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Subject: PCAOB Rulemaking Docket Matter No. 021

Overall general comments: The task of crafting a statement that is reflective of the specific guidance that should be provided is not simple. I applaud your diligence and insight.

1. The perception of what is provided is critical. I am, therefore, concerned that this rewritten statement of Auditing Standard 2 seems to focus on *efficiency* and on reducing the demands of the earlier statement. That perception was noted by some members of SAG at the February session last week..

2. There continues to be what appears to be indifference or reluctance to face what is revealed from your own reports. For example, your comments re inspections (January 22, 2007) note that auditors in some cases failed to undertake brainstorming sessions, or there was no documentation of such sessions. Mr. Somers of the POB spoke at the American Accounting Association some years ago, in which he discussed investigating audit failures to understand what happened as he noted was a process similar to the kind of investigation of an airline's crash to determine cause. His idea, as you know, was never implemented. To date, there is much relief that inspections aren't at all what SOX stated in Section 104 . . . *to access the degree of compliance*. . . Any one reading an inspection report, you quickly read

. . . a Board inspection report should not be understood to provide any assurance that the firm's audits, or its issuer clients' financial statements, are free of any deficiencies not specifically described in an inspection report.

3. It is amazing that there is so much difficulty re fraud detection. In Dicksee's Manual on Auditing as noted in his 1900 edition (which was essentially what Montgomery published in the U. S. with permission and support from Dicksee), the first of three objectives of undertaking a financial audit was: *To detect fraud*.

Do you have information that the audit failures at Enron, Tyco, WorldCom were unfair because the audits were performed appropriately in accordance with the guidance, but fraud was not disclosed. What is the evidence of the Big-Six that supports the idea that

auditors aren't being paid enough for an annual financial audit to *expect* that fraud be detected. (I have restated the Big-Six comment in a most colloquial style, so it may not be completely fair. . .)

While one SAG member said something to the effect that partners should be the ones judging risks in a client's functions, it is strange that there have been instances of relatively inexperienced auditors realizing that something was "strange." For example, at Crazy Eddie a brand new young auditor resigned from the firm because he was so stunned at the indifference of the partner to respond to information he had gathered during his first two weeks ever on an audit. Two young men in California who were just getting underway in their own practice were employed by ZZZZBest, but after one month they sensed that there were serious problems in the operations. They resigned; came to New York City to continue their practice. Yet, a major firm accepted the restriction on when they might observe a restoration project and didn't find any fraud. Did they see it and just passed on it? Did they not see it? Why didn't they question the basis of selecting a restoration site?

My two anecdotes are not sufficient for generalizations, but they hint at a valuable hypothesis that might have been the basis of serious review of some of the several seriously deficient audits of the last 6 to 8 years. SAG functions with the black box of seemingly no knowledge of actual performance of audits.

Now, the Big 6 U. S. firms are suggesting, among a list of possibilities, undertaking a forensic audit. Do they have information that is proprietary that shows clearly that the audits they did at Tyco, Adelphia, Ahold, Parmalat were properly done but that they were not successful in identifying fraud? Given the level of knowledge we have of audit quality that has been revealed through some court hearings and SEC proceedings to date, the suggestion of a forensic audit is premature. Why isn't attention on doing a quality annual audit? There is sufficient guidance that if fraud is perceived to have occurred additional steps are warranted.

4. While there appears to be less than effective audits, to date the public accounting firms registered with you seem to be doing very well. Is there any need to continue with another set of standards? Do we really need inspections? It appears that there has been fully satisfactory response to internal control problems that were confidentially provided to the firms. I must say I am not sure what is meant by the statement in PCAOB Release 104-2006-78, p. 3)

. . . have crafted and undertaken important steps that, if conscientiously implemented, will have beneficial efforts on audit quality.

Who will determine if the firms do conscientiously implement the steps? Do you just accept what they stated? Will this process be as effective (or ineffective) as the peer review process under POB? Do you see the inspection as similar to the pre peer review that many firms undertook. I noted that one SAG member said that PCAOB did

inspections; the SEC does enforcement. Who determines that enforcement is to be considered?

As long as your inspections are so gentle – and maybe in the future they will be more like a compliance audit and, therefore, follow some clearly stated assumptions about the process – there is serious questions about the value of any changes in standard. As some of your SAG members said last week, there had been sufficient guidance, and even statutory requirements.

Your task is difficult. It appears that there is considerable evidence that there was not adherence to the statutory requirements for internal control (since December 1977) and there has not been adherence to the reasonably well written standards and related statements as reflected in your accepting ASB's standards as interim standards and have not, to my knowledge, rewrote all those standards and doing so does not appear to be a priority item on your agenda.

So focusing on standards seems questionable. Until there is a rigorous, but impeccably fair and just inspection process the total task of the PCAOB is not likely to meet the demands for quality audits.

Some minor points:

1. Should the language always be technically clear? One minor illustration: In para. 41, is the phrase "*important* to the conclusion. . . " do you mean *material or significant to providing reasonable assurance about the controls*
2. *Professional skepticism* is a fundamental attitude that requires absolute internalization on the part of every auditor. At some point you use the term *neutral* which is a reasonable qualifier similar to the term *indifferent*. I find that research chemists and research physicists who are grounded in statistics understand the technical meaning of the terms *neutral and indifferent*. Many auditors are not so knowledgeable about statistical and general research methodologies. Should your guidance be more informative for auditors?

This isn't great, but consider: *Professional skepticism* is a mental attitude of suspended judgment about whether the client's financial statements are free of fraud or are not free of fraud. That suspended judgment is transformed into a judgment after obtaining sufficient competent evidence to support the statement of a conclusion.

3. There seems to be insufficient of understanding of "reasonable assurance" in many places. (In your October 2006 SAG meeting, as I recall, a member asked something to the effect "couldn't we have a higher level of assurance?")

"Reasonable assurance" is not low level. A confidence level of 95 percent (if an audit is based on a statistically driven strategy) is high level of reasonable

assurance. This level is implied in SAS No. 39, I would say. Of course, this applies to material matters. Some of the SAG members seemed to think that it is reasonable because you can't possibly find petty fraud. Yet, the guidance is referring to *material*.

“Absolute assurance” is a hypothetical level, not only for audits but for endless phenomena in our world. It would be delightful if I could get *absolute assurance* that if I completed a highly touted course in Spanish or French or Italian that I would speak sufficiently to be taken as a native, I would be thrilled!

I keep wondering – and I know nothing about group activity – that a smaller group of SAG members would really think through carefully and be far more sensitive to the empirical evidence that is available – or could be gathered – and, thus, an advisory board would be far more helpful to your staff than the present meetings appear to provide.

Best wishes in your difficult task.

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