorandum is included in the auditor’s work papers at or near the end of each audit and describes, among other things, the major risks associated with the audit.

It also was noted that the Financial Accounting Standards Board (FASB) is considering a recommendation for a new disclosure framework that would require companies to disclose key assumptions, ranges of outcomes, and other items significant to the preparation of the company’s financial statements. Some IAG members believed that, if investors received a firm’s summary memorandum and the information provided by the new disclosure framework being considered by FASB, investors would have important new information.

The point was made that at the end of the audit there are a handful of issues that are problematic, and investors want to know about these issues. One member suggested that the PCAOB require that auditors disclose in the audit report, or elsewhere, the three to five most debatable aspects of the financial statements. Another member suggested disclosure of issues an engagement team discusses with its firm’s national office. Some members indicated that disclosure of the auditor’s findings is what is important, such as the information that is provided to the audit committee.

It was noted that everyone seemed to be talking about the same thing – distilling into meaningful disclosure the issues that concerned the auditor and how the auditor got comfortable enough to issue his or her opinion.

A note of caution was made, however, that because of concerns that the disclosure of divergent views of management and auditors (and others) may cause a movement in stock prices and, thus potential liability, a longer report or an “auditor discussion and analysis” might not result in new or detailed information being provided to investors.

Suggestions by IAG members therefore included that the PCAOB consider requiring disclosure of the major issues that concerned the auditor during the audit and how the auditor became comfortable enough to issue a clean auditor opinion. IAG members also suggested that disclosures could include the auditors’ responsibilities for detecting fraud, how the auditor determined what was material for purposes of the audit, and certain information currently included in a firm’s summary memorandum.

Panel 5 – Auditor Expertise and Responsibilities

Some IAG members stated that companies issue comprehensive reports in a number of areas beyond the financial statements (management’s discussion and analysis of the company’s financial condition and results of operation, compensation discussion and analysis, enterprise risk management reports, and similar reports) but auditors’ reports remain limited to the financial statements. These members noted that investors want a validation of management’s disclosures, and that the PCAOB has the ability to expand the auditor’s role.

Some IAG members noted that auditors do not pay sufficient attention during the audit to the disclosures connected with securitizations, off-balance-sheet items and derivatives, among other areas. Some members noted that it would be helpful not only if the PCAOB provided more guidance regarding auditor examination of disclosures required by accounting principles and related rules, but also if the PCAOB initiated more enforcement proceedings against auditors who fail to audit or report appropriately on such disclosures.

In this connection, it was noted that the PCAOB’s private disciplinary proceedings should be changed to public proceedings.

It was noted that management wishing to commit fraud may attempt to alter accounts that they believe will not be subject to audit procedures and, as a result, auditors need to devise systems to identify such accounts.

It also was noted that combining forensic audit procedures with financial audit procedures in high risk areas can lead to more effective audits. Reference was made to the findings in the August 2000 report of the Panel on Audit Effectiveness, which support this conclusion. One IAG member indicated that a forensic auditor would be able to look at the overall business and audit environment and redirect the firm’s thinking to critical issues (e.g., the subprime situation, 105 Repos). Other IAG members stated that certain forensic-type procedures often are used before one company acquires another, as part of a due diligence process.

Some members indicated that the primary issue with using forensic procedures is the cost. These members indicated that sometimes it might be obvious where forensic procedures would be worth the cost, but generally there should be a risk assessment process to determine which parts of the audit would be subject to forensic procedures. They indicated that this should be a thorough assessment and not downgraded to a checklist. Some IAG members who had experience incorporating forensic procedures into financial statement audits indicated that the cost, in relation to the overall audit fee, was not significant and that there were significant benefits. Other members noted the value added by forensic procedures in relation to their cost would need to be evaluated over time.

Some IAG members noted that requiring the firms to perform forensic procedures might help the firms retain individuals with diverse talents and expertise, who otherwise might seek employment with other types of entities.

It was noted that the PCAOB's Fraud Center could assist auditors in determining if or how to use forensic audit procedures.

Some IAG members indicated that once the auditor has found problems, the question is whether the auditor will "stand up" to the company. They indicated that the only way to assure that the auditor will carry through is for the PCAOB to insist on it.

Suggestions by IAG members therefore included that the PCAOB consider expanding the role of the auditor to include more than reporting on a company's financial statements and internal control over financial reporting. Some IAG members suggested the PCAOB consider requiring auditors to pay more attention to disclosures required by accounting principles and related rules and look into the incorporation of forensic audit procedures into high risk areas of the audit on a cost-effective basis. IAG members also recommended that the Board make its private disciplinary proceedings public.

Panel 6 – General Discussion

Executive Compensation

Some IAG members noted that the attention being paid to executive compensation by Congress (claw back provisions, etc.) and the SEC includes concerns about how compensation affects management's judgments related to the financial statements. It was noted that accounting choices can affect the CEO's pay.

Some IAG members indicated that the auditor could validate management and board of director disclosures related to executive compensation. Other members indicated that auditors could indicate whether executives' incentives are aligned with investors' incentives.

It also was noted that there is a tendency to look at the compensation of only upper level management, but that fraud risks motivated by compensation can occur at other employment levels as well, and that audit committees might want auditors to help identify those levels.

A concern was expressed, however, that it may be "overstretching" auditors to require that they consider executive compensation other than as a component of a traditional audit risk analysis.

Inspections

Some IAG members noted that the Board is working on using its inspection process to inform its standard-setting process. IAG members suggested that the PCAOB formalize the process by which it uses information from inspections to inform its standard-setting projects.

Investor Education/Expectation Gap

Some IAG members suggested that the PCAOB start a general education program to inform investors and the public of the benefits and the limitations of the public company audit process and the significance/impact of new auditing standards. Some IAG members also indicated that, either separately or as part of that program, the PCAOB could encourage senior partners from major accounting firms to meet with investors. During those meetings, the significance of recent accounting changes and other matters could be discussed.

* * *