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

at a Hearing on

Accounting and Auditing Oversight: Pending Proposals and Emerging
Issues Confronting Regulators, Standard Setters and the Economy

Before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets
and Government Sponsored Enterprises

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

Chairman Garrett, Ranking Member Waters, 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 work of the PCAOB.

I appreciate the Subcommittee’s continued interest in high quality audits for public companies and SEC-registered broker-dealers. Further, on behalf of the PCAOB, I commend the Committee’s members, Representative Westmoreland and Ranking Member Frank, for bringing forward bipartisan legislation, H.R. 3503, to bring transparency to the PCAOB’s disciplinary proceedings. Transparency would enhance the PCAOB’s effectiveness – as well as public confidence in the PCAOB’s oversight and in the auditing profession’s credibility as a relevant participant in the capital markets – by permitting the Board to disclose its disciplinary proceedings, and I encourage the Congress to pass it.

I. Introduction

Public securities markets provide a reliable funding mechanism for American – and, increasingly, foreign – businesses. More than half of American households invest their savings in securities to provide for retirement, education, and other goals. Our economy is resilient, even in the face of the recent financial crisis, in part because millions of savers continue to be willing to invest in business enterprises to fuel growth, growth that results in more workers, more savings and more investment. This cycle promotes economic wealth, but it relies on the system of accurate financial disclosures by public companies to the investors who entrust capital to them.

As Chairman of the PCAOB, I believe that the PCAOB, and the accounting firms that we oversee, play a critical role in enabling markets to provide investors with reliable information upon which to make their own investment decisions. The financial audit is the linchpin for investor confidence in that information, and a reliable audit is one led by an auditor that is independent, objective, and skeptical, and applies the diligence needed to meet PCAOB standards.

If investors lose confidence in financial reporting, they will 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 job losses.

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.

The PCAOB is a non-profit, independent institution designed to bring expertise and a variety of perspectives to the task of setting appropriate standards and overseeing the practice of auditing public companies and SEC-registered broker-dealers. This independence is critical for the Board to fulfill its Congressionally mandated mission of protecting the interests of investors. By law, all of the PCAOB's responsibilities are discharged under the oversight of the U.S. Securities and Exchange Commission ("SEC"). Chairman Mary Schapiro, the Commissioners, and Chief Accountant Jim Kroeker have taken a deep interest in the PCAOB's work, and I am grateful for their support and for the strong working relationship they have fostered between our organizations.

II. Current PCAOB Activities and Priorities

A. Inspections

The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") requires the PCAOB to conduct a continuing program of inspections of registered accounting firms. There are currently 2,398 accounting firms registered with the Board. The Board's statutory inspection authority relates to audits of issuers, brokers, and dealers. The Board does not inspect firms that perform no such work, although many such firms have chosen to register.

During an inspection, the PCAOB assesses the firm's compliance with applicable laws, rules and professional standards. As part of an inspection, PCAOB inspectors evaluate the design and effectiveness of a firm's quality control system as well as the quality of the firm's work in the portions of audits selected for inspection.

Registered firms that issue audit reports for more than 100 issuers are required to be inspected by the PCAOB annually. In 2011, the PCAOB inspected 10 such firms. As part of these inspections, PCAOB inspectors examined portions of more than 340 audits performed by these firms.

Registered firms that issue audit reports for 100 or fewer issuers are, in general, inspected at least once every three years. At any time, the PCAOB may also inspect any other registered firm that plays a role in the audit of an issuer, and the PCAOB has a practice of inspecting some firms in that category each year. The PCAOB inspected

203 firms in these categories in 2011, including 42 non-U.S. firms located in 15 jurisdictions. In the course of those inspections, PCAOB staff examined portions of more than 485 audits.

1. Inspections of Public Company Audits.

PCAOB inspections of public company audits are handled in one of two programs. First, we have a global network firm program. Second, we have a program covering the other registered firms located in the U.S. as well as non-U.S. firms not covered in the global network firm program.

Our global network firm program covers inspections of the largest U.S. firms and approximately 190 of their foreign affiliates, which participate in the audits of issuers that file financial statements with the SEC.

Each registered firm in a global network of firms is a separate legal entity that is subject to the same frequency of inspections as any other registered firm. Substantial portions of the audits of many of the largest U.S. companies are performed by affiliated network firms, including firms we cannot inspect due to resistance by local authorities.

The selection of issuer audits for review is influenced by a number of factors. The selection can be based on the risk that an issuer's financial statements could be materially misstated; characteristics of the particular issuer or its industry; the audit issues likely to be encountered; considerations about the firm, a particular practice office or an individual partner; prior inspection results; or other factors.

The PCAOB prepares a report on each inspection and makes portions of that report publicly available, subject to statutory restrictions on public disclosure. The Board issued 344 inspection reports in 2011.

If an inspection report includes criticisms of or identifies potential defects in a firm's system of quality control, those criticisms are initially kept nonpublic, as required by the Act. The firm has 12 months from the issuance of the inspection report to address the criticisms to the Board's satisfaction. If it does so, the criticisms remain nonpublic. If it does not do so, then, subject to the firm's right to seek SEC review of the Board's determination, the Board publicly discloses those criticisms.

As a matter of law, the full reports on inspections are nonpublic although certain parts of the reports are public. Inspectors have identified a concerning number of deficiencies in successive inspection cycles for the largest firms, and at times on those firms' largest engagements. While our 2011 inspection cycle is not yet complete, our inspectors' preliminary results show that the number of deficiencies identified continues to be high relative to earlier years.

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The PCAOB's second inspection program focuses on the smaller registered firms (i.e., firms that audit 100 or fewer issuers) that are not members of a network covered in our global program. Currently approximately 600 such domestic firms and 75 non-affiliated, foreign firms are subject to triennial inspection.

In 2010, the PCAOB established an Office of Outreach and Small Business Liaison, to focus on outreach to auditors of the small business community. This office serves as a point of contact for anyone with questions about the PCAOB's activities. It also assists in identifying areas where information related to the PCAOB's work may not be well understood.

In addition, for several years, the PCAOB has conducted a series of meetings with auditors from smaller, unaffiliated firms that lack the resources of the large, networked firms but nevertheless can bring significant expertise to bear for investors in the vast array of small public companies. These meetings, called the Forum on Auditing in the Small Business Environment, are day-long events designed to allow auditors in smaller firms to learn about the PCAOB's work, to provide their own insights and suggestions, and to ask questions about PCAOB activities, including inspections and new auditing standards and guidance.

The format of these forums promotes an open dialogue among PCAOB representatives and forum participants. In 2011, 762 people attended small business forums held in seven cities. The PCAOB plans to hold seven more such forums in 2012.

2. Pilot Program for Inspections of Broker-Dealer Audits.

In 2011, the PCAOB continued its work to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which gave the PCAOB authority for inspection, standard setting and enforcement for the audits of brokers and dealers registered with the SEC.

On June 14, 2011, the Board adopted a temporary rule that provides for an interim inspection program for firms that perform audits of the financial statements of brokers and dealers.

The interim inspection program allows the Board to assess registered public accounting firms' compliance with current laws, rules, and standards in performing audits of the financial statements of brokers and dealers. As part of this program, information will be gathered to help guide the Board's decisions about the scope and elements of a permanent inspection program, including whether to differentiate between classes of brokers and dealers; whether different inspection schedules would be appropriate with respect to firms that only audit certain types of brokers and dealers;

and whether to exempt any public accounting firms from inspections related to their audits of broker and dealers.

The SEC approved the temporary rule on August 18, 2011. By year-end, the PCAOB had inspected eight firms and examined portions of 19 audits of brokers and dealers.

The PCAOB does not expect to issue firm-specific inspection reports as part of the interim inspection program. Instead, to keep the public informed, the Board will annually publish a report describing the progress of the interim program. The first such annual progress report is expected to be issued in August 2012.

After gaining valuable insight through the interim inspection program and analysis of broker-dealer characteristics, I anticipate that the Board will then carefully consider whether there should be exemptions from the permanent program, including for auditors of brokers that do not receive or hold customer funds.

Further, in an effort to provide information to and seek the views of auditors of brokers and dealers, the PCAOB in 2011 inaugurated the Forum on Auditing Smaller Broker-Dealers, drawing 321 attendees in Jersey City, NJ, and Huntington Beach, CA. The PCAOB plans four additional such forums in 2012 in Chicago; Houston; Jersey City; and San Diego.

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

Public companies, whether located in the U.S. or abroad, access U.S. capital markets by complying with certain U.S. legal requirements, including the requirement to periodically file audited financial statements with the Securities and Exchange Commission.

Under the Sarbanes-Oxley Act, the auditor of financial statements – whether a U.S. auditor or a non-U.S. auditor – must be registered with the PCAOB, and the PCAOB must regularly inspect the firm to assess its compliance with U.S. laws, rules and professional standards in connection with those audits. As of Dec. 31, 2011, 908 non-U.S. accounting firms were registered with the PCAOB.

The PCAOB has conducted inspections in 37 non-U.S. jurisdictions since non-U.S. inspections began in 2005. In 2011, the PCAOB reached cooperative agreements with auditor oversight authorities in the United Kingdom, Canada, Switzerland, Norway, Japan, Taiwan, Israel, Dubai and the Netherlands.

These cooperative agreements generally provide a basis for cooperation in the oversight, including inspections and investigations, of firms subject to the jurisdiction of

both parties to the agreement. Many of the PCAOB's cooperative agreements also permit the PCAOB to exchange confidential information with its non-U.S. counterparts, under authority granted to the PCAOB by the Dodd-Frank Act.

The PCAOB in 2011 remained unable to conduct inspections of registered firms in certain European Union member states and China, due to asserted restrictions under local law or objections based on national sovereignty. Due to the position taken by the authorities in China, the PCAOB also was prevented from conducting inspections of registered firms in Hong Kong to the extent that their audit clients had operations in China. Discussions with local oversight authorities in Europe and China continue.

While we work on negotiating access, the PCAOB has issued staff audit practice alerts and other reports to keep auditors and the public apprised of audit risks presented in non-U.S. audits. Specifically, the PCAOB has issued two staff audit practice alerts relating to (i) appropriate use of non-U.S. auditors and related risks that should be addressed,¹ and (ii) audit risks identified in emerging markets.² In addition, in March 2011, the PCAOB issued a research note on trends and risks related to reverse merger transactions involving companies from the China region.³

C. Enforcement

The Board has broad authority to impose sanctions on registered firms and associated persons that have violated applicable laws and standards. Disciplinary cases that have become public recently have focused on audit failures related to both U.S. and non-U.S. companies traded in U.S. markets; failures to follow standards on quality control and auditing; and auditors' failures to comply with the Board's processes and rules.

For example, in 2011 the PCAOB announced a settlement with five India-based affiliates of PricewaterhouseCoopers, for their audits of Satyam Computer Services.

¹ 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).

² PCAOB Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* (Oct. 3, 2011).

³ 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.

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This followed the extraordinary public statement of Satyam's then-Chairman that the company had reported inflated profits over several years and was showing on its balance sheet more than \$1 billion in non-existent cash and bank balances. The SEC, in an order in its proceeding against the auditors, noted that the fraud was accomplished through the company's use of fictitious invoices, bank statements, and bank confirmations. The Satyam audit was a high profile example of auditors failing to exercise professional skepticism.⁴ Their deficient audit procedures contributed directly to their failure to uncover the Satyam fraud.⁵

Also, just last month, the Board issued another settled disciplinary order against one of the largest registered accounting firms. In this order, the Board censured Ernst & Young LLP ("E&Y"), imposed a \$2 million civil money penalty against the firm, and sanctioned four of its current and former partners for violating PCAOB rules and standards.⁶

This order related to three E&Y audits of Medicis Pharmaceutical Corporation and a consultation stemming from an internal E&Y audit quality review of one of the audits. Specifically, the company's initial basis for establishing its sales returns reserve conflicted both with U.S. generally accepted accounting principles ("GAAP"), and with the firm's internal accounting guidance that addressed revenue recognition for sales with rights of return. Rather than appropriately addressing this material departure from GAAP, E&Y and its personnel wrongly decided in an internal consultation that another flawed rationale supported the company's existing accounting. The company ultimately corrected its accounting for its sales returns reserve and filed restated financial statements with the SEC as a result.

In another recent settled matter, the Board revoked a firm's registration, and barred two of its partners, for violations of quality control and auditing standards,

⁴ Under PCAOB standards, "professional skepticism" is an attitude that includes a questioning mind and a critical assessment of audit evidence. See AU 230.07.

⁵ In addition to censuring the firms, the Board (i) levied a \$1.5 million fine, (ii) barred the firms from taking on any new SEC issuer work for 6 months, and (iii) ordered them to retain an independent monitor to oversee development of quality control improvements ordered by the Board. The SEC brought a simultaneous proceeding against the firms under Rule 102(e), including a \$6 million penalty.

⁶ See In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA (Feb. 8, 2012).

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including in audits of two China-based reverse merger companies, and for failing to cooperate in the investigation and in an inspection.⁷

There is also a significant body of cases that focus on firms' failure to cooperate with the PCAOB's inspection or enforcement programs. For example, in two other settlements last year, the Board barred two audit personnel at a large firm, including the engagement partner on the relevant audit, for improperly creating, backdating, and adding documents to audit work papers shortly before a PCAOB inspection.⁸

The PCAOB closely coordinates its enforcement efforts with the SEC, including on China audit firm matters. 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.

III. New Audit Standard-Setting Initiatives

The Sarbanes-Oxley Act charges the Board with establishing auditing and related professional practice standards for audits of public companies and SEC-registered broker-dealers, and the Board has followed a transparent and fair process for doing so. The Board uses information that it learns in its inspections and from other sources to evaluate the need for changes in auditing standards. In developing new standards, the PCAOB casts a wide net to seek advice from various interested people and groups on ways to improve audits.

The Board's actions are informed by meetings and dialogue with investors, auditors, representatives of public companies and members of the academic community, among other ways through its Standing Advisory Group. Further, the Board holds roundtable discussions and other public meetings to deepen its dialogue with commenters and other interested parties. The Board also works closely with the SEC on the development of standards and monitors the work of accounting standard setters, such as the Financial Accounting Standards Board, for developments that may affect auditing.

PCAOB standards are rules of the Board. To adopt or change them, the Board uses a notice-and-comment process similar to the process used by federal agencies and other standard setters, under which the Board proposes standards for public comment before adopting new or amended standards in a public meeting. All Board standards must be approved by the SEC before they can become effective.

⁷ See In the Matter of Chisholm, Bierwolf, Nilson & Morrill, LLC, Todd D. Chisholm, CPA, and Troy F. Nilson, CPA (Apr. 8, 2011).

⁸ See Peter C. O'Toole (Aug. 1, 2011); Darrin G. Estella (Aug. 1, 2011).

In the past year, the Board has engaged in a number of projects related to auditing and related professional practice standards:

- The Board proposed a new auditing standard, *Related Parties*, and amendments to certain PCAOB standards regarding significant unusual transactions, intended to enhance auditing procedures in areas that have, at times, been used to engage in fraudulent financial reporting,
- The Board also proposed amendments intended to improve the transparency of public company audits by requiring the disclosure of the engagement partner's name in the audit report and the disclosure of other independent public accounting firms and other persons that took part in the audit.
- The Board repropoed a new auditing standard, *Communications with Audit Committees*, and related amendments that are intended to enhance the relevance and quality of the communications between the auditor and the audit committee.
- The Board proposed auditing and attestation standards that would apply to the audits of SEC-registered brokers and dealers and to the supplemental information accompanying audited financial statements.
- Finally, the PCAOB issued two Staff Audit Practice Alerts in 2011 – one intended, as discussed above, to increase auditors' awareness of risks when performing audits of companies with operations in emerging markets, and the other to assist auditors in identifying matters related to the economic environment that might affect the risk of material misstatement in financial statements.

These projects, as well as the Board's planned future standard-setting projects, are described in Appendices 1 and 2, respectively.

In addition, the Board has recently issued two concept releases, soliciting public comment on possible changes to PCAOB standards affecting two major areas of audit practice: (i) the auditor's reporting model, and (ii) auditor independence, objectivity and professional skepticism, including mandatory term limits, or rotation, for auditors of companies traded in U.S. markets. These concept releases did not propose new auditing standards. Rather, they sought the public's views on particular matters so that the Board can better evaluate the need for future standard-setting. To this end, the PCAOB held a roundtable on the auditor's reporting model in September 2011.

Further, the PCAOB recently held a public meeting on auditor independence, objectivity and professional skepticism.⁹ Forty-seven panelists appeared at the two-day public meeting, offering varied perspectives as investors, senior executives and audit committee chairs of major corporations, chief executive officers of audit firms, academicians and other interested parties. The PCAOB plans to hold additional such meetings around the country, in an effort to obtain public comment from a wide and diverse set of interested parties on this important topic.

IV. Pending Legislative Proposals

A. Providing Public Transparency to PCAOB Disciplinary Proceedings

The Subcommittee's invitation letter invited comment on H.R. 3503, introduced by Congressman Westmoreland and co-sponsored by Committee Ranking Member Frank to make the PCAOB's disciplinary proceedings public.

Under the Sarbanes-Oxley Act as it exists today, the PCAOB's disciplinary proceedings are nonpublic, unless the Board finds there is good cause for a hearing to be public *and* each party consents to public hearings.¹⁰ 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.

PCAOB disciplinary proceedings remain nonpublic even after a hearing has been completed and adverse findings made by a disinterested hearing officer, if the auditors and firms do not consent to make the proceedings public and opt to appeal. In addition, unlike the authority the Securities Exchange Act of 1934 provides the SEC 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.

Continued 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.

First, the public is denied access to important information regarding PCAOB cases. During the course of the proceeding, investors, audit committees, and other

⁹ The agenda and a webcast of the meeting are available at http://pcaobus.org/News/Events/Pages/03212012_PublicMeeting.aspx.

¹⁰ See Sarbanes-Oxley Act, Section 105(c)(2).

interested parties are kept in the dark about a respondent's alleged misconduct – no matter how serious. Even after the Board has found sufficient cause to initiate formal proceedings and a disinterested hearing officer has found that the alleged violations occurred, the matter may still remain unknown to the public at least until the case is appealed to the Commission. As a result, investors are unaware that companies in which they may have invested are being audited by accountants who have been charged, even sanctioned, by the Board. For example, during the nonpublic proceedings regarding Gately & Associates, the firm issued 29 additional audit reports on public company financial statements between the commencement of the Board's proceeding and when the Board was able to make its charges public, which was not until the Commission affirmed the Board's decision to expel the firm from public company auditing.¹¹

Second, respondents have an incentive to litigate Board cases, regardless of whether they believe they will ultimately prevail. Contesting the allegations allows respondents to continue with their public company audit practice without any disclosure to clients or investors of the Board's charges for as long as the litigation is ongoing. In the Gately & Associates matter, over two years elapsed between the filing of the Board's case and the Board's publication of the sanctions. During that time, the firm continued its public company audit practice.

Third, the public cannot properly evaluate the Board's enforcement program. During the course of a PCAOB disciplinary proceeding no investor, no other auditor, no audit committee, no member of the media is entitled to know what conduct the Board considers to merit discipline, whom the Board has charged, and what issues are being litigated. As a result, the public is uninformed about the level of activity in the Board's enforcement program and how the Board uses its enforcement resources.

If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding. Any administrative trial would be open to the public. If there were an appeal to the Commission and an oral argument, the public could attend. The ability – or inability – of the SEC's staff to prove its charges would be a matter of public record.

The SEC determined more than twenty years ago that its disciplinary proceedings against accountants and auditors should be public. In the 1980s, the SEC faced the same problem as now confronts the Board. SEC disciplinary hearings

¹¹ See In the Matter of the Application of Gately & Associates, LLC and James P. Gately, SEC Release No. 34-62656 (August 5, 2010). The number of opinions issued was obtained from Audit Analytics.

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involving accountants and auditors were private until 1988, when the Commission amended its rules to make the hearings presumptively public.¹² The reasons cited by the SEC for the change included:

- 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. This state of affairs is not good for investors, for the auditing profession, or for the public at large. Investors would be best served by similar transparency in PCAOB disciplinary proceedings.

B. March 21 Discussion Draft

The Subcommittee's invitation letter also invited comment on a discussion draft of potential legislation that would amend Section 103 of the Sarbanes-Oxley Act to prohibit the PCAOB from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis.

The Board, of course, has not proposed mandatory audit firm rotation. Rather, as described above, the PCAOB is engaged in a deep and wide-ranging public dialogue about ways to enhance the independence, objectivity and professional skepticism of public company auditors. The Board initiated this discussion by issuing a concept release, which asked not only whether others agree or disagree that the Board should focus on this issue, but also sought specific ideas for improving independence, objectivity, and skepticism, including the possibility of rotation. This dialogue was prompted, among other things, by concerns developed over the last nine years of the PCAOB's inspections of public company audits. It was also prompted by the

¹² SEC Release No. 34-25893 (July 7, 1988); 53 FR 26427 (July 13, 1988).

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Government Accountability Office's statutorily required 2003 report on mandatory audit firm rotation, which noted the significant implementation issues that would be associated with mandatory audit firm rotation and concluded that the PCAOB and the SEC would need more time and experience to evaluate whether term limits are necessary to preserve auditor independence.¹³

With the benefit of nearly a decade of inspections, the Board has begun that evaluation. As the Board's concept release states –

Since its creation, the Board has conducted hundreds of inspections of registered public accounting firms each year. These inspections provide the Board with a unique insight into the state of the audit profession and the conduct of public company audits. Based on this insight, the Board believes that the reforms in the Act have made a significant, positive difference in the quality of public company auditing. Yet, as described below, the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.¹⁴

The PCAOB is not alone in its concern over the number of deficiencies found in inspections and the larger questions that arise from these findings. Similar concerns have been expressed by regulators in Canada, Germany, the U.K., the Netherlands, Australia and elsewhere.¹⁵ As the Canadian Public Accountability Board recently

¹³ See U.S. General Accounting Office, Required Study on the Potential Effects of Mandatory Audit Firm Rotation (2003), at 5.

¹⁴ See PCAOB Release No. 2011-006, Concept Release on Auditor Independence and Audit Firm Rotation (Aug. 16, 2011). Pursuant to the Sarbanes-Oxley Act, the details of the PCAOB's inspections are subject to a broad confidentiality restriction such that they may not even be shared with Congress. Sarbanes-Oxley Act, Section 105(b)(5). Last Congress, the House Financial Services Committee unanimously approved an amendment offered by then-Representative Adam Putnam (R-FL) to amend the Act and allow the Board to do so, but that provision has not been enacted.

¹⁵ See Audit Oversight Commission, *Report on the Results of the Inspections according to § 62b WPO for the Years 2007-2010*, at 3 (Apr. 6, 2011) (Germany):

In general the inspection findings . . . show that there is still room for improvement in terms of the audit quality, according to the AOC.

This particularly applies in view of the auditor's indispensable professional scepticism towards statements made by the audit client. In this respect

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reported in a summary of worldwide inspection findings, “[i]nsufficient Professional Skepticism . . . is undoubtedly the most common finding – that auditors are too often accepting or attempting to validate management evidence and representations without sufficient challenge and independent corroboration.”¹⁶ Based on such concerns, the European Commission also is considering reforms to enhance auditor independence.

In light of these findings and related developments, the PCAOB has solicited ideas and begun a vigorous, substantive and constructive debate on the best ways to achieve greater auditor independence, objectivity and professional skepticism. Part of this debate has involved bringing interested and experienced parties together for in-depth discussions. As previously mentioned, the PCAOB just last week held a two-day

the inspections showed indications in some cases that the audits had not been conducted with the necessary professional scepticism, especially in the audit fields which were exposed to increased risks in the context of the financial market and economic crisis and consequently required particular professional scepticism on the part of the auditor.

See also U.K. Professional Oversight Board, *Audit Inspection Unit 2009/10 Annual Report*, at 4 (July 21, 2010) (stating that “[f]irms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients” and that “[a]uditors should exercise greater professional scepticism particularly when reviewing management’s judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern”); Netherlands Authority for the Financial Markets, *Report on General Findings Regarding Audit Quality and Quality Control Monitoring*, at 13-14 (Sept. 1, 2010); Australian Securities & Investment Commission, *Audit Inspection Program Public Report for 2009-2010*, at 13-14 (June 29, 2011); Canadian Public Accountability Board, *Enhancing Audit Quality: Report on the 2010 Inspections of the Quality of Audits Conducted by Public Accounting Firms*, at 3 (April 2011); Federal Audit Oversight Authority, *Activity Report 2010*, at 23 (Feb. 14, 2011) (Switzerland).

In addition, the Canadian Public Accountability Board just last month issued a Special Report on Auditing in Foreign Jurisdictions, in which the CPAB “found a lack of professional skepticism when auditors were confronted with evidence that should have raised red flags regarding potential fraud risk.” Canadian Public Accountability Board, *Auditing in Foreign Jurisdictions: CPAB Special Report*, at 1 (Feb. 2012).

¹⁶ See Canadian Public Accountability Board, *Auditing in the Decade Ahead: Challenge and Change*, Audit Quality Symposium Pre-Reading Materials, at 36 (2011).

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public meeting at which the PCAOB heard from forty-seven participants. We plan to hold additional meetings around the country over the course of the next year or so.

During this dialogue, I have been struck and encouraged by auditors' heightened self-awareness that the world is changing and that a new look at measures to maintain the relevance and reliability of audits is warranted. Most accounting firms appear to appreciate that the profession is evolving and that additional enhancements to auditor independence, objectivity and professional skepticism are needed.

As an independent standard setter, the PCAOB has brought people with a variety of viewpoints together to explore this critical issue in greater depth. If this process results in the PCAOB proposing any rules – whether they involve term limits or not – they will be subject to further public comment and SEC approval.

For these reasons, I encourage the Subcommittee to respect the decision made by Congress to entrust these judgments to the independent standard-setting process of the body charged with examining public company audits and, based on that examination, considering what improvements are needed in those audits to protect investors and further the public interest.

* * *

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.

APPENDIX 1 – RECENT STANDARD-SETTING ACTIVITIES

Proposed Standards and Amendments

Audits of SEC-Registered Brokers and Dealers

The Dodd-Frank Act gave the PCAOB the authority to oversee auditors of SEC-registered brokers and dealers, including authority to set standards and rules for audits of brokers and dealers.

The SEC decides what parts of the financial reports filed by registered brokers and dealers should be audited by PCAOB-registered accounting firms and the standards that should be used in conducting those audits. In June 2011, the SEC proposed to amend its rules to require that certain audit and attest reports be prepared by PCAOB-registered auditors using standards established by the PCAOB. On July 12, 2011, the Board proposed attestation standards for auditors tailored to the SEC proposed rule amendments. The Board also proposed a standard for audits of supplemental information accompanying audited financial statements that would apply to audits of brokers and dealers and audits of issuers. The deadline for comments on the proposed PCAOB standards was Sept. 12, 2011. Further action on the Board's proposals is dependent on the SEC's adoption of the proposed amendments to its rules.

Audit Transparency

The audit report is typically an investor's primary source of information about the audit. Usually a single page, the report provides general information about how every audit must be conducted, states that the audit complied with applicable standards, gives the firm's opinion on the company's financial statements or internal control over financial reporting, and includes the signature of the firm that issued it. While the report provides useful information—the opinion, primarily—it tells the reader little about the key participants in the audit.

On Oct. 11, 2011, the Board proposed amendments to its standards that would improve the transparency of public company audits by requiring that audit reports disclose the name of the engagement partner as well as the names of other independent public accounting firms and other persons that took part in the audit. The amendments would also require registered public accounting firms to disclose the name of the engagement partner for each audit listed on the firms' annual reports filed with the PCAOB. The deadline for comments on the proposed amendments was Jan. 9, 2012.

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Communications with Audit Committees

On Dec. 20, 2011, the Board repropose a new auditing standard, *Communications with Audit Committees*, and related amendments. The standard is intended to benefit investors by establishing requirements that enhance the relevance and quality of the communications between the auditor and the audit committee.

The Board originally proposed the auditing standard in March 2010. Interest in the proposed standard prompted the Board to reopen the comment period and host a roundtable discussion with representatives of audit committees, investors, auditors, issuers and others.

The repropose standard incorporates comments and suggestions received; reflects information that is aligned with the Board's new risk assessment standards that took effect in 2011; and adds a requirement to communicate information about significant unusual transactions. The repropose also provides commenters with an opportunity to comment on the standard in relation to the audits of brokers and dealers. The deadline for comments was Feb. 29, 2012.

Auditing Related Party Transactions

Related party transactions often involve difficult measurement and recognition issues that not only can lead to errors in financial statements but also, in some cases, have created opportunities for fraudulent financial reporting and the misappropriation of assets. Studies have shown that such transactions have played a recurring role in financial failures, from those that led to the Sarbanes-Oxley Act to those recently alleged in certain emerging market companies. Significant transactions that are outside a company's normal course of business present similar issues. On February 28, 2012, therefore, the Board proposed a new standard, *Related Parties*, as well as amendments to certain PCAOB auditing standards to assist auditors in detecting and addressing the audit risks associated with related parties and other unusual transactions. The comment period expires May 15, 2012.

Concept Releases

Auditor's Reporting Model

Auditors, as a result of performing required audit procedures, often have significant information regarding a company's financial statements and the audit of such financial statements. Although that information is not reported in the standard auditor's report to the financial statements users, the information might be useful to investors and other financial statement users.

On June 21, 2011, the Board issued a concept release to seek public comment on potential changes to the auditor's reporting model based on concerns of investors and other financial statement users.

The concept release raised for consideration several alternatives for the auditor's reporting model that could increase its transparency and relevance to financial statement users. The alternatives include a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the auditor's view of the company's financial statements (an "Auditor's Discussion and Analysis"); required and expanded use of emphasis paragraphs in the auditor's report; auditor reporting on other information outside the financial statements; and clarification of certain language in the auditor's report. The concept release noted that the identified alternatives are not mutually exclusive and that other alternatives may exist.

The concept release was preceded by several discussions with the PCAOB's Standing Advisory Group and Investor Advisory Group, in addition to extensive outreach by PCAOB staff in 2010 and early 2011. The staff presented the findings from that outreach to the Board at an open meeting March 22, 2011, and the Board approved the concept release June 21, 2011. The Board solicited further comment at a roundtable on Sept. 15, 2011, with participants representing investors, other users and preparers of financial statements, audit committee members, academics and auditors. The deadline for comments on the concept release was Sept. 30, 2011.

Auditor Independence and Audit Firm Rotation

An audit has value to financial statement users because it is performed by a competent third party who is viewed as having no interest in the financial success of its audit client. Investors should be able to take comfort in the fact that

independent professionals have performed required procedures and have a reasonable basis for the audit opinion.

Questions persist, however, about whether more can and should be done to enhance auditor independence, objectivity and professional skepticism. As a result of PCAOB inspections, the experience of other audit regulators and concerns expressed by investors, the Board issued a concept release Aug. 16, 2011, seeking public comment on a variety of possible approaches to improving auditor independence, objectivity and professional skepticism.

One possible approach is mandatory audit firm rotation, which would limit the number of consecutive years a registered public accounting firm could serve as the auditor of a public company.

The release sought comments on, among other things, whether a rotation requirement would risk significant cost and disruption and how mandatory rotation would serve the Board's goals of protecting investors and enhancing audit quality. The Board also sought comment on whether other measures could meaningfully enhance auditor independence.

The deadline for comments was Dec. 14, 2011. The Board also held the first of several public meetings to obtain further comment last week, on March 21 and 22. The Board reopened the comment period in connection with the public meeting, until April 22, 2012.

Staff Audit Practice Alerts

The PCAOB publishes Staff Audit Practice Alerts to highlight new, emerging or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. The PCAOB issued two alerts in 2011 in response to events in emerging markets and in the global economic environment that exposed possible threats to the reliability of some companies' financial statements and heightened the need for vigilance on the part of auditors.

Audit Risks in Certain Emerging Markets

On Oct. 3, 2011, the PCAOB issued Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets*, to increase auditors' awareness of risks when performing audits of companies with operations in emerging markets.

The alert was prompted by disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the Board's oversight activities. The practice alert focuses on risks of misstatement due to fraud that auditors might encounter in audits of companies with operations in emerging markets—risks that also may be present in companies in developed markets.

Conditions and situations indicating heightened fraud risk include discrepancies between a company's financial records and audit evidence obtained from third parties; auditors' difficulties in confirming cash and receivable balances; and the recognition of revenue from contracts or customers whose existence cannot be corroborated.

Risk in the Current Economic Environment

On Dec. 6, 2011, the PCAOB issued Staff Audit Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment*, to assist auditors in identifying matters related to the economic environment that might affect the risk of material misstatement in financial statements and, therefore, require additional audit attention.

The alert updated Staff Audit Practice Alert No. 3, issued in December 2008, in light of global economic conditions and new risk assessment standards that took effect for audits in 2011. The alert directs auditors' attention to considering the impact of economic conditions on the audit; auditing fair value measurements and estimates; considering a company's ability to continue as a going concern; and auditing financial statement disclosures.

APPENDIX 2 – FUTURE STANDARD SETTING PLANS

Among the auditing issues on the Board's standard-setting agenda are those dealing with:

Specialists. The Board is considering possible revisions to the standard on the auditors' use of specialists to strengthen requirements related to certain aspects of specialists' work, such as the auditor's evaluation of the work of a specialist.

Part of the audit performed by other auditors. In many public company audits, the accounting firm issuing the audit report does not perform 100 percent of the audit procedures. This may be especially common in, but not limited to, audits of companies with operations in more than one country. In these situations, audit procedures on or audits of the company's foreign operations are performed by other accounting firms or other participants in the audit not employed by the auditor. The Board is considering possible revisions to its standards to strengthen requirements regarding the work performed by the various auditors participating in the audit.

Assignment and documentation of firm supervisory responsibilities (failure to supervise). The Sarbanes-Oxley Act authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons. To assist its oversight, the Board is considering possible rulemaking or standard setting that would require firms to make and document clear assignments of the supervisory responsibilities that should already be part of any audit practice. The Board sought comment on rulemaking concepts related to supervision in a release issued Aug. 5, 2010.

Fair value measurements. The Board is evaluating potential revisions to the PCAOB standards on fair value measurements and other accounting estimates.

To assist in its evaluation, the Board formed the Pricing Sources Task Force in March 2011. This group of investors, financial statement preparers, auditors and representatives of pricing services and brokers met three times in 2011 to discuss the valuation of financial instruments that are not actively traded and the use of third-party pricing sources to value such instruments.

Going concern. The Board is considering possible revisions to the auditing standard on the auditor's evaluation of a company's ability to continue as a going concern. Among other things, the Board is considering how to enhance the auditor's evaluation process and the usefulness of the auditor's communication to investors regarding going concern uncertainty.

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Confirmation. The Board is considering possible revisions to the proposed standard, *Confirmation*, that would update and expand the requirements related to the auditor's use of confirmations. Confirmations are the direct communications between an auditor and a third party about a particular item affecting a company's financial statements. The standard was proposed July 13, 2010.

Quality control. The Board is in the process of evaluating potential revisions to its quality control standards, including the SEC Practice Section standards.

Codification of PCAOB standards. The Board is considering a potential framework of organization and codification of its auditing standards.

Subsequent events. The Board is also considering possible revisions to the auditing standards related to events or transactions that occur subsequent to the balance-sheet date.