The views expressed in this document are solely the views of the Investor Advisory Group members who prepared it and do not necessarily reflect the views of the PCAOB, the members of the Board, or the Board’s staff. The PCAOB makes no representation as to the accuracy or completeness of this information.

During our earlier telephone call we discussed the issues of the governance of audit firms, their transparency, the quality of the global audits, the need to ensure the independence and objectivity of auditors including through auditor rotation and the need for forensic audit steps.

Transparency and Firm Governance

The largest audit firms often referred to as the “Big Four” audit most of the large public companies in the United States. These large firms audit all but one or two of the S&P 500 companies. Grant Thornton and BDO Seidman, are the next two largest firms but have only a small percentage of the revenues, work force and offices of the larger firms. The U.S. Treasury Advisory Committee on the Auditing Profession (ACAP) final report states:

“In 2006, in the United States, the largest four auditing firms audited nearly 98% of total public company market capitalization, 98% of the largest public companies (those companies with over $1 billion in annual revenues), 99% of total public company revenues, and 64% of all public companies. In 2006, they derived 94% of all public company audit and audit-related fees compared to 96% in 2004 and 2002....The four largest firms each generated U.S. revenues in 2007 of over $5.4 billion, with the largest firm generating $9.8 billion. The four largest firms each have over 1,715 partners, 15,200 nonprofessional staff, and 22,000 total staff, with the largest firm having 2,760 partners, 29,700 professional staff, and 41,000 total staff. The next four largest firms each generated U.S. revenues in 2007 of over $480 million, with the largest of the midsize firms generating $1.389 billion. These midsize firms each have over 200 partners, 1,500 nonprofessional staff, and 2,300 total staff, with the largest of the midsize firms having 700 partners, 5,900 nonprofessional staff, and 8,200 total staff.”

The large audit firms are loose global affiliations of audit firms spread throughout the world. They have entered into affiliation agreements, often for marketing purposes. However, in each country, the local firm is a separate and distinct legal entity with separate and distinct management.

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For example, on their website PWC states: “PwC” refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.” Deloitte and Touche on their global website states:

“Deloitte” is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management, and tax services to selected clients. These firms are members of Deloitte Touche Tohmatsu Limited (DTTL), a UK private company limited by guarantee. Each member firm provides services in a particular geographic area and is subject to the laws and professional regulations of the particular country or countries in which it operates. DTTL does not itself provide services to clients. DTTL and each DTTL member firm are separate and distinct legal entities, which cannot obligate each other. DTTL and each DTTL member firm are liable only for their own acts or omissions and not those of each other. Each DTTL member firm is structured differently in accordance with national laws, regulations, customary practice, and other factors, and may secure the provision of professional services in its territory through subsidiaries, affiliates, and/or other entities.”

The transparency of the global networks of the largest auditing firms varies around the globe. The European Union has adopted its Eight Directive, Article 40 Transparency Report. The EU directive requires disclosure in an annual report posted to the website of; legal and network structure and ownership direction; governance description; most recent quality assurance review; public company audit client list; independence practices and confirmation of independence compliance review; continuing education policy; financial information including audit fees, tax advisory fees, consulting fees; and partner remuneration policies. The Article 40 Report also requires a description of the auditing firm’s quality control system and a statement by firm-management on its effectiveness.

In the United Kingdom, they have required the largest firms have audited a financial statement which has been posted to the website.

In the United States, and despite the important role they play as gatekeepers in the capital markets, the auditing firms are not required to prepare an annual report or make publicly available information similar to that which has been available in the EU or UK. The largest audit firms operate as limited partnerships and neither the state boards of accountancy, many of whom have CPA’s on their boards, nor the SEC have ever required transparency of the firms. The U.S. Treasury Advisory Committee on the Auditing Profession (ACAP) did request significant financial information from the US firms as part of its deliberations, but was only provided very limited information, none of a firm specific level. During its deliberations, the ACAP learned that the largest firms do not prepare financial statements in accordance with generally accepted accounting principles (GAAP) and did not provide that information on either an audited or unaudited basis to all their partners.
Section 102 – Registration With The Board of the Sarbanes-Oxley Act of 2002 does give the PCAOB the authority to require audit firms to include in registrations with the Board; “(A) the names of all issuers for which the firm prepared or issued audit reports...; (B) the annual fees received by the firm from each such issuer for audit services, other accounting services, and non-audit services...; (C) such other financial information for the most recently completed fiscal year of the firm as the Board may reasonable request; (D) a statement of the quality control policies of the firm for its accounting and auditing practices;...and (H) such other information as the rules of the Board or Commission shall specify as necessary or appropriate in the public interest or for the protection of investors.”

The ACAP urged the PCAOB to begin requiring in 2010, the larger auditing firms to produce an annual report including (a) information required by the EU Eight Directive and (b) and key indicators of audit quality and effectiveness as determined by the PCAOB. It also recommended that beginning in 2011, the largest audit firms be required to file annual audited financial statements with the PCAOB on a confidential basis. However, a number of members of the ACAP committee including its co-chairs, Arthur Levitt and Donald Nicoliasen urged the financial statements should be made publicly “...available, including to audit committees and the investing public.”

It was noted during our telephone call that it is difficult at best for members of audit committees to obtain information regarding the global networks of firms and how they manage their audits and audit quality. The firms do not publish any key indicators of audit quality that investors could use to compare the quality of the work of one firm with another. In addition, while public companies have to file their annual reports and certify as to the accuracy and completeness of their disclosures, there is no such requirement for the auditing firms.

The ACAP receive a comment from a retired Big Four firm audit partner who recommended key factors with respect to audit quality should include the following:

<table>
<thead>
<tr>
<th>Key Ingredient</th>
<th>Relevant Audit Quality Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experience and Knowledge</td>
<td>1. Years of experience</td>
</tr>
<tr>
<td></td>
<td>2. The rate of turnover</td>
</tr>
<tr>
<td></td>
<td>3. The amount of training per professional</td>
</tr>
<tr>
<td>Time to Do the Job Right</td>
<td>4. Chargeable hours managed per partner,</td>
</tr>
<tr>
<td>(And in a Timely Manner)</td>
<td>5. Chargeable hours per partner</td>
</tr>
<tr>
<td></td>
<td>6. Chargeable hours per professional</td>
</tr>
<tr>
<td>Adequate Supervision</td>
<td>7. The ratio of staff to partners</td>
</tr>
</tbody>
</table>

The PCAOB also oversees the firms that audit public companies. It is generally believed these firms operate with thin levels of capital due to the fact they distribute most of their earnings each year in
order for the partners to pay their taxes on the earnings. This also allows a transfer of assets to the individual partners and out of reach for the most part, of any shareholders who litigate against them.

The PCAOB (and SEC) do not currently receive the financial information the ACAP recommended the PCAOB receive. As such, it was discussed that it would be difficult for the PCAOB as the regulator, to understand and monitor the financial stability of the audit firms. It was also discussed that in light of the recent financial crisis, and increased focus on systemic risk, that the PCAOB would perhaps be viewed as negligent in its duties if it did not get financial information on the audit firms, and use it in monitoring the firms, including their ability to make the necessary investments in their people and resources necessary for a quality audit.

During the ACAP deliberations, some audit firms did not support publication of annual financial statements. And certainly since the publication of the ACAP report, none of the large audit firms have published financial statements or a comprehensive annual report. The firms noted they were private entities and expressed concern that the information would be used against them in litigation cases. However, investors noted the audit function is a regulated, public interest and franchise granted to the firms by the government. It was also noted that during litigation, the courts may require the financial statements to be produced anyway, as was a case in recent years in a high profile case in Florida.

It was noted during the discussion that the governance of the firms could also be improved if, as the ACAP recommended, the firms were to appoint outside directors. It was not discussed as to whether this would/should be done through independent advisory boards, or on the actual boards of the partnerships. During the Senate Banking Committee’s public hearings, former SEC Chairman Richard Breeden, who currently manages a private equity fund, and who has previously been a partner in what is now PricewaterhouseCoopers, testified as follows:

> “Require Audit Firms to have boards of directors with a majority of outside directors.

Getting to the heart of these problems involves shifting the balance of priorities inside the auditing firms in the direction of greater concern for getting the numbers right, and for creating healthy governance structures that will open up the highly insular big firms.

One way of shifting internal dynamics in favor of the public trust would be to require that, as a condition of satisfying the "independence" requirements, an auditing firm for a public company must have a board of directors with full

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2 Deloitte and Touche publishes an annual report, Deloitte 2010 Annual Review, Reaching New Heights, As One. However this report only includes very selected financial results and does not include financial statements. See: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Other%20Assets/AR2010/dttl_2010_annual_review_051010.pdf

power to remove management, to determine compensation, and to set overall policy. At least a majority of the members of such a board should be from outside the firm. As with stock exchanges, there should be a minimum number of "non-industry" directors on each board representing the interests of shareholders and users of the markets. Officers of audit clients should not be eligible to sit on such boards.

For historic, licensing and other reasons, the Big Five operate as limited liability partnerships rather than as corporations. They are by far the largest private business organizations that do not have a real board of directors. Internal governance comes from various committees drawn from within the firm, whose members are elected or chosen by the partners or the CEO. They are generally subordinate to the CEO, not independent of him or her. While it is an axiom of good corporate governance to have a majority (and typically much more than a majority) of independent directors who can among other things hold the CEO accountable for performance of the firm, the large accounting firms may not have ANY independent directors to provide a wider public perspective or to have the power to remove the CEO.

A board composed of independent directors (with similar standards for independence as a corporate director is required to have) would go a long way to bringing a more balanced approach to how these firms manage conflicts between their legitimate profit interests and their public responsibilities. Ultimately the CEO of any Big Five firm should be subject to getting replaced if the board does not have confidence in the firm’s ability to deliver on its professionalism. There should be accountability for performance in audit quality, not just profit per partner, and that accountability at the top would be better exercised by a board of directors rather than the government. When Andersen was agonizing over its doubts regarding Enron’s potential accounting fraud in February of 2001, discussing the issues with a board including outside independent directors could certainly have given management a better perspective on the decision they had to make and its potential impact on investors, retirees, and others.”

It was highlighted during our discussions how the inspection reports the PCAOB issues, as a result of the examination of the audits conducted by the firms, were beneficial, but could be improved if the entire report was made public. Recently, PCAOB Acting Chairman Daniel Goelzer sent a letter to congress urging congress to give the PCAOB the ability to make its enforcement actions public, just as the SEC does with its Rule 102(e) enforcement actions against professionals. On August 24, Acting Chairman Dan
Goelzer asked Congress to amend the Sarbanes-Oxley Act, so that PCAOB disciplinary proceedings will be public. Right now, the PCAOB is virtually unique among similar regulators in that its disciplinary proceedings are required by law to be kept confidential through charging, hearings, initial decision, and even appeal.

A case that recently became public only after the completion of SEC review of the Board's decision provides a good example. In Gately & Associates, the firm issued 29 additional audit reports on public company financial statements between the commencement of the Board's proceeding and the public disclosure of the Board's charges, which did not occur until the SEC affirmed the Board's decision to expel the Gately firm from public company auditing. That information, had it been available, may or may not have made a difference to company being audited and investor decisions regarding the firm or the companies it audits. But the public should have had the opportunity to see the charges and make their own decision.

**Independence of Audit Firms**

It was noted during our discussions, that there is concern regarding the level of independence of the audit firms from the companies that they audit and who pay them. It appears the audit firms are once again expanding into consulting services such as risk management and governance. Some of the audit firms have also announced acquisitions of consulting firms.\(^4\)

It was expressed that key to concern over independence was the level of “coziness” the firm had with the management of the company being audited. Many of the auditors of the large companies involved in the financial crisis, such as Lehman Brothers, AIG, Citigroup and Merrill Lynch had long running audit relationships with those companies. A 2003 study of rotation of audit firms by the Government Accountability Office (GAO) found the following tenure of audit firms at that time, approximately a year after the demise of Arthur Andersen which resulted in many changes of auditors.

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\(^4\) For example, in their 2010 Annual Report, Deloitte and Touche disclose that of their $26.6 billion in revenues, $7.5 billion was from consulting revenues up from $4.5 billion in 2006. It was also their fastest growing segment in 2010 with a growth rate of 14.9%.
A Glass Lewis study of auditor changes during the four year period from 2003 to 2006 found the following:³

<table>
<thead>
<tr>
<th>4-year Auditor-Turnover Scorecard</th>
<th>Post Andersen³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies changing auditors</td>
<td>6,543</td>
</tr>
<tr>
<td>% of public companies</td>
<td>51.9%</td>
</tr>
<tr>
<td>Total auditor changes</td>
<td>7,629</td>
</tr>
<tr>
<td>Auditor-turnover rate</td>
<td>60.6%</td>
</tr>
</tbody>
</table>

³ Arthur Andersen LLP surrendered or licenses to practice public accounting on Aug. 31, 2002. Scorecard includes 2,304 changes from Andersen, plus 2003-2006 auditor changes.

The Glass Lewis study found that despite the GAO survey results, financial management of thousands of public companies did decide to make the change in auditors.

It is also worth noting that the auditors of public companies such as Enron, HealthSouth, Adelphia, Xerox, Tyco and many more, had been the auditor for many years. Yet despite that entire knowledge one would have expected the personnel on the audit to have gained from a long term relationship, did not result in some of the largest errors and frauds in financial statements being detected. These were all frauds that resulted in the financial statements being corrected and restated for errors aggregating billions of dollars. It begs the question; if an independent auditor cannot find errors in the billions of dollars, what is the value of an audit?

Support for mandatory rotation of the auditors was discussed by the subcommittee. The subcommittee did support such a policy. It was noted that management of companies often cite costs for changing as a basis not to adopt such a policy. This is consistent with findings of the GAO study which included a survey of financial management. However, members of the subcommittee found the cost issue to be a “red herring.” The Glass Lewis report supports the view the cost issue is a red herring as it identifies that thousands of companies have changed their auditor in the past decade. In addition, the purpose of the audit is provide investors (and audit committee members) confidence that an independent set of eyes have looked at the numbers reported by management and objectively without bias determined they can indeed be relied upon. If investors’ confidence in that process is diminished or lost, the benefits of the audit (and its costs) are questioned.

Members of the subcommittee also noted that with only a handful of large firms capable of serving multinational conglomerates, it would be important to consider an appropriate transition to ensure a knowledgeable replacement auditor was available for rotation. However, this is viewed as a manageable issue.

**Global Audit Quality**

The business of public companies has become significantly more global in the past three decades. Countries such as China, India and Brazil are very attractive expansion opportunities for global businesses. China now has surpassed Japan as the second largest economy in the world and expected within the next decade to surpass the U.S. as the largest. The growth of GDP in Brazil and India and other emerging countries has been higher than that in the U.S. and Europe, resulting in companies expanding to these countries including the building of new plants and establishment of research centers.

It is not unusual now that U.S. companies derive a majority of their revenues from operations outside the U.S. For example, IBM, General Electric and Coca Cola all derive a majority of their revenues from outside the United States. IBM and GE also have a majority of their investment in plants located outside the United States and Coca Cola has very significant investments in non U.S plants.

SOX Section 106 – Foreign Public Accounting Firms states:

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“(a)(1) IN GENERAL – Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States...

(b)(1) CONSENT BY FOREIGN FIRMS – If a foreign public accounting firm issues an opinion or otherwise performs material services upon which a registered public accounting firm relies in issuing all or part of any audit report or any opinion contained in an audit report, that foreign public accounting firm shall be deemed to have consented- (A) to produce is audit work papers for the board or the commission in connection with any investigation by either body…”

The subcommittee members noted it was difficult to obtain information regarding the quality of audit work performed by affiliates of U.S. firms. As noted above, this may include audit work performed with respect to the majority of revenues and plant.

Unfortunately, the large audit firms still rely on “credentialing” when it comes to the audit work performed by their international affiliates. That is, they rely on the work of the foreign affiliate provided the partner and firm have acceptable credentials. While they may visit foreign locations on a periodic basis, rotating which locations are visited from year to year, the lead partner does not typically supervised that work in the same manner as the work in the home country is supervised.

For example, the PCAOB December 23, 2010 inspection report on Grant Thornton in Dubai notes they were not the principal auditor but did perform work on which the principal auditor was relying. However, the PCAOB inspection team found “… what it considered to be audit deficiencies. The deficiencies included a deficiency of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to fulfill the objectives of its role in the audit. That deficiency was the failure to perform adequate audit procedures with respect to revenue.” In another example, involving the inspection of PJSC Deloitte & Touche Ukrainian Services Company, dated December 23, 2010, the “…inspection team identified what it considered to be audit deficiencies. The deficiencies identified included a deficiency of such significance that it appeared to the inspection team that in one of the audits the Firm did not obtain sufficient competent evidential matter to fulfill the objectives of its role in the audit. That deficiency was the failure to report to the principal auditor waived audit adjustments that exceeded the threshold specified in the principal auditors' instructions.”

In addition, recent articles have cited concerns over audits performed of Chinese companies by US companies, including where a material portion of the work was performed by Chinese auditors.  

The PCAOB has publicly noted that it has been unable to reach agreements with its foreign counterparts to perform joint inspections. In part that was because SOX limited the ability of the PCAOB to share information with those regulators. However, the passage of Dodd/Frank in 2010 has now resulted in the PCAOB to share this information. This has recently allowed the PCAOB to make progress in negotiating

new agreements with countries such as England. However, countries such as China, France, and Germany have steadfastly refused to cooperate with the PCAOB and prohibited it from performing inspections of audit work performed in those countries, with respect to U.S. listed companies. As a result, staff of the PCAOB has noted that they are considering whether or not the report of auditors should be modified, to provide information as to the amount of the assets, revenues, and/or cash flows that have been audited by an audit firm that has not been inspected by the PCAOB.

After enactment of the Dodd-Frank Act, the European Commission, and later the European Parliament, approved a three-year adequacy determination as to the PCAOB. That determination permits individual member states to enter into bilateral inspections arrangements with the Board, subject to certain conditions. The PCAOB is in various stages of negotiations with several EU audit regulators, but no agreements have yet been reached. It appears the adequacy determination was more the end of the beginning, rather than the beginning of the end, in terms of re-opening the door to European inspections. The PCAOB is still working through issues on such matters as joint inspection procedures and data protection. Some of the EU counter-parts would prefer that the PCAOB rely on their inspections and not conduct their own, joint or otherwise, of firms that operate in their country, notwithstanding that those firms have active U.S. SEC practices.

Forensic Audit Procedures

There has been much discussion in the auditing profession regarding the extent to which a typical annual audit of a company should incorporate forensic auditing procedures. A study by the Association of Certified Fraud Examiners found that companies may be losing up to 5% of their revenues to fraud. That study also found that independent audits fail fairly poorly when it comes to detecting fraud. It states:8

“Organizations tend to over-rely on audits. External audits were the control mechanism most widely used by the victims in our survey, but they ranked comparatively poorly in both detecting fraud and limiting losses due to fraud. Audits are clearly important and can have a strong preventative effect on fraudulent behavior, but they should not be relied upon exclusively for fraud detection.”

The report went on to highlight that external audits only detected 4.6% of frauds as illustrated in the following chart.

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8 Report To The Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners. 2010.
In September, 1998, as a result of growing concern about the failure of audits to detect frauds and erroneous financial reporting, the Chairman of the SEC requested that a panel be established to study the effectiveness of audits. The Panel on Audit Effectiveness, after many public hearings and comments as well as in-depth study, issued its recommendations in August 2000. The Panel did find and recommend a “Forensic-type Fieldwork Phase.” It stated:

“Introduction of a “forensic-type fieldwork phase.” Not unlike the traditional planning, interim, final and review phases of audits, this new forensic-type phase should become an integral part of the audit, with careful thought given to how and when it is to be carried out. A forensic-type fieldwork phase does not mean converting a GAAS audit to a “fraud audit.” Rather, the characterization of this phase of a GAAS audit as a forensic-type phase seeks to convey an attitudinal shift in the auditor’s degree of skepticism. Furthermore, use of the word phase does not mean that the work cannot be integrated throughout the audit.

During this phase, auditors should modify the otherwise neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, override of internal control and falsification of documents. The key question that auditors should ask is “Where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it?”

Auditing standards should require in this phase:

- Performance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal control by management (recognizing that management includes many levels of personnel in an entity, including personnel outside of the United States, and not just top corporate-level management.”

[Footnotes omitted]

The Association of Certified Fraud Examiners has documented how tips are the number one way of detecting fraud. Yet today’s auditing standards do not even require the auditor to gain and understanding of how a company’s whistle blower system works.

Shortly after the corporate scandals involving companies such as Enron, Adelphia, HealthSouth, Tyco and Xerox, the larger audit firms often assigned staff from their forensic accounting practices to assist and provide valuable assistance on audits. These were often forensic experts with very useful experience in identifying fraud and fraud risks. However, in recent years, this practice has for the most part, been discontinued.

**RECOMMENDATIONS**

**Transparency and Firm Governance**

To improve the transparency of the largest audit firms, and to ensure the PCAOB can proactively oversee the firms, including financial difficulties they might encounter, we recommend:

(1) The firms produce an annual report filed with the PCAOB that is made public and certified to y the executives of the firm. As recommended by the ACAP, it should include:

   a. legal and network structure and ownership direction;
   b. governance description;
   c. most recent quality assurance review;
   d. public company audit client list and number of years as auditor for each;
   e. independence practices and confirmation of independence compliance review;
   f. continuing education policy;
   g. financial information including audit fees, tax advisory fees, consulting fees;
   h. partner remuneration policies;
   i. a description of the auditing firm’s quality control system both in the U.S. and globally and a statement by firm-management on its effectiveness;
   j. Key quality control factors established by the PCAOB.

(2) We also believe the report should include the annual financial statements of the audit firm prepared in accordance with GAAP.

We support the PCAOB requiring the governing boards of the firms, either on the board itself or on an advisory board, appoint no less than 3 independent members. These independent members should include in the annual report of the firm, a report on their activities for the year.

We urge the new chairman of the PCAOB, as well as the entire board, to continue to ask congress to pass legislation make its disciplinary proceedings public.

**Independence of Audit Firms**

We believe the PCAOB should undertake a project to establish periodic mandatory rotation of the auditor, for example every ten years. During that time period, to strengthen auditor independence and
avoid any “opinion shopping”, we would recommend that any rules adopted permit the auditor to be removed only for cause, as defined by the PCAOB.

We believe that any costs of mandatory rotation will be outweighed by the benefits that are likely to be achieved, including increased confidence in financial reports, if not outright improvement in the accuracy and completeness of these reports.

**Global Audit Quality**

We recommend inclusion in the annual report of the audit firm, of its key quality control factors, global quality control processes, and how it is structured and operate should contribute to the transparency and quality of global audits.

We recommend the PCAOB, as it updates its standards, undertake to study and strengthen the supervision by the lead responsible partner, of the foreign audit work performed. We do not believe mere acceptance of the foreign auditors “credentials” is sufficient to ensure high quality audits are performed, and the interests of investors are adequately protected.

We believe the auditor’s report should be modified to state the amount or percentages of assets and revenues that have been audited by any auditor, who has refused to be inspected by the PCAOB. We support the PCAOB’s efforts to negotiate joint inspection agreements with foreign regulators. However, we do not believe mere reliance on those regulators inspections, without first determining and monitoring their quality, is an acceptable protection for investors.

**Forensic Audit Procedures**

Consistent with the recommendations of the Panel on Audit Effectiveness, we recommend the PCAOB revise its standards to require forensic auditing procedures and include greater guidance on the forensic audit procedures that should be performed. This should include requiring auditors to understand the whistle blower programs and their independence and effectiveness.