Ross Roundtable
On
The Auditors' Auditor:
Initial Inspection Reports by the PCAOB

The Sarabanese Oxley Act (The ACT) established an independent, non-governmental body, the Public Company Accounting Oversight Board (PCAOB) to oversee the auditors of publicly-traded companies in order to protect the interests of investors In 2003 the PCAOB conducted limited inspections[1] of the four large accounting firms, who voluntarily cooperated with these inspections. The Roundtable provided an opportunity for members of academe, the business community, financial analysts and other interested parties to hear a first-hand report from the PCAOB and the firms audited, related to the initial inspections. It also provided an opportunity for participants to ask questions, make comments and suggestions. The PCAOB was represented by Douglass R. Carmichael (Chief Auditor). Participating accounting firms were represented by Bob Guido (Ernst & Young), John Gribble (PricewaterhouseCoopers), and David Brumbeloe (KPMG).

"Much to do about nothing"…. Was the controversial opening statement at the Roundtable regarding the findings of the limited inspections. A statement designed to promote interesting discussions and debates among the participants. What have we learned from the inspection reports? Are the initial findings such that the investing public can sleep quietly? The representatives of the accounting firms were asked to give their *initial* reaction to the *initial* inspections.

- After 37 years involved in "quality control", the limited inspection was a learning experience. The PCAOB was learning how to be a regulator, and we were learning how to be regulated.
- The review was hard—but fair. We learned, and will continue to learn, and are training to get ready for the review on an ongoing basis.

[1] A summary of the limited inspections was made available to participants and attendees of the Roundtable.

- Fair – but a shock to the system. Nothing similar had ever been experienced. Top notch inspectors put to rest previous concerns. They had many years of training and experience and were able to discuss the accounting issues.

- What have we changed? Insufficient documentation is no longer acceptable. The PCAOB requires complete documentation, and now, so do we.

- Our people have been made aware that internal inspection reviews, can be re-reviewed by the PCAOB.

Doug Carmichael briefly outlined the PCAOB's framework for inspection as being more than an engagement review. The PCAOB tries to connect the dots from training => management => communication => compensation => promotion. How does the firm reward and advance people? What are the lines of communication? The focus is on "*the tone at the top*", a comment that was pervasive throughout the discussion. Peer reviews are analyzed to determine if promotions are based on bringing in business, or for dedication to audit quality.

The PCAOB has the unique position of being the only organization in the world that has both the professional standard setting and the investigative function under one umbrella organization. This unique position enables the PCAOB to obtain input on audit documentation and implementation issues, and promulgate timely standards bypassing the usual inter-organizational lags. The Board anticipates increasing the number of limited inspections from the current 64 to 650 in 2005. Inspections will differ from prior efforts in that the focus will be on high-risk audits, attempting to identify forward-looking problems.

<u>Quality Audits:</u> "Quality" of audits were defined as audits wherein the auditor has sufficient knowledge of the business to understand the implication of items, that although not meeting the definition of *material*, may have implications for the future. Quality in terms of judgments made. Major debacles have not always been a result of reports prepared in violation of GAAP. They may have conformed in "letter"-- but not in "spirit"-- and thus presented misleading information. Quality of judgment, includes aggregate judgment. To the extent that the PCAOB is able to identify either intentional

or unintentionally "misleading" information, it would raise concerns. If not acted upon, it would be brought to the attention of the SEC. Quality audits should include reading and understanding major contracts, and analyzing how SAS 99 [fraud detection] was implemented in practice.

Independence versus Competence: Participants suggested that the PCAOB focus on issues of independence. Knowledge and expertise will not lead to quality audits if the auditors are not independent. Recent failures were not due to procedural errors, but rather a lack of independence. Spending limited resources on the duplication of auditing procedures is not in the public interest. The PCAOB's response was that it is not always possible to distinguish between poor judgments made based on lack of independence, lack of competence or due care. The PCAOB inspectors are looking at independence in both appearance and fact. Given their objective of measuring the overall effectiveness of the auditors in the field, successful delineation of the source of the problem is more likely than focusing on independence in isolation.

What about the small-size firm? Representatives of the AICPA commented that a major issue confronting the profession today was a lack of competence rather than due care and independence, and questioned if the PCAOB had educational processes in place. The response was that although the PCAOB was not an educational body, they had started an outreach effort for smaller firms. Efforts have been made to explain how they will have to perform and what the inspectors will be looking at. The PCAOB will be providing limited training regarding the application of new standards.

The larger firms admitted to both having the resources and putting into place training programs at all levels, including senior manager and partner. Based on recent inspections, new training and guidance have been put into place across the U.S. and the world. It is expected to take at least three years to train specialists in 404 integration. Small firms neither have the resources for the necessary training nor can they absorb the cost of shutting down their business while inspections are going on.

Tone at the top: The Act requires a 12-month waiting period prior to public disclosure of quality-control issues. This waiting-period gives firms time to rectify their internal controls and procedures. In response to requests that the PCAOB make public the criteria it uses to evaluate the "*tone at the top",* they were told the benefits of publication would be considered. However, the initial reports discuss in detail the procedures that were performed to evaluate the *tone at the top*, details of which are publicly available. Although not spelled out explicitly, it would be possible to infer the criteria. Additional comments and suggestions were made that although the identity of the firm need not be made public, overall findings concerning quality control would provide a service to the investing public.

Art: A specific skill in adept performance, held to acquire the exercise of intuitive faculties that cannot be learned solely from study.

Science: Methodological activity, discipline, or study.

Quality audits are a marriage of both art and science. "Scientific" analysis of decisions and judgments made 2-3 years ago, most in good faith, fails to capture the "art" of the moment. This is indeed an issue that is of major concern to all, and it begs the question, "will firm's become overly conservative in reporting results of operations?" Of increasing concern is the controversial move towards fair-value accounting —which is perhaps more *art* than *science.* At a recent Ross Roundtable on Fair-Value Measurement. the discussion crystallized the controversy surrounding fair-value measurements, and consequentially principles versus rule-based accounting, reducing it to one ingredient of *Reliability, --- verifiability.* The issue of *verifiability* is not only associated with auditors seeking protection against litigation, *verifiability* is a critical need of our capital markets. PCOAB inspections have now added a new concern. In addition to concerns of litigation, fair value measurements must pass an additional level of scrutiny. Scrutiny after the fact—facts unknown at the time decisions were made. Hindsight is "20/20".

The Anatomy of Change: The profession has undergone more change in the past three years than the last 30 years. We have been reminded who we are working for. The stage has been set and the players are trying to understand their new roles. Firms and audit committees are taking their responsibilities very seriously. The focus is on corporate governance; the tone set by board of directors and senior management. They are becoming involved; asking hard questions; participating in discussions. Audit committees feel increasingly pressured in trying to adapt to the new rules.

Standard setting has been an “ivory tower” activity; auditing is in the trenches. GAAP and GAAS are moving closer together. The FASB and the PCAOB are interacting and serve as participating members of their respective advisory committees. There has been a lot of interchange in fair value measurements and audit problems—with fair-value falling into the high-risk category. Change was long overdue. Change has taken place—at an unprecedented rate. Has the pendulum swung too far? The PCAOB, the SEC, and the representatives of the large accounting firms all echoed the same thoughts--we are learning, we will continue to learn—and we shall do so--until we get it right!