
STANDING ADVISORY GROUP MEETING

STATUS OF PCAOB-RELATED RECOMMENDATIONS FROM THE U.S. DEPARTMENT OF THE TREASURY'S ADVISORY COMMITTEE ON THE AUDITING PROFESSION

APRIL 7-8, 2010

On October 6, 2008, the U.S. Department of Treasury's Advisory Committee on the Auditing Profession ("ACAP") issued its final report and recommendations to enhance the sustainability of a strong and vibrant public company auditing profession.^{1/} A number of the recommendations involve the Public Company Accounting Oversight Board ("PCAOB" or "Board"). Below is a list of the formal recommendations – organized by area focus – that refer to or involve the PCAOB, as well as PCAOB developments on the implementation of those recommendations.^{2/} In some cases, the explanatory text to these recommendations includes other suggested action for the PCAOB and, as appropriate, these suggestions are referred to in the update below.

^{1/} U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* ("ACAP Final Report") (October 6, 2008), available at: <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>.

^{2/} Some of the recommendations affecting the PCAOB may also require certain action by the Securities and Exchange Commission ("SEC" or "Commission"). As a practical matter, the PCAOB consults with the SEC on policy level issues, such as those discussed in ACAP's Final Report. For its 2009 calendar year, the Board was required to consult with the Commission with respect to the implementation of the ACAP recommendations. See Order Approving Public Company Accounting Oversight Board Budget and Annual Accounting Support Fee for Calendar Year 2009, SEC Release 33-8989 (December 17, 2008).

This paper was developed by PCAOB staff to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; not does it necessarily reflect the views of the Board or staff.

Human Capital Recommendations

1. Recommendation 3. Ensure a sufficiently robust supply of qualified accounting faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits. * * * (b) Emphasize the utility and effectiveness of cross-sabbaticals.

In connection with this recommendation, the ACAP recommended expanding faculty fellowship programs in agencies, such as those at the SEC and the Financial Accounting Standards Board ("FASB"), and making them available at the PCAOB.

On December 22, 2009, the PCAOB announced the establishment of and candidate solicitation for an Academic Fellow Program. This program is designed to appoint an experienced researcher and academic, with an active interest in auditing and oversight matters, to serve as an Academic Fellow for a term of up to 12 months. The Academic Fellow for the 2010-2011 academic year will be assigned to the PCAOB's Office of Research and Analysis ("ORA").

The Academic Fellow will be expected to provide analytical support and advice to ORA as well as other offices and divisions of the PCAOB and develop innovative ideas and problem-solving concepts within the framework of responsibilities of ORA. Such projects may include research on accounting and auditing matters, risk-assessment research, and/or other research and work relating to PCAOB activities.

Applications for the 2010-2011 Academic Fellow Program were due on January 30, 2010. The PCAOB has received applications and is in the process of making its final selection. It is anticipated that the Board will announce the Academic Fellow for the 2010-2011 academic year in the near future.

Firm Structure and Finances Recommendations

2. Recommendation 1. Urge the Securities and Exchange Commission (SEC), and Congress as appropriate, to provide for the creation by the Public Company Accounting Oversight Board (PCAOB) of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection experiences, practices, and data and innovation in fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.

The PCAOB had discussions, on an informal basis, with various experts to solicit views on the potential scope, structure, and organization of a national center focused on the prevention and detection of financial fraud (the "Center").

Based on these discussions, the PCAOB developed a preliminary outline for the Center. The Center would (1) maintain a repository of information related to financial reporting fraud, including types of fraud, case histories and lessons learned, current trends and risks, and best practices to identify financial reporting fraud; (2) produce periodic and ad hoc reports on risks related to financial reporting; and (3) publish information to enhance understanding of the risk of financial fraud.

The Board is now in the process of identifying candidates to serve as the director for the Center. On April 6, 2010, the PCAOB posted to its Web site an announcement soliciting candidates for this director position.^{3/} Once selected, the director, in consultation with the Board and PCAOB senior staff, will prepare an organizational plan and initial budget for the Center.

3. Recommendation 2. Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting. * * * (b) Require regular and formal roundtable meetings of regulators and other governmental enforcement bodies in a cooperative effort to improve regulatory effectiveness and reduce the incidence of duplicative and potentially inconsistent enforcement regimes.

In connection with this recommendation, the Committee recommended mandating regular and formal roundtables of the PCAOB, the SEC, the Department of Justice, the state boards of accountancy, and the state attorneys general, to periodically review the overall enforcement regimes applicable to the public company auditing profession.

Coordination among regulators with jurisdiction over auditor conduct is also important to identify and address any regulatory gaps that could harm the investing public, and to provide for the most effective use of scarce regulatory resources. PCAOB enforcement staff already has regular informal and case-by-case contact with other

^{3/} See PCAOB Seeks Director, Financial Reporting Fraud Resource Center, PCAOB Press Release (April 6, 2006).

enforcement agencies, as permitted by the Sarbanes-Oxley Act of 2002. The PCAOB is also considering whether a more formal meeting or meetings with appropriate enforcement agencies to discuss emerging risks in auditing, appropriate information-sharing, and other issues, would be useful in furtherance of the PCAOB's mission. In this regard, the PCAOB enforcement staff has contacted the SEC enforcement staff, with whom it closely coordinates its investigations, to discuss convening an appropriate first meeting based on these goals.

4. Recommendation 3. Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency of auditing firms.

The Board has discussed this recommendation but has not taken any action.

5. Recommendation 4. Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients.

The Board's inspection staff has obtained information regarding engagement partner changes on public company audits from certain auditing firms and, as appropriate, has utilized this information in its issuer engagement selection process.

6. Recommendation 5: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model. Further, urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.

- a. Consider Improvements to Auditor's Standard Reporting Model and Clarify in the Auditor's Report the Auditor's Role in Detecting Fraud

At its April 7-8, 2010 meeting, the PCAOB Standing Advisory Group ("SAG") will discuss this recommendation. Panelists will present information relating to the history and evolution of the U.S. standard auditor's report and the ACAP recommendation.

After the panelists' remarks, SAG members and observers will discuss in break-out sessions potential ways to: (a) change the standard auditor's report and (b) clarify in the auditor's report the auditor's role in detecting fraud. On the second day of the meeting, a summary of the break-out group discussions will be presented to the SAG and SAG members will have an opportunity to provide additional commentary.^{4/}

Based on these discussions, the PCAOB staff will recommend to the Board what action, if any, should be taken in this area.

b. Review and Update Auditing Standards Governing Fraud

One of the functions of the Board's Center on financial fraud will be to work collaboratively with the PCAOB's Office of the Chief Auditor as well as other divisions and offices to make recommendations to the Board as to whether auditing standards governing fraud detection and reporting should be changed.

The PCAOB also has several standard-setting projects on its agenda that address the assessment of fraud risk.^{5/} Below are some developments in this area.

Risk Assessment Proposal Integrating Auditor's Responsibility for Fraud: On December 17, 2009, the Board re-proposed for comment seven auditing standards and related amendments that collectively would replace the requirements for assessing risk in an audit.^{6/} Among other things, the re-proposed standards would integrate the auditor's current responsibilities for considering fraud during the audit. This integration would emphasize that consideration of fraud is a central part of the audit process and should prompt

^{4/} See ACAP Committee's Recommendation Relating to the Auditor's Reporting Model, PCAOB Standing Advisory Group, PCAOB Staff Briefing Paper (April 7-8, 2010).

^{5/} See OCA Current Standard-Setting Agenda (April 7-8, 2010).

^{6/} See Proposed Auditing Standards related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards, PCAOB Release No. 2009-007, PCAOB Rulemaking Docket Matter No. 026 (December 17, 2009).

auditors to make a more thoughtful and thorough assessment of fraud risks and develop appropriate audit responses.

The Board initially proposed these standards on October 21, 2008.^{7/} The re-proposed standards include changes in response to comments on the original proposal and other refinements. Like the original proposal, the re-proposed standards would establish requirements for audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results in forming the opinion in the auditor's report.

The comment period on the re-proposal closed on March 2, 2010. The Board received 23 comments and is considering all comments received.

At the April 7-8, 2010 SAG meeting, the PCAOB's Office of the Chief Auditor will provide a summary of the comments received.

Related Parties: Among the priorities on the Board's standard-setting agenda is a project on related party transactions, which can be a contributing factor in financial reporting frauds. At its October 14-15, 2009 meeting, the SAG discussed certain matters in connection with the development of the Board's standard-setting project on related parties.^{8/} Based on this input, the Board is evaluating potential revisions to the related parties auditing standard.

Audit Practice Alerts: In addition to its standard-setting, the PCAOB uses Staff Audit Practice Alerts to highlight new, emerging, or otherwise noteworthy circumstances – including fraud risks – that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. For example, Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* relates to auditing challenges as a result of the economic

^{7/} See Proposed Auditing Standards related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards, PCAOB Release No. 2008-006 (October 21, 2008).

^{8/} See Related Parties, PCAOB Standing Advisory Group Meeting, PCAOB Staff Briefing Paper (October 14-15, 2009).

crisis and highlights certain fraud risks.^{9/} Moreover, on April 7, 2010, the PCAOB issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, relating to significant unusual transactions that can provide opportunities for companies to engage in fraudulent financial reporting.^{10/}

7. Recommendation 6: Urge the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report.

At the October 22-23, 2008 SAG meeting, a panel consisting of an investor, an academic, and a representative from a large accounting firm, discussed whether the PCAOB should consider mandating the engagement partner's signature on the auditor's report.^{11/}

On July 28, 2009, the Board issued a concept release to solicit comment on whether the engagement partner should be required to sign the audit report.^{12/} The concept release briefly discusses views to date on this issue from the SAG and ACAP and provides some background on signature requirements in Europe. The release also discusses reasons for a signature requirement and potential amendments to PCAOB standards.

The deadline for comments on the concept release was September 11, 2009. The Board received 23 comment letters and is considering the comments received. At the October 14-15, 2009 SAG meeting, the PCAOB Office of the Chief Auditor provided an update on the concept release and comments received.

^{9/} See Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment*, PCAOB Staff Audit Practice Alert (December 5, 2008).

^{10/} See Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, PCAOB Staff Audit Practice Alert (April 7, 2010).

^{11/} See Panel Discussion – Signing the Auditor's Report, PCAOB Standing Advisory Group Meeting, PCAOB Staff Briefing Paper (October 22-23, 2008).

^{12/} See Concept Release on Requiring the Engagement Partner to Sign the Audit Report, PCAOB Release No. 2009-005 (July 28, 2009).

Based on comments received, the PCAOB staff will make a recommendation to the Board, in the near future, regarding whether and how to proceed with this initiative.

8. Recommendation 7. Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU's Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of this Report. Further, urge the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.

The Board has discussed this recommendation but has not taken any action.

Concentration and Competition Recommendations

9. Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term. * * * (b) Include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.

In connection with this recommendation, the ACAP Final Report also notes that "the PCAOB should inquire about whether the transition process [between predecessor and successor auditors] was cooperative and transparent," when the PCAOB interviews the audit committee chair in connection with an inspection of an audit engagement at a company that has undergone a change of auditors.^{13/}

The PCAOB Division of Registration and Inspections has asked certain firms about the cooperativeness and transparency of the transition process between predecessor and successor auditors in its interviews of audit committee chairs that have undergone a change in auditors.

^{13/} ACAP Final Report at VIII:5.

With respect to the recommendation relating to including smaller audit firm representatives in committees, public forums, fellowships, and other engagements, the PCAOB has several initiatives.

First, the Board hosts the Forums on Auditing in the Small Business Environment. Each year, since the first forum was held at the end of 2004, the PCAOB has held between six and ten of these forums in locations around the United States to educate auditors of smaller public companies about the work of the Board, specifically the PCAOB inspection process and the impact of new auditing standards. Most recently, seven forums were held in 2008 and six forums were held in 2009; 658 auditors attended the seven forums in 2008, and 590 auditors attended the six forums in 2009.

Seven forums are scheduled for 2010, with the first forum to be held in Charlotte, North Carolina on April 29, 2010.^{14/} Attendance at the forums is limited to smaller auditing firms registered with the PCAOB, i.e., those firms that are subject to triennial inspections by the PCAOB. The forums are intended to give these firms an opportunity to meet directly with the PCAOB Board members and staff and gain insight with respect to the PCAOB's inspection process and its standard-setting work.

Moreover, the PCAOB includes representatives of smaller audit firms on its SAG, as well as on panels discussing certain issues with the SAG, to obtain input on standard-setting projects from auditors with this perspective.

In addition, representatives of smaller audit firms are often consulted on an ad hoc basis with respect to certain standard-setting projects. For example, representatives from smaller auditing firms assisted the PCAOB's Office of the Chief Auditor in developing staff guidance on auditing internal control over financial reporting in smaller public companies.^{15/}

^{14/} For a schedule of the 2010 PCAOB Forums on Auditing in the Small Business Environment, see <http://pcaobus.org/Featured/Pages/SmallBusinessForums.aspx>.

^{15/} See An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements – Guidance for Auditors of Smaller Public Companies, Staff Views (January 23, 2009).

10. Recommendation 2. Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms. * * * (a) As part of its current oversight over registered auditing firms, the PCAOB should monitor potential sources of catastrophic risk which would threaten audit quality.

The Board has discussed this recommendation but has not taken any action.

As part of its annual inspections of the largest firms, however, the PCAOB assesses the risk of audit failures and in so doing collects information relating to, among other things, failure of a firm to perform audit procedures in certain audit engagements, significant pending litigation and regulatory actions affecting the firm's public company audit practice, loss of public company audit clients, staff turnover, and losses of certain multinational affiliates.

11. Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.

At its October 22-23, 2008 meeting, the SAG discussed this recommendation.^{16/} Specifically, panelists provided background information on audit quality, including an overview of the ACAP recommendation, a review of selected academic research on audit quality, and key points from initiatives on audit quality by the UK Financial Reporting Council and the Transparency Report required by the EU's Eighth Directive. SAG members, as a group and in three break-out sessions, then discussed issues regarding the feasibility of developing such indicators.

^{16/} See SAG Discussion – Treasury Advisory Committee's Recommendation Relating to the Feasibility of Developing Key Indicators of Audit Quality and Effectiveness, PCAOB Standing Advisory Group, PCAOB Staff Briefing Paper (October 22-23, 2008).

In addition, the PCAOB Office of the Chief Auditor is monitoring work in this area by others, such as International Organization of Securities Commissions ("IOSCO") and the International Auditing and Assurance Standards Board ("IAASB").^{17/}

12. Recommendation 4. Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits.

(a) Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible. The American Institute of Certified Public Accountants (AICPA) and state boards of accountancy should clarify and prominently note that differences exist between the SEC and PCAOB standards (applicable to public companies) and the AICPA and state standards (applicable in all circumstances, but subject to SEC and PCAOB standards, in the case of public companies) and indicate, at each place in their standards where differences exist, that stricter SEC and PCAOB independence requirements applicable to public company auditors may supersede or supplement the stated requirements. This compilation should not require rulemaking by either the SEC or the PCAOB because it only calls for assembly and compilation of existing rules.

(b) Develop training materials to help foster and maintain the application of healthy professional skepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals.

With respect to compiling and publishing the SEC's and PCAOB's independence requirements into a single document, the PCAOB has been assisting the SEC with respect to this compilation, particularly as it relates to PCAOB's independence requirements.

^{17/} See e.g. Transparency of Firms that Audit Public Companies, Consultation Report, Technical Committee of the International Organization of Securities Commissions (September 2009).

With respect to fostering professional skepticism, inherent within the PCAOB inspection process is an evaluation of a firm's application of professional skepticism. As part of that evaluation, the inspection staff routinely evaluates the development of processes by the firms designed to improve the application of professional skepticism. Examples of the processes developed by firms include additional levels of review, increased involvement of specialists, additional guidance, and training.

13. Recommendation 6. Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.

The PCAOB engages in dialogue with its non-U.S. counterparts on a bilateral basis to facilitate joint inspections or PCAOB-only inspections of non-U.S. accounting firms registered with the PCAOB. Over 900 non-U.S. accounting firms, located in 87 countries, are registered with the PCAOB. Since its inception, the Board has conducted 226 inspections of non-U.S. firms located in 33 jurisdictions. Of these 226 inspections, 95 were conducted jointly with a non-U.S. oversight body.

Moreover, while the Board would like to further its cooperation and coordination with all of its non-U.S. counterparts, it currently faces serious challenges related to the inability to gain access to registered firms in the European Union, China, and Switzerland. The Board and its staff are continuing to work with regulators in these jurisdictions to address the conflicts of law, sovereignty, and other issues that are an obstacle to Board inspections.

The PCAOB also participates as a member in the International Forum of Independent Audit Regulators ("IFIAR"), whose purpose is to bring public auditor oversight entities together to share information and exchange ideas. Currently, there are 34 countries represented among the IFIAR members. Since the PCAOB joined IFIAR in 2006, the PCAOB has participated in seven IFIAR plenary meetings and four IFIAR inspection workshops. The PCAOB will host the next IFIAR inspection workshop in Washington D.C. in early 2011.

The PCAOB hosts an International Auditor Regulatory Institute in Washington D.C. In October 2009, the PCAOB held its third annual International Auditor Regulatory Institute ("Institute"). Representatives of auditor oversight bodies and government agencies from more than 42 countries participated to learn more about the PCAOB's programs and exchange views on issues that have an impact on the oversight of auditors.

The Institute offered seminars on the structure of the PCAOB's auditor oversight program, considerations relevant to international inspections, and current topics in enforcement and standard setting. The Institute also included a panel discussion with representatives of several of the PCAOB's international counterparts, addressing a range of issues related to auditor oversight worldwide.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.