TESTIMONY OF

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

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PCAOB
Public Company Accounting Oversight Board

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am pleased to appear today before the House Financial Services Capital Markets Subcommittee to testify on accuracy, transparency, and complexity in financial reporting. As Acting Chairman of the Public Company Accounting Oversight Board, I will address the auditor's role and experience in evaluating public companies' application of accounting and financial disclosure standards and rules. I will also discuss PCAOB's experience in establishing and monitoring the implementation of auditing and related professional practice standards.

The Sarbanes-Oxley Act of 2002 (the "Act") directed PCAOB to establish a continuous program of auditor oversight in order to achieve the Act's stated goal of protecting the public interest "in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[1] Among the responsibilities the Act assigned to PCAOB is the responsibility for establishing auditing and related professional practice standards for auditors of public companies. In addition, PCAOB is responsible for evaluating auditor application of those standards to promote high quality audits -- audits that focus on preventing the kinds of financial reporting failures that we saw in companies ranging from Adelphia to ZZZZ Best. In performing standard-setting and other tasks, we are overseen by the Securities and Exchange Commission, whose Acting Chief Accountant, Scott Taub, I am pleased to join here before you today.

Accuracy, Transparency, and Complexity in Financial Reporting

In addition to the role of the independent auditor, the accuracy, transparency, and complexity of public company financial statements are affected by a number of factors. These include the nature of the public company's business, its controls over the preparation of financial statements, applicable accounting standards and disclosure requirements, and the quality and integrity of its management.

The Financial Accounting Standards Board and the SEC are responsible for the establishment and oversight of the application of accounting standards and disclosure rules governing the preparation and presentation of public company financial statements. And, of course, corporate management is responsible for preparing and presenting those statements. The manner in which independent audits are conducted affects both the actual and perceived reliability and relevancy of a public company's financial statements. When an auditor concludes that financial statements do <u>not</u> fairly portray a company's financial

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1 Sarbanes-Oxley Act, Section 101(a).

results in conformity with applicable accounting standards, the auditor has several options: He or she may request changes to the financial statement amounts or disclosures, may modify his or her opinion on those financial statements to indicate the nature of misstatements or omissions and the extent to which the financial statements depart from a fair presentation, or the auditor may withdraw from the audit engagement without expressing an opinion.

Auditors thus play an integral role in evaluating public companies' application of accounting standards and disclosure rules and are therefore in a key position to influence, and hopefully increase, public confidence in the accuracy and reliability of the resulting financial statements.

In recent years, there has been a great deal of discussion about whether principles-based accounting standards more effectively result in understandable financial statements that better reflect the underlying financial picture of a company than do more prescriptive and more technical "rules-based" accounting standards.

The terms "principles-based" and "rules-based" typically are used to refer to the two ends of a spectrum of specificity. On one end of that spectrum are principles-based standards that contain comparatively fewer details and prescriptions and, on the other end are rules-based standards that are highly prescriptive in their requirements, and leave fewer decisions to professional judgment. Principles-based standards necessarily leave, at least in the first instance, the determination of whether the principles in the standards are fairly implemented to the judgment of public companies and their external auditors. But here's the rub – in order for a system of general principles to work, the judgment used to apply those principles cannot be based on whatever the company and its auditor *say* is fair, but rather on what informed financial statement users would *believe* is fair.

I firmly believe that a system of rules without principles is unworkable, though I expect the debate over the right balance between the two will never go away. That debate is not only healthy and timely, it is at the heart of the issue before us – complexity, transparency, and accuracy. Let me explain.

Principles-based standards have the seductive appeal of allowing more flexibility and professional judgment in dealing with different situations but, precisely because of that characteristic, they are likely to lead to increased variability in results, even when applied by conscientious corporate managers and checked by competent independent auditors. As a matter of fact, it was this debate over the variability of acceptable accounting outcomes for similar fact situations that led to the formation of the Financial Accounting Standards Board.

Public company managers have a natural desire to be successful and to be perceived as successful by the investing public. This can result in significant tension, especially when applying broad principles in preparing financial statements. That tension is greater when the company's results fail to match up to manager or investor expectations. Public companies often see a conflict between short-term incentives and long-term objectives. On the one hand, management may face a short-term incentive to present the company's results in a misleading fashion that might be rationalized as permitted by applicable accounting principles. On the other hand, the company faces the long-term objective to maintain investors' confidence by ensuring that the company's results are accurate, reliable, understandable, and useful to investors.

Some company managers have been known to challenge their auditors to "show me where the accounting standards say I can't do this." Many accounting standards were created, or modified, in order to provide a definitive answer to that question. (Many of you will recognize this as a process not dissimilar to that which gave us a substantial portion of our tax code.) When auditors succumb to the pressure of managers' desire to present an unduly rosy picture, it can lead to financial statements that fail to clearly present the company's results – much less being capable of comparison to other investment opportunities – by using complexity and non-disclosure to obscure, rather than transparency to reveal the true results. The Act's reforms, especially those related to the SEC's reviews of corporate disclosures and PCAOB's inspections of audits, go directly to reducing the incidence of this result and, with continual oversight, may permit more reliance on principles-based standards going forward. To date, however, this tension has significantly limited the benefits of principles-based accounting standards.

Another impediment to more reliance on principles-based standards is the relentless pressure put on standards-setters to make exceptions to the principles, usually to suit parochial interests of particular industries or groups of companies, or auditors seeking a safe harbor from liability exposure. The more exceptions standards-setters grant, of course, the more rules-based standards inevitably become. Rules-oriented standards *themselves* may promote complexity by encouraging companies and their financial service providers to engineer transactions that exploit existing rules to achieve particular financial statement results such as removing debt from a balance sheet. New rules may then be required to prevent abuses of these loopholes in existing standards. It can become a vicious circle.

Complexity in Auditing

Although the debate over complexity in financial reporting has largely focused on transparency of financial statement presentations, many have argued that the auditors' approach to their own work should be simplified. Indeed, as the standards-setter for audits of public companies, PCAOB has received many requests for specificity and for exceptions. The Board is mindful of the risk that acceding to these requests could result in auditing standards that are overly prescriptive rather than providing a framework that serves as the foundation for the exercise of professional judgment. In my view, overly prescriptive auditing can weaken audit quality if it encourages auditors to focus on technical compliance rather than professional judgment.

For these reasons, I believe auditing standards have been and remain relatively principles-based. Fundamentally, auditors must gather sufficient evidence to provide a proper basis for an opinion that states that:

> *In our opinion*, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.[2]

Accordingly, auditing standards require that auditors exercise professional judgment at all stages of an audit – from planning to actually performing an audit. Merely completing a checklist of all required procedures does not give the auditor the basis on which to form an opinion because judgment is essential to the auditor's formation of this opinion.

Auditing Internal Controls over Financial Reporting

PCAOB's best known standard – Auditing Standard No. 2, which establishes the framework for an integrated audit of internal control over financial reporting in conjunction with an audit of the financial statements themselves – is an example of a principles-based standard. That is, although Auditing Standard No. 2 is lengthy, a closer look at the standard exposes its true principles-based nature. Importantly, the text of the standard establishes a conceptual framework that relies heavily on auditor judgment for implementation. For example, the standard requires an auditor to exercise substantial judgment in identifying significant accounts, determining materiality, assessing the risk of misstatement, and evaluating the significance of identified deficiencies.

We have all heard anecdotes about the challenges public companies faced in the first year of implementing the internal control requirements of the Act and the SEC's rules. Among those challenges have been the difficulties auditors themselves faced in exercising their judgment on how best to implement Auditing Standard No. 2. PCAOB has attempted to mitigate those difficulties and to encourage thoughtful use of judgment in two ways: offering implementation guidance and monitoring the implementation of PCAOB auditing standards.

Implementation Guidance

First, to facilitate a smooth implementation of PCAOB auditing standards, the Board and its staff have periodically issued implementation guidance, giving careful attention to avoid detailed, rules-based or exceptions-laden approaches.

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[2] See AU § 508.08 (emphasis added).

For example, soon after the Board adopted Auditing Standard No. 2 on March 9, 2004, and it was approved by the SEC as required by the Act, on June 17, 2004,[3] the Board's staff issued a series of questions and answers over the course of several months to assist auditors in the implementation of Auditing Standard No. 2. These Q&As stemmed directly from early questions from auditors and their audit clients.

In addition, on May 16, 2005, the Board issued a policy statement regarding the implementation of the standard, accompanied by additional staff Q&As.[4] Both documents addressed how auditors can make the internal control audit more effective and efficient, and they provided specific guidance on integrating the audits, using a top-down approach, using the work of others, assessing risk, as well as other topics. Finally, on November 30, 2005, the Board issued a Report on the Initial Implementation of Auditing Standard No. 2, in which the Board clarified certain questions about the definitions of terms used in the standard, as well as ways to make the integration of the audits of internal control and the financial statements more efficient.[5]

The Board continues to monitor implementation of Auditing Standard No. 2 in order to help auditors make their internal control audits as effective and efficient as possible. In that regard, we have recently announced that, together with the SEC, the Board will host a day-long roundtable discussion among corporate managers, auditors, investors, and others about the second-year implementation of our internal control standard. We want to know where it is working and where it is not. Only in this way can PCAOB help auditors and companies share best practices.

Monitoring Implementation of PCAOB Auditing Standards

This leads me to the second method by which the Board influences the application of its auditing standards. Through its inspections program, PCAOB has the opportunity and mandate to see how auditors are implementing auditing

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[3] See SEC Release No. 34-49884 (June 17, 2004), Order Approving Proposed Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2").

[4] See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (May 16, 2005) (available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx).

[5] See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2 (Nov. 30, 2005) (available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf).

standards. Our inspections and standards-setting functions are in a continual feedback loop, so to speak. In my view, Congress showed great wisdom in structuring the Board in this fashion. This structure gives us the opportunity to explore both more broadly and in more depth what we hear anecdotally.

Let me share with you an example of using our inspections process to ensure the effective implementation of our auditing standards. Specifically, in its May 16, 2005 Policy Statement, the Board indicated its intention to use its 2005 inspections to evaluate how efficiently and effectively firms conducted the first round of audits under Auditing Standard No. 2.[6] During the summer and fall of 2005, the Board deployed a team of specially-trained inspectors to review the largest accounting firms' internal control audit methodologies, as well as components of selected internal control audits performed under Auditing Standard No. 2.

In order to allow audit firms to react as quickly as possible, PCAOB inspectors conveyed their feedback on the internal control audit methodologies and conduct of audits to the leaderships of the firms on a real-time basis. Importantly, the PCAOB inspectors' focus was not on technical compliance, but rather on making sure auditors adequately assessed and addressed the areas of greatest risk of material weaknesses in internal control. By acting in such ways, the Board hopes to preserve the principles-based approach in this and other standards and to foster sound judgment in auditing rather than an unthinking focus on technical compliance.

Additional Avenues to Promote Audit Quality

In addition to standard-setting, guidance, and inspections, we have additional avenues, including enforcement, to promote audit quality. The Board is committed to educating and seeking input not just from auditors, but also from preparers, investors, regulators, academics, and other users of financial statements, on how to improve audit quality and thereby improve the accuracy, reliability, and transparency of financial statements. Whether through speeches, our forums on Auditing in the Small Business Environment, or reports summarizing various inspection findings, PCAOB seeks to promote high audit quality by making the most of its communication opportunities.

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Mr. Chairman, I have described how the desire for specificity and exceptions from application of standards can foster unnecessary complexity, and reduced comparability and transparency, in financial reporting. I have also described the efforts of PCAOB to encourage a principles-based approach to auditing, and specifically to the auditing of internal control over financial reporting.

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[6] See PCAOB Release No. 2005-009, supra n. 5, at 13-14.

The debate over accuracy, transparency, and complexity in financial reporting has enhanced public companies', auditors', investors', and regulators' awareness of the challenges our financial reporting system faces. In my view, this is the beginning of a collaborative effort to find solutions to these challenges, including the right balance between principles-based and rules-based standards. I very much look forward to the continuing dialogue.

Thank you for the opportunity to address these important issues. I welcome any questions you may have.