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Statement of James R. Doty
Chairman
Public Company Accounting Oversight Board

Before the

United States Senate
Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance and
Investment

Hearing on the Role of the Accounting Profession
In Preventing Another Financial Crisis

538 Dirksen Senate Office Building
April 6, 2011



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Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee:

Thank you for the opportunity to appear before you today on behalf of the Public Company Accounting Oversight Board (“PCAOB” or “Board”) to testify on the role of the accounting profession in preventing another financial crisis.

I look forward to discussing with the Subcommittee the role that the PCAOB plays in protecting investors and fostering confidence in our securities markets. I joined the Board on February 1, 2011. Many of the achievements and initiatives I will describe to you were the work of, or begun by, my predecessors on the Board as well as the PCAOB staff. The PCAOB remains actively engaged in these and many new initiatives to protect the investing public by enforcing high quality audits.

I. Introduction

You have asked me to address three questions: Did the accounting profession perform as expected leading up to and during the financial crisis? What, if any, improvements have been made or should be made by the U.S. Securities and Exchange Commission (“SEC” or “Commission”), the Financial Accounting Standards Board (“FASB”), or the PCAOB as a result of the financial crisis? And what, if any, policy changes should Congress consider?

In general terms, the PCAOB’s inspections of audits conducted during the financial crisis indicated that accounting firms must do a better job of addressing in their

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audits the risks of misstatements in financial statements that emerge as economic conditions change. The PCAOB issued a report last fall describing the kinds of audit deficiencies the PCAOB identified on audits affected by the financial crisis. The PCAOB also issued several practice alerts on various auditing risks during the course of the crisis.

The PCAOB is focused on taking appropriate steps in its inspection and enforcement programs in order to improve audit quality and enhance protection of the investing public. The PCAOB is also using information gained in inspections and investigations, along with information received from investors, audit committee members, auditors and others, to improve auditing and related professional practice standards to improve the quality of audits during periods of economic stress.

I will discuss each of these points and explain how the PCAOB is using the lessons from the financial crisis to improve the quality of audits and auditor communications to investors. Finally, I will echo a suggestion made previously by the Board of a policy change for Congress to consider. It is a legislative change to enhance the PCAOB's effectiveness by permitting the Board to disclose its decisions to institute disciplinary proceedings to enforce applicable laws and standards against registered public accounting firms and their associated persons.

II. The Responsibilities of the PCAOB

More than half of American households invest their savings in securities to provide for retirement, education, and other goals. The financial statement auditor's job is to protect these investors' interests by independently auditing and reporting on management's historical financial statements. Reliable financial reporting is one of the linchpins on which our capital markets depend. If investors lose confidence in financial reporting, they may demand prohibitively high returns as a condition of investing or they may withdraw from the capital markets altogether. The result would be to make it more difficult and expensive to finance the businesses on which our economy depends. Moreover, inaccurate financial reporting can mask poor business strategies or fraud that, if left uncorrected, may result in the misallocation of capital, business failures, and layoffs. Even accurate, well-supported financial information does not mean the business strategy is good.

As the accounting scandals related to Enron, Adelphia and other public companies demonstrated, auditors can face strong pressures and incentives to acquiesce to questionable accounting. The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act") was passed in the wake of the collapse of confidence that resulted from these and other financial reporting breakdowns. Title I of the Act created the PCAOB to serve as a counterweight to those pressures and incentives. Congress

rightly determined in 2002 that rigorous, independent oversight was essential to the credibility of the auditor's watchdog function.

Prior to the creation of the PCAOB, public company auditors were subject to oversight by their professional association and to peer reviews conducted by other auditing firms. Title I of the Sarbanes-Oxley Act profoundly changed the environment in which public company auditors operate by providing for ongoing accountability to the PCAOB. The Board exercises that oversight through four basic functions –

- **Registration of accounting firms** – No accounting firm may prepare, or substantially contribute to, an audit report for a public company that files financial statements with the SEC, or for a broker-dealer, without first registering with the PCAOB. There are currently 2,431 accounting firms registered with the Board. This includes 906 non-U.S. firms and 522 firms that are registered only because they have broker-dealer audit clients. Registered firms must file annual and other reports that provide the Board and the public with updated information about the firm and its audit practice. Contrary to what some believe, mere registration with the PCAOB does not reflect an examination of the firm's audit quality, which does not happen until we inspect.

- ***Inspection of firms and their public company audits*** – Since 2003, the PCAOB has conducted more than 1,600 inspections of firms' quality controls and reviewed aspects of more than 7,000 public company audits. The audit engagements the PCAOB reviews are not selected at random. To make the most effective use of its resources, the PCAOB uses a variety of analytical techniques to select high-risk engagements and audit areas that are likely to raise challenging or difficult issues.¹ Throughout this rigorous process, PCAOB inspections have identified numerous audit deficiencies, including failures by the largest U.S. and non-U.S. firms. These findings have led to changes in firm auditing processes, and, in some cases, more audit work performed after the fact or to corrections of client financial statements.
- ***Investigation and disciplinary proceedings*** – The Board has broad authority to impose sanctions on registered firms and associated persons that have violated applicable laws and standards. The PCAOB has

¹ The PCAOB devotes considerable effort to collecting, quality checking, and analyzing data from public sources, vendors, registered firms and internal sources. The PCAOB uses this data to monitor financial reporting and auditing risks. The PCAOB's various screening techniques combine non-public data collected in the inspection process with publicly available data to identify those firms, offices, partners, engagements, and issues that present the greatest audit risks. PCAOB analysts then perform in-depth analysis to provide inspectors with actionable intelligence when they go into the field.

publicly announced the resolution of 37 enforcement proceedings. These proceedings include 29 sanctions on firms, including 19 revocations of firms' registrations, preventing them from auditing public companies in the future, and 40 sanctions on individuals. Sanctions have also included significant monetary penalties. The announced decisions do not, however, reflect the full extent of PCAOB enforcement activity. Under the Sarbanes-Oxley Act, all PCAOB investigations and all contested proceedings (*i.e.*, cases in which the Board files charges and the respondent elects to litigate, rather than settle) are non-public. There are a significant number of matters under active investigation and an additional number in litigation, which may take years to be resolved.

The Board closely coordinates its enforcement efforts with the SEC. In certain instances, the PCAOB investigates the auditor's conduct and the SEC focuses its investigation on the public company, its management, and other parties. In other cases, the SEC's Division of Enforcement takes responsibility for an auditor investigation and requests that PCAOB defer to that investigation.

- ***Establishing auditing, quality control, ethics, independence, and other standards*** – The Board is responsible for establishing the auditing

and related professional practice standards under which public company audits are performed. Prior to the Sarbanes-Oxley Act, public company audits were performed according to standards set by the profession itself. The PCAOB has an active standard-setting agenda, as I will describe later in my testimony.

All of the Board's responsibilities are discharged under the oversight of the SEC. Chairman Schapiro, the Commissioners, and Chief Accountant Kroeker have taken a deep interest in the PCAOB's work, and I am grateful to them for their support and for the strong working relationship they have fostered between our organizations.

III. Auditor Performance Before and During the Financial Crisis

Through its inspection and enforcement programs, the PCAOB actively assesses whether auditors are doing their job appropriately and takes action when they are not.

Neither financial statement audits nor PCAOB oversight are intended to assess any company's liquidity structure, capital adequacy or risk management, including financial institutions. Nor does the PCAOB set accounting and disclosure requirements. That is the purview of the FASB, the International Accounting Standards Board, in the case of institutions permitted to use International Financial Reporting Standards, and the SEC.

Rather, the PCAOB evaluates whether auditors have done their job, which is to make sure an institution's financial statements and related disclosures fairly present its results – good or bad – to investors in conformity with applicable accounting and disclosure standards. The Board is deeply focused on the lack of transparency in financial reporting during the crisis and the corresponding effect this had on the fairness of our securities markets. The Board is also focused on implementing lessons from the financial crisis in audits and our programs.

A. *Inspections*

The PCAOB's inspection program is the core of its oversight of registered firms' public company audit work. The PCAOB's inspection staff represents more than half of its staff. In addition, the PCAOB's Office of Research and Analysis devotes the majority of its resources to support the inspection program. As required by the Act, the PCAOB conducts annual inspections of firms that regularly audit the financial statements of more than 100 public companies. In 2010, the PCAOB inspected nine such firms. Firms that regularly audit the financial statements of 100 or fewer public companies must be inspected at least once every three years. The PCAOB inspected 245 such firms in 2010, including 64 non-U.S. firms located in 20 jurisdictions. Many of these non-U.S. firms are affiliated with a global network of firms. They can be quite large,

measured by number of professionals as well as by market capitalization of audit clients.

Each firm in a global network of firms, including the Big Four, is independently owned by the partners in their country. Since each of those firms must register separately with the PCAOB, they are subject to the same frequency of inspections as any other firm. Substantial portions of the audits of many of the largest U.S. companies are performed by affiliated network firms, including firms we have not inspected.

In the course of the PCAOB's 2010 inspections, PCAOB inspectors reviewed portions of more than 350 audits performed by the nine firms subject to annual inspection, and portions of more than 600 audits performed by the remaining 245 inspected firms. During 2010, the PCAOB inspected aspects of audits for some of the largest public companies in the world, including many of the largest financial services and other companies with complex financial instruments and transactions and risks driven by market volatility.²

² The Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111-203 ("Dodd-Frank"), authorized the Board to establish, by rule, a program of inspection of auditors of brokers and dealers. On December 14, 2010, the Board proposed a temporary rule that, if adopted, would establish an interim inspection program while the Board considers the scope and other elements of a permanent inspection program. Under the temporary rule, the Board would begin to inspect auditors of brokers and dealers and identify and address with the registered firms any significant issues in those audits. The Board expects that insights gained through the interim program would inform the eventual determination of the scope and elements of a permanent program.

After completion of the inspections field work, PCAOB inspectors engage in a dialogue with firms, through written comments, and in certain cases, in-person meetings, about audit deficiencies they have identified. The PCAOB then issues a report after each inspection. The inspection report is not a complete report card on the firm's entire audit practice, but rather focuses on areas where inspectors found deficiencies. The public portion of an inspection report describes matters that inspectors have identified as significant audit deficiencies. These findings, presented in Part I of the report, generally involve situations in which PCAOB inspectors believe that the auditor failed to obtain sufficient evidence to support the audit opinion or failed to identify a material departure from generally accepted accounting principles. Consistent with restrictions in the Sarbanes-Oxley Act, however, the PCAOB does not publicly disclose the identity of the companies that are the subject of audits discussed in an inspection report.

Consistent with the Sarbanes-Oxley Act, the PCAOB discusses any criticism of or potential defects in a firm's system of quality control in Part II of its inspection reports. The Act affords inspected firms one year within which to remediate Board criticisms

During the interim program, the Board at least annually would provide public reports on the progress of the program and significant issues identified, but the Board would not expect to issue firm-specific inspection reports before the scope of a permanent program is set. For more information about the proposed interim inspection program, see PCAOB Release No. 2010-008 (December 14, 2010).

concerning firm quality controls. If the Board is not satisfied with a firm's remediation efforts, the portion of the report containing the discussion of the quality control deficiencies becomes public. The Board transmits full inspection reports, including the nonpublic portions of such reports, to the SEC and appropriate state boards of accountancy. The Board is also permitted to share full reports with certain other U.S. and non-U.S. authorities. In addition, the Board sends a special report to the SEC when, as a result of information developed in an inspection, it appears that financial statements filed with the Commission, and on which the public is relying, may be materially inaccurate.

2007 – 2009 Inspection Cycles

Last fall, the Board issued a report to inform the public about the audit risks and challenges that PCAOB inspectors had found in connection with the economic crisis.³ That report discussed audit deficiencies inspectors uncovered during the 2007 through 2009 inspection cycles related to the impact of the crisis. Among other things, the report described deficiencies relating to auditing fair value measurements, especially related to financial instruments; impairment of goodwill, indefinite-lived intangible

³ PCAOB, *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (Sept. 29, 2010), available at <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

assets, and other long-lived assets; allowance for loan losses; off-balance-sheet structures; revenue recognition; inventory valuation; and income taxes.

We have observed that firms have produced internal guidance and training to address the deficiencies. They have not, however, been consistently applied by individual engagement teams.

The report does not evaluate the root causes of the crisis. Most post mortems to date have pointed to the failure of corporate risk management and financial institution liquidity structure or capital adequacy as root causes of the crisis. Other contributing factors have been cited as well, such as the behavior of the credit rating agencies, the role of the government-sponsored housing finance entities, regulatory gaps and failures, and even unintended consequences of legislative and regulatory incentives related to home ownership, to name just a few.

The PCAOB has neither the authority nor the resources to look back at the crisis with the broader view necessary to develop an informed opinion on all of the different factors that caused the crisis. The PCAOB has, however, inspected and considered the role of auditors of financial institutions and other public companies affected by the crisis. As described in our public report, inspectors identified multiple instances where auditors failed to perform the work mandated by PCAOB standards. 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 during periods of economic volatility. The PCAOB intends to use these lessons in driving improvements through subsequent inspections and appropriate standards setting.

2010 Inspection Cycle

Most of the audits that the PCAOB inspected during 2010 were of financial statements for fiscal years ending in 2009. The PCAOB staff is currently considering firms' responses to the questions and comments our inspectors raised, and are preparing draft inspection reports based on and reflecting their evaluation.

Although the PCAOB's 2010 inspection reporting cycle is not yet complete, so far PCAOB inspectors have continued to identify significant deficiencies related to the valuation of complex financial instruments, inappropriate use of substantive analytical procedures, reliance on entity level controls without adequate evaluation of whether those processes actually function as effective controls, and several other issues. PCAOB inspectors have also identified more issues than in prior years.

In any event, the Board is troubled by the volume of significant deficiencies, especially in areas identified in prior inspections. The PCAOB is working on several initiatives to drive improvements in audit quality.

2011 Inspection Plan

In 2011, the PCAOB will continue to focus on high-risk audit areas posed by the ongoing effects of the crisis and any future similar events, including, for example, the financial statement effect of the obligation to repurchase mortgages previously sold and mandated modifications to certain mortgages at financial institutions.

The PCAOB also intends to enhance its consideration of root causes when PCAOB inspectors find audit deficiencies. As in past years, the PCAOB will also continue to press firms to identify root causes of deficiencies and address them.

PCAOB inspectors will also look closely at corrective actions taken by firms when inspectors identify problems. A firm's failure to obtain sufficient evidence to support its opinion does not mean that the financial statements themselves are necessarily misstated. But it does mean that corrective actions are required, both to shore up the deficient audit as well as to better plan and perform future audits. Inspections can only protect investors from audit failures if firms act on inspection results. It is troubling to me that we do not see firms consistently going back and performing more work to address the significant audit deficiencies identified by inspections. Now, I will say, we have begun to see some firms going back quite recently, but I do not consider this problem to be resolved yet.

Moreover, my concern is compounded by the fact that we have received reports from members of audit committees that firms sometimes represent to audit committees that their PCAOB inspection reports raise merely minor concerns, typically attributable to documentation of procedures they claim – but just can’t demonstrate – they performed. Therefore, we are exploring ways to encourage the firms to provide more faithful reporting to audit committees in the future.

Inspectors will also continue to examine firms’ quality control systems to evaluate how they manage audit quality, so as to enhance the PCAOB’s basis for assessing, in this year and in future years, whether that system is appropriately designed and implemented to achieve the goal of conducting independent audits that are objective and in compliance with applicable standards. To this end, inspectors will continue to assess firms’ processes and controls in certain functional areas related to audit performance, including, for example, a firm’s monitoring of compliance with auditor independence requirements.

In addition, the PCAOB plans to expand its examination of the quality control mechanisms of large firms that participate in global networks. As I will discuss later, the PCAOB’s recent settlement with five Indian-based registered firms from PricewaterhouseCoopers’ global network (“PW India”) highlights the risks inherent in these global networks. In particular, inspectors will examine firms’ supervision of work

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performed by affiliated firms, including by assessing firms' controls over consultations on accounting and auditing standards, as well as engagement teams' use and evaluation of affiliates' work. We will also encourage firms to identify root causes and address them concomitantly throughout their global networks and not just within their U.S. member firms.

PCAOB inspectors will also examine how audit fee pressures might affect the conduct of audits. It has been widely reported that audit committees are expecting auditors to agree to fee reductions. At the same time, economic conditions are adding to the complexity of audits. While audit firms cannot be immune to economic downturns, the PCAOB will evaluate whether such pressures result in fewer hours being devoted to audits, thereby impairing audit quality.

Lastly, the PCAOB is developing a broker-dealer auditor inspection program to comply with Dodd-Frank. We expect to begin those inspections in 2011. The PCAOB's Office of Research and Analysis has worked closely with Financial Industry Regulatory Authority and the SEC over the last year to obtain critical data that will facilitate the broker-dealer auditor inspection program.⁴

⁴ On December 14, 2010, the PCAOB proposed a rule to establish an interim inspection program related to audits of broker-dealers. The comment deadline ended on February 15, 2011. The Board is considering those comments and expects to finalize the rule in the near future. See PCAOB, *Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers* (Dec. 14, 2010).

B. PCAOB Access to Non-U.S. Registered Firms

Approximately 260 non-U.S. firms are subject to regular PCAOB inspection. To date, the PCAOB has inspected 197 non-U.S. firms in 35 jurisdictions, including countries where some of the largest foreign private issuers – whose securities also trade in U.S. markets – are located such as Brazil, India, Japan, Korea, Mexico and the Russian Federation. As I mentioned earlier, in 2010 the PCAOB inspected 64 non-U.S. firms in 20 jurisdictions. Nineteen of these 64 inspections were performed on a joint basis with the local auditor oversight authority pursuant to negotiated cooperative arrangements. In each of the joint inspections, as well as the other foreign inspections not conducted on a joint basis, the PCAOB and its foreign counterpart have been able to resolve conflicts of law, sovereignty, and other issues that may arise when we are operating in another country.

It is no secret that we have not been able to inspect all of the non-U.S. firms we are required to, though. Approximately 70 firms in 24 jurisdictions – including in the European Union (“EU”), Switzerland and China – had inspection deadlines in 2010 or earlier that have not been met.

The PCAOB is working hard to reach accords that will allow PCAOB inspectors into those jurisdictions: it is one of our highest priorities. I am pleased to report that, in January, the PCAOB concluded an agreement with U.K. authorities. Based on this

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agreement, the PCAOB is planning joint inspections of two large U.K. firms beginning in May.

In addition, earlier this week, the PCAOB reached an agreement to conduct joint inspections with the authorities in Switzerland. We will commence joint inspections in Switzerland in May, with the goal of inspecting three Big Four affiliate firms by the end of the year.

The U.K. and Swiss agreements are a significant step forward for U.S. investors. They are not “mutual recognition” arrangements, but arrangements for joint inspections that will enable PCAOB inspectors to evaluate audit work in these countries that U.S. investors rely on.

These arrangements are the first cooperative agreements that the PCAOB has concluded since the passage of Dodd–Frank, which amended the Sarbanes-Oxley Act to permit the PCAOB to share confidential information with its non-U.S. counterparts under certain conditions. That amendment removed one of the obstacles to PCAOB inspections asserted by the EU.

We hope that these agreements will serve as a model for cross-border cooperation with other regulators in the European Union. We continue to make progress on this front and are encouraged by our discussions with authorities in several

jurisdictions. However, the negotiations with other EU regulators continue to progress quite slowly.

The PCAOB continues to be unable to conduct inspections in China, based primarily on assertions by the Chinese of national sovereignty issues. Currently, three mainland Chinese firms are overdue for inspection, and inspections of eight Hong Kong firms have been commenced but not completed because we were denied access to documents relating to operations of their clients in mainland China.

The PCAOB's inability to gain access to PCAOB-registered firms in China is especially troubling given the growth in the number of Chinese companies seeking access to capital in U.S. securities markets. Last month, the PCAOB issued a research note on trends and risks related to reverse merger transactions involving companies from the China region.⁵ This note followed a July 2010 staff audit practice alert on auditing public companies with operations in China and other jurisdictions that accessed the U.S. markets through reverse mergers.^{6/}

⁵ PCAOB, *Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010* (March 14, 2011), available at http://pcaobus.org/News/Releases/Pages/03152011_ResearchNote.aspx.

^{6/} PCAOB Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (July 12, 2010).

There are also significant risks associated with audits of operations of U.S. companies in China. For example, we are finding through our oversight of U.S. firms that even simple audit maxims, such as maintaining the auditor's control over bank confirmations, may not hold given the business culture in China.

If Chinese companies want to attract U.S. capital for the long term, and if Chinese auditors want to garner the respect of investors, they need the credibility that comes from being part of a joint inspection process that includes the U.S. and other similarly constituted regulatory regimes. In light of these risks, the PCAOB's inability to inspect the work of registered firms from China is a gaping hole in investor protection.

C. *Enforcement*

The PCAOB has broad authority to impose sanctions on registered firms and their associated persons that have violated applicable laws, rules and standards. The PCAOB is engaged in several investigations relating to audits of financial institutions and other public companies affected by the crisis. These investigations, and any contested disciplinary proceedings that may result, are confidential under the Sarbanes-Oxley Act.

As an example of the scope of the issues the PCAOB is addressing rigorously through enforcement, earlier this week the Board issued a settled order against five PW India firms in connection with the audit of the financial statements of Satyam Computer

Services, an India-based, multi-national IT service provider with securities traded on the New York Stock Exchange. The Board's order included a \$1.5 million penalty against two of those firms for violations of PCAOB rules and standards that contributed to the firms' failure to detect an accounting fraud by Satyam management. The Board also found that all five firms violated the Board's quality control standards. In addition to the penalty, the Board (i) imposed significant limitations on the PW India firms' ability to accept new clients or issue audit reports, (ii) required the appointment of an independent monitor to ensure audit quality improvements, and (iii) censured the firms.

The Board-imposed sanctions are in addition to a \$6 million penalty and other sanctions imposed on the firms by the Commission. The PCAOB closely coordinated its investigation of the PW India firms with the SEC. This coordination will continue, as the independent monitor will report its findings to both the SEC and the PCAOB.

IV. Auditing Standards

The PCAOB's standard-setting program responded to the financial crisis at various stages by reminding auditors how existing standards apply in the context of specific challenges. The PCAOB issued Staff Audit Practice Alerts to explain to auditors how applicable requirements bear on various issues raised by the crisis. For example, in December 2007, the PCAOB staff issued Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, and in December 2008, the PCAOB issued Staff Audit Practice Alert No. 3,

Audit Considerations in the Current Economic Environment (December 5, 2008). These alerts helped auditors to focus on applicable audit requirements. They covered several audit topics relevant to the crisis, including auditing fair value measurements and accounting estimates; auditing the adequacy of disclosures; the auditor's consideration of a company's ability to continue as a going concern; and additional audit considerations for selected financial reporting areas.

In light of the Lehman bankruptcy examiner's report, as well as deficiencies identified by PCAOB inspectors in connection with the auditing of significant unusual transactions, the PCAOB issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (April 7, 2010). This alert focused auditors on the evaluation of significant transactions that may be mechanisms to dress up a company's balance sheet, as opposed to serving a valid business purpose.

In December 2010, the PCAOB issued Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities* (December 20, 2010), to focus auditors on auditing liabilities and related disclosures resulting from issues arising from mortgage and foreclosure-related activities. As we continue to identify or anticipate new audit practice issues or challenges, the PCAOB will continue to issue timely guidance to auditors.

Practice Alerts remind auditors of existing requirements. The Board also uses information that it learns in its inspections and from other sources to change the underlying auditing standards. In developing new standards, the PCAOB casts a wide net to seek input from various interested people and groups on ways to improve audits.

The PCAOB has used insights gleaned from the crisis, including information from outside sources and from our oversight programs, to develop new standards to address risks that became apparent in the crisis, including standards for how auditors assess the risk of material misstatements in financial statements. The PCAOB meets quarterly with the representatives of the SEC and FASB to discuss and facilitate financial reporting and auditing initiatives. The PCAOB also is in the process of exploring potential improvements in standards that would address, among other things, the content of auditors' reports, how auditors evaluate management's estimates of fair values of assets and liabilities, and when an auditor should modify their report because of going concern uncertainties. These projects and others are described below.

A. *Risk Assessment Standards*

In 2010, after two rounds of public comment and several public meetings with our Standing Advisory Group (composed of investors, auditors, financial statement preparers and others), the Board adopted, and the SEC approved, a series of eight new auditing standards, effective for 2011 audits. These standards address fundamental

aspects of the audit, including audit planning and supervision, the auditor's assessment of and response to the risks of material misstatement in the financial statements, and the auditor's evaluation of audit results and audit evidence. The standards require the auditor to consider more thoughtfully, throughout the audit, the risk of misstatement due to fraud. They also require auditors to perform procedures to evaluate the completeness and fairness of financial statement disclosures, which are critical to providing investors a fair understanding of many matters that became particularly important during the financial crisis, such as valuation of complex financial instruments.

B. The Auditor's Report

The auditor's report is the primary means by which the auditor communicates to investors and other users of the financial statements regarding its audits of financial statements. The form of the report has not evolved significantly from the pass-fail model of the early years; however, over the years, several committees and groups, such as the Cohen Commission, Treadway Commission, and the American Assembly, have suggested improvements or changes to the auditor's report. Similarly, in 2008, the Advisory Committee on the Auditing Profession convened by the U.S. Department of the Treasury ("ACAP") recommended the PCAOB consider improvements to the auditor's reporting model and clarify in the auditor's report the auditor's role in detecting

fraud. ACAP noted that the greater complexity in financial reporting supports improving the content of the auditor's report beyond the current pass-fail model.^{7/}

On March 22, 2011, the Board held an open meeting to hear from the PCAOB's Office of the Chief Auditor on the results of the staff's outreach on a project to take a fresh look at the auditor's reporting model. The staff presented views and advice they received over several months from numerous in-depth meetings with dozens of people experienced in using or preparing audit reports, including investors, auditors, preparers, audit committee members, researchers, and others.

Separately, the Board's Investor Advisory Group ("IAG") discussed this issue at its March 16, 2011, meeting. At that meeting, the Board heard a presentation from a task force of the group's members about a survey they conducted to solicit views regarding changes to the auditor's report. The group surveyed institutional investors, including investment banks, mutual funds, pension funds, hedge funds, and others. Both the IAG survey and our staff's outreach underscore that investors believe they need more information from the auditor regarding the auditor's views on audit risk, management's judgments and estimates, and the quality of management's accounting policies.

^{7/} An unqualified opinion indicating that the company's financial statements are presented fairly in accordance with the applicable financial reporting framework is considered the "pass" determination in the pass-fail model.

The Board's outreach effort, especially at such an early stage in the project, was unprecedented. In addition, the PCAOB's open meeting to discuss the input received was the first of its kind. The PCAOB staff is now preparing a written concept release to describe several potential changes for Board consideration and, if agreed, public comment.

C. *Fair Value*

As noted in the Board's 2010 report on observations from audits during the crisis, PCAOB inspectors identified many audit deficiencies relating to auditing fair value estimates. In many cases, the deficiencies related to insufficient evidence gathered by the auditor when using third party pricing sources (e.g., pricing services or broker quotes) when valuing financial instruments such as investment securities. The largest accounting firms are devoting substantial effort to these issues, and we have seen some audit teams do what we expect. We are also hearing that the work that is required to validate pricing service reports is more than management is doing. To give deeper consideration to ways to prevent such deficiencies, the PCAOB has organized an ad hoc task force of our Standing Advisory Group to include investors, auditors, preparers, broker-dealers, and pricing services. Staff of the SEC and FASB will observe this task force. The task force's work is expected to inform the Board's development of new auditing requirements.

D. Going Concern

Under the Board's standards, the auditor should modify the report if there is a significant doubt about a company's ability to continue as a going concern for a reasonable period of time.

Investors and others have raised questions about why more audit opinions expressing substantial going-concern doubt were not issued before companies affected by the financial crisis failed (or would have failed except for government intervention). The FASB has a project on its agenda that is intended to improve the ability of investors to understand the risks and uncertainties about an entity's ability to continue as a going concern and to meet its obligations when they become due. Such improvements in the accounting standards could assist in providing an early warning for investors. The PCAOB is working closely with the FASB and the SEC on this matter. If the PCAOB determines to issue further guidance in this area, it will be closely coordinated with the FASB's efforts. The Board recognizes the importance of this subject to investors.

E. Related Parties and Significant Unusual Transactions

The Board is considering revising its standard on relationships and transactions with related parties, including financial relationships with executive officers and transactions that are outside the normal course of business. As part of that project, the Board is evaluating ways for the auditor to gain a deeper understanding of the risk of

misleading financial statements or disclosures, by considering a company's financial relationships with its executive officers and evaluating how those relationships might affect management's financial reporting incentives. Transactions with related parties and significant unusual transactions can pose significant risks of material misstatement. Their substance might differ materially from their form. They might be structured to achieve desired accounting results inconsistent with the underlying economic substance. And they might include terms not available in third-party, arm's-length transactions.

V. Policy Changes for Congress to Consider

Under the Sarbanes-Oxley Act as it exists today, the PCAOB's disciplinary hearings — our version of trials and appeals — are non-public, unless the Board finds there is good cause for a hearing to be public *and* each party consents to public hearings.⁸ The auditors and audit firms charged with violating applicable laws, rules or standards have little incentive to consent to opening the case against them to public view and in fact, none have ever done so. On the contrary, the fact that, absent consent, PCAOB disciplinary proceedings are required to be secret creates a considerable incentive to litigate. PCAOB disciplinary proceedings remain non-public even after a hearing has been completed and adverse findings made by a disinterested

⁸ Section 105(c)(2) of the Sarbanes-Oxley Act of 2002.

hearing officer, if the auditors and firms do not consent to make the proceedings public and opt to appeal. Litigation postpones — often for several years — the day on which the public learns that the PCAOB has charged the auditor or firm, the nature of those charges, and the content of adverse findings.

This secrecy has a variety of unfortunate consequences. Interested parties, including investors, audit committees, issuers and other auditors, are kept in the dark about alleged misconduct, even after a hearing and adverse findings. Investors are unaware that companies in which they have invested are being audited by accountants who have been charged by the PCAOB. In addition, unlike the authority the Exchange Act provides the Commission in its administrative proceedings, the PCAOB has no authority, while litigation is pending, to issue temporary cease-and-desist orders in appropriate cases, to prevent threatened violations or harm to investors or the public interest.

This state of affairs is not good for investors, for the auditing profession, or for the public at large. It is unlike the disciplinary proceedings of other, comparable regulators. Indeed, decades ago, the SEC found that non-public proceedings in cases against auditors of public companies were not in the best interest of investors and opened their administrative proceedings against auditors to the public. The reasons cited by the Commission for the change included:

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- Virtually all other administrative proceedings brought by the SEC (including those against brokers, dealers, investment advisers, and public companies) and all SEC injunctive actions are public,
- Private proceedings create incentives for delays,
- The public and audit professionals are interested in timely disclosure of the standards used to commence disciplinary proceedings (the public and other auditors have a legitimate interest in learning, on a timely basis, the facts and circumstances that have led to the institution of proceedings), and
- Public proceedings are more favored in the law than closed-door proceedings.

These same reasons support the need for public PCAOB disciplinary proceedings. The Board, however, unlike the SEC, lacks the authority to make its proceedings public through a change to its rules. Investors would be best served by similar transparency in PCAOB disciplinary proceedings.

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In conclusion, I appreciate the Subcommittee's interest in the work of the PCAOB and I look forward to working with you in the future. I would be happy to answer any questions.