

## Audit committee perspectives on the PCAOB

On February 3–4, 2011, members of the Audit Committee Leadership Network (ACLN) met in New York. In one session, members engaged in a dialogue with Daniel L. Goelzer, who is a member of the Public Company Accounting Oversight Board (PCAOB).<sup>1</sup> Mr. Goelzer served as acting chairman of the PCAOB from August 2009 through January 2011.<sup>2</sup>

This document summarizes the key points that members raised in that discussion, along with background information and perspectives that members shared before the meeting.<sup>3</sup> While Mr. Goelzer's remarks were off the record, this document refers to certain public speeches and statements by Mr. Goelzer and other PCAOB officials.<sup>4</sup> For further information about the network, see "About this document," on page 11. For a list of participants, see Appendix 1, on page 12.

### Executive summary

Members engaged in a lively conversation about the PCAOB and several themes emerged:

- **Audit chairs believe the PCAOB can add more value** (*Page 2*)

The PCAOB faces the challenge of overseeing a profession that is under scrutiny in the United States and abroad. It is taking steps to improve the quality of the audit and address the many issues that emerged from the financial crisis. ACLN members encouraged the PCAOB to continue exploring new ways of providing value, such as by focusing more on identifying and promulgating best-practice insights drawn from its inspections of the audit firms and assessing the state of the profession each year. At the same time, some members emphasized that a significantly expanded scope for the regulator was unwelcome and that greater accountability was desirable, especially better measures of success. Many members favored greater input from audit committees, particularly as new standards are being developed.

- **Audit chairs want more visible results from the inspection process** (*Page 5*)

ACLN members discussed the inspection process and the reports produced on audit firms, especially those issued annually for the largest auditors. Audit chairs who had been interviewed as part of an inspection suggested interviews should be mutually beneficial and entail more rigorous questions. Several members urged the PCAOB to think about ways to make the reports more useful (e.g., by identifying thematic findings that cut across the audit profession).

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<sup>1</sup> In another session, members discussed regulatory compliance. See Audit Committee Leadership Network, "[Regulatory compliance](#)," *ViewPoints*, February 2011.

<sup>2</sup> Network members have previously met with other chairmen of the PCAOB: Mark Olson in 2007 and William McDonough in 2004. See Audit Committee Leadership Summit, "[Enhancing trust and competition in global public capital markets](#)," *ViewPoints*, April 6, 2007.

<sup>3</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and guests and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Member quotes appear in italics.

<sup>4</sup> The opinions expressed in this document represent those of the Audit Committee Leadership Network.

- **Audit chairs are wary of changes to the auditor's reporting model and audit committee communications** (Page 7)

ACLN members voiced concerns about possible improvements to the auditor's reporting model, which the PCAOB is currently considering revising.<sup>5</sup> Members warned that expanded disclosures were not really in the best interests of the largest investors. A radically reformed auditor's report represents a fundamental change in corporate governance, and members would prefer the audit committee to be responsible for oversight of financial reporting on behalf of investors. They were also skeptical of the PCAOB's proposed standard on audit committee communications, which they believe is unnecessary at best and potentially distracting for audit committees.<sup>6</sup>

For a list of discussion questions for audit chairs, see Appendix 2, on page 13.

### **Audit chairs believe the PCAOB can add more value**

The PCAOB was established in 2002 by the Sarbanes-Oxley Act to oversee the auditors of US public companies to protect the interests of investors. Until then, the accounting profession had been self-regulated, but the accounting scandals at the start of the 21st century led to a number of reform initiatives, one of which was to establish independent external oversight of the public company auditing profession.<sup>7</sup>

The PCAOB is at a turning point. Last summer, it survived a constitutional challenge to its existence when the Supreme Court issued a narrow opinion against the PCAOB, ruling only that the manner under which PCAOB board members can be removed from office was unconstitutional. This was remedied by the opinion, and the PCAOB was able to continue its operations uninterrupted.<sup>8</sup> In January 2011, the Securities and Exchange Commission (SEC) appointed two new members and a new chairman, Mr. James R. Doty to the Board.<sup>9</sup> With these operational and organizational issues resolved, the PCAOB can take a fresh look at its programs and focus on the challenges of regulating a profession that is under scrutiny, overseas as well as in the United States. For basic facts about the PCAOB, see Appendix 3, on page 14.

### **Audit chairs suggested ways the PCAOB can provide additional value**

In the discussion with Mr. Goelzer, ACLN members questioned whether the PCAOB is strengthening the independent audit and its value to stakeholders. In raising this question, many members said they believe the PCAOB tends to criticize and find fault without providing recommendations or best practices that could help

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<sup>5</sup> Daniel L. Goelzer, "[The Public Company Accounting Oversight Board – Recent Accomplishments and 2011 Agenda](#)," speech at the AICPA National Conference on SEC and PCAOB Developments, Washington, DC, December 7, 2010.

<sup>6</sup> Public Accounting Oversight Board *Proposed Auditing Standard Related to Communications with Audit Committees* (Washington, DC: Public Accounting Oversight Board, 2010).

<sup>7</sup> In 2010, the Dodd-Frank Act expanded the PCAOB's authority to also oversee the auditors of brokers and dealers. Under the Sarbanes-Oxley Act, auditors of brokers and dealers were required to register with the Board. Dodd-Frank provides the PCAOB with standards setting, inspection, and disciplinary authority over broker-dealer audits. See Public Company Accounting Oversight Board, "PCAOB Statement upon Signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act," news release, July 21, 2010.

<sup>8</sup> Kara Scannell and Michael Rapoport, "[Justices Keep Sarbanes-Oxley, Adjust Structure](#)," *Wall Street Journal*, June 29, 2010.

<sup>9</sup> The Securities and Exchange Commission, "[SEC Appoints James R. Doty as Chairman, Jay D. Hanson and Lewis H. Ferguson as Members of PCAOB](#)," news release, January 7, 2011.

to improve the overall profession. A member suggested, *“I don’t think [you have to share] everything, but if you see themes across audits, you could discuss this with the audit firms.”*

Some members saw room for the mission of the PCAOB to be broader and pointed out that the PCAOB is well positioned to provide insight in the form of a “state of the profession” report, though they acknowledged that the PCAOB might be under pressure to provide positive assessments of the profession. Another member, however, was less keen on an expanded role for the PCAOB: *“I do not want to increase the scope of the PCAOB one little bit.”*

Others brought up the issue of accountability: *“While the mission is grand, how do you measure success?”* The PCAOB’s strategic plan includes a number of performance measures, such as the number of inspections conducted, the timeliness of inspection reports, the timeliness of the resolution of investigations, progress on standards-setting initiatives, and the number of countries where the PCAOB has made progress on an international dialogue.<sup>10</sup> However, members expressed interest in seeing measures that more explicitly demonstrate improvements in overall audit quality.

In addition, members expressed concern that the PCAOB does not often hear audit committee perspectives, despite the fact that the regulator’s rules can have a consequential impact on audit committee practices. Members raised questions about the PCAOB board members’ experience with audit committees, and although they were pleased that the new chairman has worked extensively with audit committees as an adviser, they suggested that more experience would be beneficial in the future. In addition, ACLN members noted that some audit chairs participate in the PCAOB’s Standing Advisory Group (SAG) and were hopeful their input is taken seriously.

### Improving the audit

In the aftermath of the financial crisis, investors, management, boards, regulators, and legislators across the globe have been assessing the need for policy changes that could impact auditors and audit committees.

In September 2010, the PCAOB issued a report on findings resulting from inspections that took place during the financial crisis (2007–2009). In the report, the PCAOB identified instances in which auditors appeared not to have met PCAOB standards in certain areas of financial reporting, such as fair value measurements, impairment of goodwill, indefinite-lived intangible assets and other long-lived assets, allowances for loan losses, off-balance-sheet structures, revenue recognition, inventory, and income taxes.<sup>11</sup> The report also noted that auditing firms responding to the increased risks stemming from the crisis took actions such as issuing technical guidance, requiring additional training, developing new audit tools, requiring additional audit procedures, and increasing monitoring of audit engagement personnel.<sup>12</sup>

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<sup>10</sup> Public Company Accounting Oversight Board, *Strategic Plan 2010 – 2014* (Washington, DC: Public Company Accounting Oversight Board, 2010), 29.

<sup>11</sup> Public Company Accounting Oversight Board, [“PCAOB Issues Report on Inspection Observations of Auditing During the Economic Crisis,”](#) news release, September 29, 2010.

<sup>12</sup> [Ibid.](#)

The PCAOB has noted that auditors must continue to improve their quality control systems and has indicated that the report's findings will inform future PCAOB actions, including inspections, enforcement, and standards setting.<sup>13</sup> In a December 2010 speech, Mr. Goelzer stated, "In my view, the report neither shows that audit failures caused the financial crisis nor that better auditing could have prevented it. What it does show is that the major firms must do a better job in adjusting to emerging audit risks as economic conditions change so that investors will have reliable information about the performance and financial position of public companies under economic stress."<sup>14</sup>

Members also discussed the European Commission's recently issued consultation document (a "green paper") on audit policy. That document raises a number of significant questions about the audit profession's structure and functioning, such as audit firm rotation, audit firms' provision of non-audit services, third-party appointment of auditors, joint audits, and the concentration of the industry.<sup>15</sup> Members wanted to know whether the PCAOB will be pressured to take up these issues as well.

It is worth noting that several of these issues have been raised in the past, such as during consideration of the Sarbanes-Oxley Act and in initiatives prior to the financial crisis, including by the Treasury Advisory Committee on the Auditing Profession.<sup>16</sup> The PCAOB is currently considering new standards relating to issues that are also being discussed in Europe, including a standard on the auditor's reporting model and a standard on communications with the audit committee.<sup>17</sup> [See pages 7 - 10 for audit committee chairs' views on these proposals.](#)

### **Impact of fee pressures on audit quality**

In his December speech, Mr. Goelzer noted that while "audit committees are expecting auditors to share in the economic pain that companies are feeling by agreeing to fee reductions," the economic conditions have also led to more complex audits. One of the priorities he identified for the PCAOB is investigating how fee reductions affect audit performance and the extent to which they lead to audit deficiencies.<sup>18</sup>

In discussing the issue of audit fees, several members emphasized the importance of maintaining audit quality, sometimes in the face of strong pressure from management to reduce fees. One member said, "*We allow the company and the external auditor to negotiate, and then we meet independently with each to try to broker a solution. We don't want any degradation in quality.*" Another member said, "*I'm the external auditor's advocate, and if there's a problem, I need to help them. You have to have helped them, so they have confidence in you. You need communication and trust with the external auditor.*"

Members also noted, however, that they sought fees that were reasonable. One member commented "*We want a fair return for the external auditor, but we aren't going to write a blank check.*"

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<sup>13</sup> [Ibid.](#)

<sup>14</sup> Daniel L. Goelzer, "[The Public Company Accounting Oversight Board - Recent Accomplishments and 2011 Agenda.](#)"

<sup>15</sup> European Commission, [Audit Policy: Lessons from the Crisis](#) (Brussels: European Commission, 2010).

<sup>16</sup> US Department of the Treasury, Advisory Committee on the Auditing Profession, *Final Report*, October 6, 2008.

<sup>17</sup> Daniel L. Goelzer, "[The Public Company Accounting Oversight Board - Recent Accomplishments and 2011 Agenda.](#)"

<sup>18</sup> [Ibid.](#)

The PCAOB advances its mission in a number of ways:<sup>19</sup>

1. **Registering accounting firms.** All accounting firms that prepare audit reports for public companies must register with the PCAOB, and they must file periodic reports about their practice.<sup>20</sup> As of February 2011, 2,396 firms were registered.<sup>21</sup>
2. **Conducting inspections.** The PCAOB inspects registered accounting firms to evaluate their systems and processes, as well as their audits of specific companies. By the end of 2009, the PCAOB had conducted more than 1,300 inspections, and it had issued more than 1,000 reports since inspections began in 2004.<sup>22</sup> It also inspects the auditors of US public companies in jurisdictions outside the country. By end of 2010, it had conducted 268 inspections of firms located in 34 jurisdictions, many with the help of local auditor oversight authorities.<sup>23</sup>
3. **Conducting investigations and disciplinary proceedings.** The PCAOB can impose sanctions on registered firms and their employees if they violate applicable laws or auditing standards. Sanctions can include revoking a firm's registration, suspending or barring individuals from working on audits, and imposing monetary penalties. In 2010, the Enforcement Division opened 27 investigations and announced settlements in seven disciplinary proceedings.<sup>24</sup>
4. **Establishing standards for audits of public company financial statements.** Based on its oversight activities and its research, the PCAOB develops new standards to improve auditing and related professional practices. So far, it has developed 15 new auditing standards.<sup>25</sup> Of those standards, eight were issued in 2010: AS7 is intended to enhance the engagement quality review, and AS8 through 15, which the Board refers to as risk assessment standards, are designed to improve the auditor's assessment of and response to risks in the audit.<sup>26</sup>

*Note: This box does not take into account the PCAOB's expanded mandate to oversee the audits of brokers and dealers.*

## Audit chairs want more visible results from the inspection process

<sup>19</sup> Basic information summarized from Public Company Accounting Oversight Board, [Making a difference in the reliability of financial reporting](#), 5, with additional and updated statistics from the sources indicated.

<sup>20</sup> The Sarbanes-Oxley Act also requires broker dealers to have their balance sheets and income statements audited by PCAOB-registered accounting firms.

<sup>21</sup> Public Company Accounting Oversight Board, [Registered Public Accounting Firms With the Public Company Accounting Oversight Board As of Tuesday, February 8, 2011](#) (Washington, DC: Public Company Accounting Oversight Board, 2011), 1.

<sup>22</sup> Public Company Accounting Oversight Board, [Making a difference in the reliability of financial reporting](#), 2.

<sup>23</sup> Daniel L. Goelzer, "The Public Company Accounting Oversight Board – Recent Accomplishments and 2011 Agenda."

<sup>24</sup> [Ibid.](#)

<sup>25</sup> [Ibid.](#)

<sup>26</sup> Martin Baumann, [presentation to the AICPA National Conference on SEC and PCAOB Developments](#), Washington DC, December 7, 2010.

Members focused on the PCAOB's inspection process, discussing not only the inspections themselves but also the reports produced and the value that could be gained and shared from this work.

### How PCAOB inspections and reporting work

The PCAOB's 2009 annual report notes that its inspection program "is the core of its oversight of registered firms' public company audit work."<sup>27</sup> The PCAOB is required to conduct annual inspections of firms that audit more than 100 issuers (nine firms in 2010), and every third year it is required to inspect firms that audit fewer than 100 issuers. It provides written reports on the inspections to the SEC and certain state regulators, and certain portions of the report are made public.<sup>28</sup>

The public portion of the PCAOB inspection report (often called Part I) lists deficiencies identified in engagements that were reviewed as part of the inspection and is available on the PCAOB's website.

PCAOB inspections also include reviews and testing of firms' systems of quality controls (often called Part II, which, by law, is not public).<sup>29</sup> PCAOB inspectors focus on issues such as management structure and processes (including tone at the top), partner management practices (such as the allocation of partner resources and partner evaluation), policies and procedures for addressing the risks involved in working with certain clients, processes for monitoring audit quality, and policies and procedures for considering the independence implications of non-audit services.<sup>30</sup>

If the PCAOB finds defects in the inspected firm's quality control systems, the firm has 12 months to remedy the problems. If the remedies satisfy the PCAOB, the inspection report remains confidential. However, if the firm does not remedy the problems satisfactorily within 12 months, the PCAOB makes public the portions of the report addressing the problems.

### Members' views of the inspection process and reports

At the meeting and in pre-meeting conversations, members raised a number of concerns about the PCAOB inspection process and reports:

- **The questions that inspections staff ask of audit chairs in interviews reflect a lack of understanding and aren't sufficiently rigorous.** A member who was interviewed by an inspection official noted, "*It was time-intensive, but not as rigorous as it should have been. There were really no hard questions. They asked questions such as 'Do you think they're honorable? Do you think they work hard? Do they cover the right things in the audit?'*" Another member commented, "*The questions showed a lack of understanding of our role.*" Members felt that as audit committee chairs, they learned little from the interviews even though such interactions should be mutually beneficial. One member suggested that the PCAOB should provide a report back to the board or audit committee on their findings for that company's audit.

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<sup>27</sup> Public Company Accounting Oversight Board, *Making a difference in the reliability of financial reporting*, 10.

<sup>28</sup> Public Company Accounting Oversight Board, "Inspections," PCAOB website.

<sup>29</sup> Public Company Accounting Oversight Board, *Making a difference in the reliability of financial reporting*, 12.

<sup>30</sup> *Ibid.*

Another member suggested that management should be interviewed as well, to provide the PCAOB with a better picture: *“I don’t understand why you do this with audit committees and not management ... Why not evaluate the communications between the chief financial officer and the auditor?”*

- **The inspection reports (Part I) are less useful than they could be.** Members urged the PCAOB to think more about how to make the reports useful. Audit committees use them, but they were not designed with such users in mind. One member explained, *“The audit committees I sit on look at the inspection reports you issue on firms to understand what it means for us and to see if we’ve selected the right external auditor, but it’s hard to know from those reports what is relevant to us ... We don’t get all we can out of it, and we have to ask the external auditor what is relevant to us.”*
- **Audit chairs want insights on the non-public (Part II) sections of inspection.** While the PCAOB, by law, is not allowed to share the non-public sections of inspection reports with audit committees, audit firms can and often do discuss the nature of the findings with audit committees. Some members reported that *“our national partner provides us with an oral review of Part II.”*
- **Inspections and the associated reports are not focused on identifying and communicating best practices.** Several members suggested that the inspections and reports could be a key avenue for identifying and promulgating best-practice insights.

### **Audit chairs are wary of changes to the auditor’s reporting model and audit committee communications**

The PCAOB is currently pursuing a number of standards-setting initiatives, including a project related to the auditor’s reporting model and an updated standard on communications between the auditor and the audit committee.

#### **The review of the auditor’s reporting model**

The official report that the auditor provides on a company’s audited financial statements is currently a one-page pronouncement stating that the company either passes or fails, or, in some cases, passes with qualifications. Given the auditor’s knowledge of the company, some observers believe the auditor could provide more insight in its report. Over the years, the question of how the auditor’s report could be improved has arisen.<sup>31</sup> On occasion, the debate has resulted in changes to the standard report, but these changes have rarely been significant.

Today, the auditor’s report is undergoing another round of scrutiny. ACLN members and other observers note that while the notion of improving the auditor’s report is not new, the impetus to do so may be especially strong this time around. In a recent speech, Mr. Goelzer mentioned that pressure for change is coming from many quarters.<sup>32</sup>

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<sup>31</sup> In the United States, the Treasury Advisory Committee on the Auditing Profession recommended a review in its 2008 report. Overseas, the International Organization of Securities Commissions and the International Auditing and Assurance Standards Board are evaluating potential improvements. The European Commission’s green paper on audit policy and the UK FRC consultation take up enhancing the audit report as well.

<sup>32</sup> Daniel L. Goelzer, [“The Public Company Accounting Oversight Board – Recent Accomplishments and 2011 Agenda.”](#)

At the PCAOB, the Office of the Chief Auditor is currently researching the issue, and it was discussed at the April and July SAG meetings. In December, Mr. Goelzer summed up some of the ideas that are currently circulating:

The Board will have to make some difficult choices next year if it decides to change the time-honored pass/fail report. There is no shortage of ideas. During a discussion of the reporting model at our Standing Advisory Group meeting last April, some suggested that the auditor should provide more information about the audit itself and how it was performed. Others want the auditor's views on the management judgments embodied in the financial statements regarding such things as estimates and the selection of accounting policies. Auditors have proposed that their reports should be clearer about limitations on the ability to detect fraud. Some users have suggested expanding the auditor's current opinion to include new material; others have suggested that the pass/fail report should be accompanied by a separate auditor's report akin to the MD&A.<sup>33</sup>

While a formal proposal has yet to be issued for public comment, the PCAOB has heard from some in the investor community who advocate changes to the auditor's report. To determine the best way forward, it is conducting a series of focus groups early in 2011.<sup>34</sup>

ACLN members were generally wary of changing the auditor's report:

- **Investors demanding change may not be representative.** Members are skeptical about how representative the investors who are clamoring for change really are. They observed that the largest investors by capital in their companies have not expressed a view publicly or in meetings with executives about wanting any change in the auditor's report, and they pointed to the problem of information overload: *"Who are the investors who are saying they want more information? Our 10-K is 200 pages: it's [already] daunting."*
- **There may be a number of other problems.** A member noted, *"You are getting into an area that is subjective, and it's additional information that is not necessarily beneficial."* Some members echoed the concerns of other observers about liability issues: *"Auditors are acutely aware of their risks and liabilities. They are more than ever risk averse and conservative."*

Regarding the idea that the information given to the audit committee should be more broadly available, one member asked rhetorically, *"Then why should there be an audit committee?"* The member added, *"If this is the way you're going, you may be redefining the corporate governance model."*

In pre-meeting conversations, some members did see potential value in reforming the auditor's report. One member remarked, *"I think this would be desirable. Auditors ... are in a position to give disclosures ... Maybe a fuller report would be appropriate. They're capable of that."* Another member noted the value of what was gained out of discussions with the auditor: *"Those internal discussions are quite useful. I can see why those on the outside might want that."*

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<sup>33</sup> [Ibid.](#)

<sup>34</sup> [Ibid.](#)

The standards-setting agenda of the Office of the Chief Auditor indicates a concept release on the auditor's reporting model will be issued by the second quarter of 2011, with roundtable discussions on the proposal scheduled for the third quarter, and a proposed standard to be issued for public comment in late 2011.<sup>35</sup>

### **The proposal on communications between the auditor and the audit committee**

On March 29, 2010, the PCAOB proposed for comment an auditing standard called "Communications with Audit Committees." Building on the requirements of Sarbanes-Oxley, the proposed standard seeks to enhance the relationship between the auditor and the audit committee by improving communications between them. A final standard is expected by mid-2011.

The proposed standard supersedes two existing interim standards on communications with the audit committee (AU Section 380 and AU Section 310), incorporating their provisions and adding others. Many of the provisions describe practices that are already required by other codes, such as the New York Stock Exchange listing requirements and SEC rules. The key requirements of the proposal and select responses from the comment letters and roundtable discussion on the matter are listed below:

- 1) Establishment of a mutual understanding of the terms of the audit engagement, documented in an engagement letter. (During the PCAOB's consideration of the proposal, Mr. Goelzer said that this requirement would better align its standards with the objectives for communication between audit committees and auditors outlined in the Sarbanes-Oxley Act.<sup>36</sup>)
- 2) Communication of an overview of the audit strategy, including a discussion of significant risks, the use of the internal audit function, and the roles, responsibilities, and location of firms participating in the audit. (Mr. Goelzer stated, "The goal here is to make audit committee oversight more effective by arming the committee with up-front information regarding the auditor's view of the risks and how they will be addressed."<sup>37</sup>)
- 3) Communication regarding critical accounting policies, practices, and estimates. (Mr. Goelzer noted that "these topics are particularly relevant in light of the additional attention that the economic crisis has brought to management's judgments and estimates, particularly related to fair value."<sup>38</sup> Investors commenting on the PCAOB proposal supported these proposed requirements, but other commenters were worried that they might lead to a check-the-box exercise and that the audit committee might be overwhelmed by unhelpful information and detail that could obscure critical issues.<sup>39</sup>)
- 4) Communication regarding the auditor's evaluation of events or conditions that indicate there could be substantial doubt about a company's ability to continue as a going concern. (While not many

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<sup>35</sup> Public Company Accounting Oversight Board, *Office of the Chief Auditor Standard-Setting Agenda* (Washington, DC: Public Accounting oversight Board, 2010), 5.

<sup>36</sup> Daniel L. Goelzer, "[Statement on Proposed Auditing Standard Related to Communications with Audit Committees.](#)"

<sup>37</sup> [Ibid.](#)

<sup>38</sup> [Ibid.](#)

<sup>39</sup> Public Company Accounting Oversight Board, *PCAOB Roundtable: Communications with Audit Committees* (Washington, DC: Public Company Accounting Oversight Board, 2010), 4.

comment letters submitted to the PCAOB touched on this requirement, a few commenters expressed concern that the requirement could lead to the auditor communicating about going-concern issues even when the auditor does not have significant doubts.<sup>40)</sup>

- 5) Evaluation by the auditor of the adequacy of the two-way communications. (Commenters to the PCAOB recognized the value of enhancing two-way communications, but several suggested that the audit committee as well as the auditor should be involved in evaluating the communications.<sup>41)</sup>

ACLN members raised questions about the PCAOB's efforts to improve communications between the auditor and the audit committee:

- **A standard is unnecessary at best.** One member said, *"If I felt there was a problem, I would speak up. Why would you wait for [the PCAOB] to fix something that is not right? Any audit committee chair that would wait shouldn't be an audit committee chair or even on a board."* Another member concurred: *"Audit committees are not stupid – they see the needs, and they know what to discuss."*
- **A standard could even be harmful.** Some members voiced concerns about being overwhelmed by too much irrelevant information: *"[The auditor] could just become a reporting entity, [producing] lengthy, overworded, byzantine documents."* These members worried the standard would adversely affect the audit committee's agenda: *"It might have unintended consequences in skewing the committee to focus on what the auditor focuses on, not what the audit committee should be focusing on."*

However at least one member supported the initiative, saying: *"More color around internal controls, the use of accounting principles, and the quality of accounting of estimates and judgments [would be useful]."*

## Conclusion

In discussion with Mr. Goelzer, audit committee chairs in the ACLN suggested a number of ways that the PCAOB can improve independent audits. For example, members highlighted the opportunity for the PCAOB to identify best-practices insights that could be broadly shared, thereby helping auditors and audit committees alike to perform better. At the same time, many audit chairs were wary of expanding the scope of the PCAOB's activities and urged the regulator to be mindful of unintended consequences in its efforts to develop standards on critical issues such as the level of disclosure should be required in an auditor's report. In addition, members suggested the PCAOB engage more often with audit committees to gain additional insight, especially to avoid standards that overwhelm the audit committee and crowd out more strategic issues from the audit committee agenda. Several members, for their part, promised to engage more actively with the PCAOB on matters of significant relevance to audit committees.

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<sup>40</sup> Based upon a review of the comment letters available on the PCAOB website.

<sup>41</sup> Public Company Accounting Oversight Board, *PCAOB Roundtable: Communications with Audit Committees*, 5.



## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

*The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, any Ernst & Young member firm, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to the global organization of member firms of Ernst & Young Global Ltd., each of which is a separate legal entity. Ernst & Young LLP is a client-serving member firm in the U.S.*

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## Appendix 1: Participants

Audit Committee Leadership Network members participating in all or part of the meeting, who sit on the boards of over 30 large, mid-, and small-cap public companies between them, included:

- Denny Beresford, Kimberly-Clark
- Leslie Brun, Merck
- Dick Harrington, Aetna and Xerox
- Judy Richards Hope, General Mills and Union Pacific
- Labe Jackson, JPMorgan Chase
- Mike Losh, AON and TRW Automotive
- George Muñoz, Altria and Marriott International
- Oscar Munoz, United Continental Holdings
- Chuck Noski, Microsoft
- Bill Osborn, Caterpillar
- Bernd Voss, ABB and Continental AG (European Audit Committee Leadership Network member)
- Steve West, Cisco Systems
- Chris Williams, Wal-Mart

Ernst & Young professionals participating in the meeting included:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Area Managing Partner



## Appendix 2: Questions for audit committee members

- ? Does your audit committee see Part 1 of the PCAOB's inspection reports? If so, do you discuss these results? How so? Is the discussion useful?
- ? Does your audit committee or members of the audit team receive verbal feedback on Part 2 of the inspection report? If so, is this discussion helpful?
- ? How can the PCAOB improve its inspection reporting to be more useful to other stakeholders, such as investors?
- ? What could the PCAOB do to make the inspection process more credible and effective? Should the PCAOB have a role in identifying and sharing audit best practices so as to improve the profession as a whole?
- ? Does your external auditor communicate with the audit committee if the company is chosen for an inspection?
- ? Do you see a need for an improved auditor's report or audit committee report? If so, what should the reports include? What are the risks and obstacles involved in attempting to improve the auditor's report?
- ? Does your audit committee have any concerns about the quality of communication with your external auditors? Could a PCAOB audit standard contribute to better communication?
- ? Will the PCAOB's proposed changes (taken together) have a positive impact on relations between the auditor and the audit committee? What are the risks associated with these changes?
- ? Do you think audit committee views are sufficiently taken into account in the PCAOB's standards setting process? Do you comment on PCAOB proposals? If not, why not?
- ? How do you ensure that pressure to manage audit fees does not undermine the quality of your audit? How do you as an audit committee member weigh in on this discussion?

### Appendix 3: Basic facts about the PCAOB

The mission of the PCAOB is to

oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Pursuant to the recently enacted Dodd-Frank Act, the PCAOB also oversees the audits of broker-dealer compliance reports under federal securities laws to promote investor protection.<sup>42</sup>

Sarbanes-Oxley made the SEC responsible for oversight of the PCAOB. In consultation with the chairman of the Board of Governors of the Federal Reserve System and the secretary of the Treasury, the SEC appoints the five board members, who serve staggered five-year terms. The SEC also approves the PCAOB's rules, standards, and budget.<sup>43</sup>

The PCAOB's funding has, until 2011, come from annual fees assessed on public companies in proportion to their market capitalization.<sup>44</sup> The 2011 fiscal year budget is \$204.4 million, an increase of \$21.1 million (11.5%) over the 2010 budget that is responsive to the regulator's significantly increased responsibilities following the passage of the Dodd-Frank Act.<sup>45</sup> For example, Dodd-Frank requires the PCAOB to inspect the auditors of brokers and dealers (the PCAOB's rule proposal to implement this requirements is pending). As such, the Dodd-Frank Act now requires the Board to allocate its funding among issuers and brokers and dealers.

The PCAOB's 2011 budget estimates that total staff by the end of the year will number just over 700, an increase of about 80 employees from the previous year. Nearly 60% of the staff work in the Division of Registration and Inspections.<sup>46</sup> The PCAOB works with a number of advisory and working groups, including the SAG, which consists of auditors, investors, public company executives, and others, and the Investor Advisory Group (IAG), which was established more recently to deepen the involvement of investors and consists of a broad spectrum of the investor community.<sup>47</sup>

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<sup>42</sup> Public Company Accounting Oversight Board, "[Mission, Structure & History.](#)"

<sup>43</sup> Public Company Accounting Oversight Board, "[About the PCAOB.](#)"

<sup>44</sup> [Ibid.](#)

<sup>45</sup> Public Company Accounting Oversight Board, "[PCAOB Approves 2011 Budget and Related Strategic Plan.](#)" news release, November 23, 2010.

<sup>46</sup> [Ibid.](#)

<sup>47</sup> Public Company Accounting Oversight Board, *Making a difference in the reliability of financial reporting*, 24-25.