Comment Letter to PCAOB about the Proposed Reporting Model

9/24/11

I have read only 100 pages of the transcript provided for the September 15 meeting. I appreciate the immediate posting of this transcript. (I am merely an ordinary auditing faculty member who has great respect for the auditing process. I came into the field just after the U. S. Government report **on *The Accounting Establishment was published in 1977.)*** I was amazed at the lack of attention to that publication by public accountants. (My search was back in the late 1970's and possibly not sufficient to locate the discussions that followed.) I spent a week at the SEC in the Summer of 1980, when the POB was a common topic of discussion. I was at the SEC with a colleague; we had several meetings with the Chairman of the SEC, who, it appeared to us, was successful in supporting the POB under the direction of the professional body. That oversight board was disappointing; yet there was little criticism. When it was disbanded, there was virtually no comment.

I thought the Sarbanes-Oxley Act of 2002 was an appropriate step in establishing a new structure for oversight. It was wise that the Act did not require that audit standard setting be a task the new organization assumed, but the Board could determine to be the standard setter. When the April 2003 Board, with an Interim chair, voted "yes" to be the standard setter, I was somewhat surprised. Possibly, there was a long discussion that was considered private; what was disclosed on the Website was a straight forward conclusion;, only one question from a member of the Board that it was true that the Board did not have to be the standard setter (the response to the Board Member's question was "yes") . . the board did not have to assume the task, and then the vote with no further questions. In a day or two the chief accountant was announced. (The vision statement of the CEOs of the Big 6 firms included, in a side bar a statement that the PCAOB was mandated to be the standard setter. That is an incorrect statement) Several accountants from out side the U. S. asked me about this decision . . they all felt that there could be a conflict of interest to have the standard setter and the oversight functions handled by the same organization.

Now, please understand that I don't have a comprehensive view of your organization and what you have determined to do. My comments are presented in a highly tentative manner. I am guessing that the interaction with those present on September 15 was far more extensive than what is presented in the transcript. My comments:

Possibly, there was a discussion that wasn't recorded that presented the auditing framework assumptions that guided the proposed new reporting model. I was looking for some discussion of critical postulates. (After a review of all the sets of postulates we could find, a colleague and I concluded that the tentative postulates of Mautz and Sharaf (*The Philosophy of Auditing, AAA, 1961, first date of issue)* were most impressive. One of their tentative postulates that we have continued to believe is a critical foundation is: No. 7: ***When examining financial data for the purpose for the purpose of expressing an independent opinion thereon, the auditor acts exclusively in the capacity of an auditor.***

What is being proposed as some participants interpreted what is stated in the new reporting model seems to set aside this powerful postulate. There were references in the pages I read to "direct communication between the auditor and the investor" and "say more about the health of the business." There are a number of comments that don't seem to reflect a thorough understanding of the need for objectivity in the performance of an audit.

The auditor, as you well know, is to *verify* what is presented by the client. That process is guided by both GAAS and the criteria, GAAP. Does it make sense that the auditor become a predictor of the future of a client? How reasonable are the wishes of investors?

I will say nothing more about this first point. I would like to see a reasoned rationale for setting aside the current role of the auditor. as stated in the above identified postulate. It is stunning that there is consideration that the auditor's task is to assure the investor about the company's future. I guess there is no need for an audit. A statement of one's prediction will be sufficient.

There were enough statements that appeared not to destroy the current postulate identified above, including some statements from Board members, that I shall be optimistic that the final proposal will be a wise one.

The last revision of the standard report included a statement at the end of the scope paragraph that states: *"We believe that our audit provides a reasonable basis for our opinion."* I was surprised at that sentence and thought that it would not be retained in the final version. It was, however. *Belief* is a somewhat ambiguous word; it can refer to faith without evidence or to careful attention to evidence. Given the responsibilities of auditors as they develop conclusions, I continue to wonder the value of that sentence in both the standard report of the ASB and of your Board.

Is there a way to inform interested parties of the nature of a *quality* audit? (To date, inspections provide no evidence of the quality of audits performed by the issuers.) There are, of course, explicit disclaimers about the use of the information in a publicly issued inspection report; the careful reader realizes that generalizations about the issuer are not warranted. The discussion of procedures implies that a random selection is not used; a typical empirical study of an issuer's audit behavior is not undertaken. When I learned that the first chairman of the Board indicated that the strategy for inspections would be a supervisory approach, because he believed that would be the effort that would lead firms to undertake quality audits. There was no detailed rationale provided for this strategy, but after reading the first two reports on the limited audits of the major 4 public accounting firms related to the financial audits and to the quality control assessment, I concluded that initial observations of the quality of audits motivated the supervisory approach. It is not clear why that approach is persisting until now – the latter segment of 2011. I have been unable to get an authoritative response to the question: Does a supervisory model for an inspection meet what the Act states re *determining compliance?*

The Center for Audit Quality issued a bulletin of limited pages entitled *Guide to Public Company Auditing. .* Consider page 9, headed *Finding Fraud.* Highlighted is: Because the audit goal is "reasonable assurance" a properly planned . . . . audit may not detect fraud. . . . " I asked 10 individuals, as individuals, not in a group who know virtually nothing about an audit to read this page and give me a guess about the value of an audit. (these are academic professors in fields distant from accounting and business who have TIAA-CREF pension plans and pay no attention to what their pension plans do; they just have confidence in the firm. . .) Without exception, each said: "Well, it appears that the audit is worthless. . . obviously, reasonable assurance is not a very high level of assurance." I have distributed this page to students, who are surprised by the lack of explanations. (See the proposed revision to the *Yellow Book of GAO,* which includes a valuable explanation of *reasonable assurance, fpr example.)*

I guess what we hear from investors does vary. After I initially read the proposal for a new format for the auditor's report, I asked a number of investors, who know what an audit a simple question: What do you want from an auditor's report? The answer I got was: "I want to know that the financials audited are reliable. That is what is important." I can read what is of interest to me and make my own judgment. It seems completely out of "character" for an auditor to communicate directly with me. Apparently, that isn't what some of those who participated in your meeting recently learned from those with whom they spoke.

As I view (from a questionable perspective) the activities of PCAOB from its getting underway in early 2003 to the present, these are matters that seem critical:

1. Provide more information to the public. Just two illustrations:

   1.1 I read many inspection reports; some include a letter from the issuer. A common comment is that professional judgment is required in many instances and professional judgment can vary. . . . "and we have undertaken the steps you proposed; we found no need to change our earlier conclusion." . . however, the reader wonders: was the issuer right? Did the PCAOB follow up with acceptance of the explanation? What happened?

   Professional judgment is grounded in technical knowledge of GAAP and GAAS; variations provided by inspections must be as carefully identified as is the case of the auditors on the job. What is being done to resolve the differences, that appear to disappoint the issuers?

   1.2 I have wondered about the audit documentation for AU 380, a continuing interim statement. Is any audit documentation required related to the audit itself or is that matter considered a part of quality control? In the inspections I have read, I have never seen a reference to insufficiencies of reporting related to AU 380.

2. How do you justify the following:

   2.1 In early 2007, as I recall the Center for Audit Quality was established. From what I have learned that is an advocacy group with one of the highest paid lobbyists as its executive director. Before that first year ended, the CAQ had a celebration for the first five year anniversary of the PCAOB. .. An oversight board accepting such a celebration seemed surprising. Is it common for issuers to provide elegant parties for the audit team and the key national leaders of the public accounting firm that provides an unqualified report?

2.2 How is the independence of inspectors and that of the office of the chief accountant maintained? We talk so much about division of duties where there is potential conflict of interest. Now we have an oversight board that is also the standard setter. (My accounting friends from other countries find this status difficult to believe)

In my brief reading of the transcript, I was reminded of a newsletter I read at J. C Penny just months before the company left New York to establish their headquarters in Texas. I was studying materials in their archives to trace J. C. Penny's development of his code of ethics. However, I read some newsletters that include copies of letters the company received from their auditors when the audit was completed. One that I read noted that no adjustments were necessary at the conclusion of their audit. I haven't thought about this, but could the proxy statement about the audit committee say something far more substantive than is the case now? In reviewing four statements about audit committees in proxy statements, the class and I were disappointed at how little we learned. Would issuers be willing to present, in some appropriate form, some degree of explanation of those matters that are presented to the audit committee? (During the financial crisis of the last several years, there have been some amazing disclosures of ineffective boards . . and of audit committees. . . governance at the board level is likely to be worthy of improvement.)

I know that establishing a new organization is no simple task. I know it takes time. I dislike being critical. I believe that the 2002 Act was promising. It is not clear that the implementation is as effective as we had anticipated. I am sorry that I see the problem re reporting in a broader framework than is likely to be justified. . .

Is it really only the content of the auditor's report that needs attention? I doubt it. I wonder if what we need is a reliable conclusion by the auditors?

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