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Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 030

Thank you for the opportunity to provide comments on the new proposed standards related to audit committee communications and other amendments. This is a subject matter of importance to both audit committees and investors and I commend the PCAOB for working to address these issues.

Attached are my comments. If you have any questions, please let me know (ebloxham@thevaluealliance.com or 614-571-7020).

With best regards,
Eleanor Bloxham
CEO, The Value Alliance and Corporate Governance Alliance
614-571-7020
ebloxham@thevaluealliance.com

Re: PCAOB Rulemaking Docket Matter No. 030

I provide my comments based on my expertise in the board governance arena and the duties of audit committees, their need and that of investors for sound financial reporting -- as well as my understanding of current issues in the auditing process.

In the main, I very much agree with the direction of the PCAOB in this rulemaking. Certainly, given the important role of audit committees today, clarification on the communications process between the audit committee and the auditor is worthwhile.

My major suggestions on the proposals fall into three broad categories.

(1) Consider ways for this rule-making to help address issues which arose in the financial crisis – as well as other broader financial reporting issues.

Financial reporting in general -- In the April 2010 edition of the Corporate Governance Alliance Digest (<http://www.thevaluealliance.com/PDF/CGADigest040810.pdf>), I discussed a recent survey by CFO Magazine of directors and financial managers, which had some surprising results. "According to the survey, **1 out of 2 senior finance executives do not believe the Board understands the business performance information** that finance provides to the board. And almost 1 in 6 board members surveyed serve on boards where they don't believe the Board understands the business performance information it receives." Specifically, as it relates to GAAP reporting, "according to the survey, *almost one in five - 19% of board members do not think the GAAP reporting provided by finance is "excellent" and almost one in three -- 32% of financial executives do not rate GAAP reporting as excellent.* "

The financial crisis - Clearly there was a systemic breakdown in the financial crisis we have just experienced. Information in the periodic reports *did not* tip off investors, analysts or even many audit committees about the financial conditions/positions of companies that went, practically overnight, from being well capitalized and highly admired to institutions with plummeted stock prices in desperate need of financial bailout.

The financial crisis is not an event that should be ignored when it comes to the issue of financial reporting or *auditor communications*. As easy as it might be to do so, this was not just an event which should be ignored as a one-time, unforeseeable occurrence. It was a systemic failure that has lessons within it that regulators should seek to solve to prevent recurrence.

Clearly, not everyone was in the dark: some firms, at the time, were able to take advantage of a dangerous market while others held assets whose valuations were questionable (loans themselves, loans packaged as securities, or synthetically created).

While auditors may have attested that "the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows", many investors would argue, I think rightly, that for many firms, the financial statements

did not present fairly, in all material respects, the financial position of the Company. The risks were hidden and thus the reports were misleading.

How can this rulemaking take some small steps to address these issues?

(a) One way is thru the language chosen in the rule itself. **The language chosen should reflect the aims of the Sarbanes Oxley Act of 2002.**

It is critically important to reinforce the overarching objective of financial reporting in the language that is conveyed to auditors in this PCAOB rulemaking. Of course, the importance of the Sarbanes Oxley Act ("SOX") is recognized in the very first sentence of the introduction to the invitation to comment. It is very important to re-enforce its importance in the rule itself, however, as it is far too common and too easy for auditors to focus narrowly on the objectives of issuers *meeting accounting standards* rather than the SOX objectives related to providing financial reports, which include *broader disclosures required to ensure that the financial reports present fairly the financial position/condition of the company -- and are not misleading.*

Make the broader objective clear up front. For example, it would be helpful to begin the rule with an outline of the objective of a fair presentation which includes both the statements and related disclosures.

Throughout the rule, use language that is consistently broad in proactively reinforcing the responsibilities with respect to full disclosures -- to ensure a *fair presentation, in all material respects*, of the financial position/condition of the issuer. For example, paragraph 2 of the proposed standard could be enhanced with an addition to its last sentence which reads "and communication of other matters is encouraged, by this standard, on any and all matters that would lead to better financial reporting and fair presentations of financial condition or position – and enhances the audit committee's oversight efforts". Paragraph 4 could be broadened from "any discussions regarding the application of accounting principles and auditing standards" to "any discussions regarding the application of accounting principles and auditing standards or the fair presentation of financial condition." For example, paragraph 20 could be broadened from "could be significant to the company's financial statements or the auditor's Report" to "could be significant to the company's financial statements, related disclosures, a fair presentation of financial condition, or the auditor's Report." In paragraph 22, "oversight of the financial reporting process" could be broadened to "oversight of the financial reporting process and the fair presentation of the company's financial condition". Paragraph 27 could be broadened from "material misstatement" to "material misstatement or unfair presentation". Section C1 of Appendix C, describing the auditors responsibilities, should include assessments of the quality of the financial reporting with respect to its fair presentation, in all material respects, of the financial position of the Company. Again, the language could be broadened from "material misstatement" to "material misstatement or unfair presentation." Communications about management consultations with non-accountants should include consultations not only on accounting or auditing matters, but more broadly on financial reporting and related risk matters with non-accountants also. (Question 12)

All of this focus on providing the bigger picture could seem like a minor point but, with a history of rules based auditing, *it is essential* to provide a level of specificity with respect to *all that should be considered* in order to change mindsets and/or improve outcomes.

(b) Another way to address the lessons from the financial crisis and issues in financial reporting more generally is to **enhance the communications requirements in the proposed rule.**

Communications by the external auditor to the audit committee should include a self-assessment of its work the prior year.

This self-assessment should include an analysis of issues missed in the last audit which may have given rise to misleading or missing information related to the financial position of the firm **and how the audit process will be enhanced going forward** to better ensure issues of that type are not missed in subsequent audits. **The rule should specify this** as one of the items the auditor should communicate to the audit committee.

Using the financial crisis as an example, the auditor would communicate that the financial condition at the financial services firm, pre-crisis, was not clearly represented in the periodic reports and communicate with the audit committee how, going forward, in broad terms, the audit will address issues of market conditions and lack of reliability of credit ratings and valuation models, as examples, in its review of a fair presentation of financial position. (As we all know, issues with credit raters came to public awareness with Enron and have been discussed ever since. This wasn't a one-time event. What is key is establishing a communication environment, with the audit committee, which fosters learning.)

A formal requirement in this rule to communicate a self-assessment and changes to the audit process, going forward, will help to ensure a learning process for both the audit firm and audit committee and represent a small step, but an important one, toward preventing future failures by auditors to sound the alarm related to "going concern" and other vulnerabilities in the financial reporting.

Paragraph 22 should include language such as: "This communication includes a self assessment by the auditor of prior years' work and, prior to the audit's start, how weaknesses will be corrected in this year's audit." In communication of the audit findings, the auditor should explain how it made those corrections.

(2) **Re-consider assumptions about the timing and the nature of two-way communications.** In the April edition of The Corporate Governance Alliance Digest <http://www.thevaluealliance.com/PDF/CGADigest040810.pdf>, I reviewed some interesting academic literature on auditing which suggested that it is very important to be "*aware of the way in which information is presented*" ... "and the issues that could impair judgment as a result"

"One recent study showed that 'when auditors are initially exposed [to] more ambiguous information, they are less likely to ultimately identify the error'. (<http://ssrn.com/abstract=1113496>, The Impact of Initial Information Ambiguity on the Accuracy of Analytical Review Judgments, Luippold, Kida)"

“Another study showed that a management diversion to look at error free accounts causes auditors to miss earnings management issues elsewhere. In fact, this study showed that, with no management interference, *surprisingly, over 2/3 of the time, auditors were unable to uncover earnings management issues – and over 90% of the time auditors were unable to uncover the error* if they were diverted by management to look at reliable accounts. (*Now You Don't See It*, Sarah Johnson, CFO Magazine, March 1, 2010; <http://ssrn.com/abstract=1424004> Managing Audits to Manage Earnings: The Impact of Baiting Tactics on an Auditor's Ability to Uncover Earnings Management Errors, Luippold, Kida, Piercy, Smith)”

(a) I provide this to say that **it should not be assumed that the audit committee, sharing information about what it “knows” in advance of the audit, will be helpful** (i.e. tips or complaints). In fact, if the audit committee provides auditors with “false clues” (Not intentionally, but because these are the complaints they have received) it may worsen the already low ability (according to the academic literature) of auditors to spot issues in the periodic reports. It may cause the auditor to focus on yesterday's problems rather than forestalling future ones.

On that basis, I would recommend the following communications timeline. First, have the auditor undergo the testing. After it is complete, have the auditor solicit the audit committee for its views with respect to complaints, tips and other risks – and then have the auditor follow up to test for those, if they have not already been specifically addressed. This could be easily done by clarifying the timing on paragraph 8 of the standard.

If this suggestion is not adopted, based on the academic research, this new rule may create more harm than good – worsening, rather than improving, audit quality. It may also undermine the ability of the audit committee to assess the competence and thoroughness of the external auditor.

(b) Audit committee members will come and go and external auditors will turnover. Retention of background knowledge is as (if not more) important to the audit committee as the auditor; therefore, **it is important for the auditor to repeat communication** of recurring matters. (Question 17) I think the engagement letter should be required **annually**. (Question 3) There will be new audit committee members, new directors and new auditors. It is less assumptive and enables all parties to reach a more robust understanding. Regarding paragraph 10 of the standard, the “if applicable” language should be removed – and this information should be provided, in writing, **pre-engagement to the extent possible** and as soon as possible thereafter to promote the audit committee's ability to oversee the auditor.

(c) **Communications by the auditor should be in writing to the audit committee, on all matters, followed by engaged discussion.** (Question 16)

The option to present information orally only makes communication (i.e. a two way understanding) less likely. It will also create less assurance that all of the required communications have occurred – or occurred in a thorough manner. It will also dampen the effectiveness of the discussion.

Why? Written communications, followed by discussion, provide all types of people – those who assimilate information by themselves, in groups, in writing or orally, the best opportunity to understand and evaluate the information presented. Written communications, followed by discussion, which is what well governed boards practice and are accustomed to, as a protocol, will provide the best opportunity for real communication and information exchange.

Paragraph 23 of the standard should say “The auditor should communicate to the audit committee the matters in this standard both in writing and orally.”

(3) Recognize the responsibility of the audit committee for oversight of the external auditor and of management.

How specifically will this impact the rule as written?

(a) Corrected misstatements, including those detected by management, should be communicated to the audit committee. (Question 15) This will promote the audit committee’s oversight of management. In addition, related to paragraph 12 of the standard – 12.d. in communicating critical accounting policies and practices, accounting estimates **should be communicated whether or not** the auditor determines that potential bias exists. This helps in the audit committee’s oversight of the external auditor. Related to the note to paragraph 12, the audit committee has oversight responsibility *for both* the external auditor and management. The auditor **should communicate all described matters**, whether or not they believe management has or has not omitted or inadequately described them. This will promote the audit committee’s oversight of management and of the external auditor. Paragraph 16.e. append the words “and why” – the auditor should communicate the treatment **preferred by the auditor and why**. This will allow the audit committee to better understand the reasoning and compare it with other arguments they may have heard. Paragraph 21 significant difficulties should be communicated during the audit **in a timely manner in order to seek resolution**. Again, it is the audit committee that has oversight responsibility for both the external auditor and management. In assessing the adequacy of two-way communications (paragraph 26) the auditor should also include: e. **the extent to which the audit committee provides oversight** over the auditor’s work and f. the **thoroughness of the audit committee’s assessment** and oversight of the auditor’s work.

(b) Outline the circumstances under which the auditor is prohibited from communicating with management -- and must keep communications confidential.

For example, information in the executive sessions of the audit committee should be kept between the audit committee and the auditor and not shared with management. (I am personally aware of an auditor who, apparently, regularly tipped off management about executive audit committee discussions in order to prepare them.) This thwarts the ability of the audit committee to properly oversee management and determine their skill level and motivations. It also undermines good communications with the external auditor if the audit committee believes its concerns and issues (i.e. the information shared) will not be held in confidence. Thus, I believe the auditor’s own actions can impact paragraph 26.c. of the standard.

This is just one example – the PCAOB should explore and document others in the rule.

(c) Outline that the auditor should (and the default position, on all matters, should be to) communicate through the audit committee and communicate findings to the audit committee first.

Management may provide information to the auditor in the course of the audit but the audit committee is the body charged under SOX to provide oversight to the external auditor. Therefore, the auditor should provide the audit committee with information first. The auditor and audit committee should then agree on a chain of communication involving management with which the audit committee feels comfortable.

This will allow the chains of communication to be somewhat flexible but still recognize that the primary information flow regarding the audit, its scope, its findings etc. are with the audit committee, not with management.

For example, paragraph 4 of the standard – advance discussion with management - should be discouraged. For example, Appendix C, Section C1 – b.2.a. ii and iii. After informing the audit committee, determine the protocol for informing management.

Since there may be issues due to lack of management information or other management related problems, Appendix C, Section C1 – b.2.a.iv. should consider communications with the independent Chair, lead director, chair of the nominating and governance committees, or the independent directors first, as appropriate. Similarly, since there could be issues with both management and the audit committee, related to paragraph 28 of standard itself, the auditor should consider taking such actions as a. communicating with the independent Chair, the lead director, the chair of the nominating and governance committee, the independent directors or the full board, as most appropriate to the circumstance.

Regarding Appendix C, Section C1. – c.5, to enhance the two-way communication and emphasize the oversight duties, at the conclusion of the engagement, *the audit committee will provide the auditor with a letter from management* that confirms certain representations made during the audit -- and c.6. Management is responsible for affirming *to the audit committee* and to the auditor.

Language suggestions

- Paragraph 18 of the standard – should communicate the basis for the auditor’s determination that the uncorrected misstatements were immaterial, *if they were*
- I recommend that, in the standard and the appendices, the term “material”/”materiality” be defined.
- AU sec 722 uses the term accountant rather than auditor.