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Public Company Accounting Oversight Board

Remarks of Mark W. Olson at the AICPA National Conference on Current SEC and PCAOB Developments

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INTRODUCTION

I appreciate the opportunity to be here today to offer you a sense of some current priorities and recent developments of the Public Company Accounting Oversight Board (or PCAOB), and how they may intersect with U.S. competitiveness, an issue, which for good reason, is currently at the top of many agendas.

I would like to share my views on the PCAOB application of a supervisory model in overseeing auditors. The six months that I have logged with the PCAOB, added to my years in banking supervision, have only strengthened my belief that the Board's mandate to oversee the auditors of public companies continues to be best accomplished through robust supervision that is premised on a communicative relationship. In addition to a close dialogue with the firms that the PCAOB supervises, our overall mandate is best achieved through communication with external stakeholders. This philosophy has assisted the work of the Board immensely.

Before I go further, I must note that the views I express today are my own, and not necessarily those of other Board members or staff of the PCAOB.

PCAOB CURRENT PRIORITIES

To begin our discussion this morning, I would like to mention where I see the PCAOB organizationally and then share with you some of our priorities.

Where the PCAOB is organizationally

Now in its fourth year of operation, the PCAOB has established a strong foundation for its oversight of public company auditors. Importantly, the Board continues to assess its oversight program, as we learn from our inspections program and the open and frank dialogue that we have with the audit firms. Based on what we learn, the Board is prepared to make appropriate adjustments to assure that it achieves the objectives of the Sarbanes-Oxley Act in the most effective and efficient manner possible. A supervisory model must remain flexible to keep pace with a dynamic industry.

From an organizational perspective, we must continue with our work to move the PCAOB from its start up phase into its steady state.

Standard Setting

Standard setting is one of the key roles of the PCAOB, and Tom Ray, the PCAOB's Chief Auditor and Director of Professional Standards, will speak later at this conference on the PCAOB's current standard setting priorities. My focus will be on highlighting how the PCAOB receives input regarding our rulemaking process. This is particularly important as we are at a critical stage in the PCAOB's rulemaking initiative for its auditing standard for internal control.

The Board seeks out input regarding its standards and rules from the many entities that have a stake in the changes that they may bring - including investors, accountants, executives and others through its Standing Advisory Group (or the SAG); comments received from the public; from domestic and international regulators; and from the many small business forums that we conduct across the United States. One important feature of this process is that the outreach takes place both prior to and after the effective date of a standard or rule.

Revising Auditing Standard No. 2 (AS2)

With regard to AS2, the PCAOB announced on December 5th that it will consider at a public meeting on December 19th proposing for

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public comment a new auditing standard to supersede the Board's existing auditing standard on internal control over financial reporting, and other related proposals. The proposals are the result of the PCAOB's two-year assessment of the standard's implementation for audits of issuers of all sizes. The PCAOB has focused on exploring ways to improve its audit requirements and accounting firms' implementation of them, while preserving the intended benefits. The proposal will be designed to focus auditors on areas that pose higher risk of fraud or material error in order to achieve cost-savings and the objectives of Section 404.

The PCAOB is working closely with the SEC to ensure that our goals are carefully aligned. Tom Ray is going to provide an overview of some key features you can expect to see reflected in the Board's proposal. However, it also is important for you to know that the PCAOB has remained committed to the four goals it announced in May:

- **First**, the PCAOB plans to propose changes to make the standard simpler to read, easier to understand and more clearly scalable to companies of any size. At the same time, by emphasizing core principles, the new proposal is expected to focus auditors on the areas of greatest importance.
- **Second**, the PCAOB is critically evaluating every area of the audit of internal controls to determine whether the existing standard encourages auditors to perform procedures that are not necessary to achieve the intended benefits of the audit.
- **Third**, the PCAOB plans to propose changes that would make explicit in the standard the PCAOB's past guidance on how to make internal control audits as efficient as possible.
- **Fourth**, the proposal should emphasize the importance of a company's control environment, and how it can impact the risk of financial reporting fraud or other material failure, in order to focus auditors on what really matters, which is identifying material weaknesses in a company's system of internal control before those weaknesses result in material misstatements in the company's published financial statements.

The SEC simultaneously is in the process of developing risk-based management guidance for implementing Section 404 that its Commission will consider on December 13th. It is important that these two initiatives are closely coordinated and that they are available for public consideration concurrently - the PCAOB has made coordination with the SEC a priority.

Beyond AS2

Based on our press coverage, one might be led to believe that the PCAOB's sole focus is AS2. The hard working professionals in the PCAOB's Office of the Chief Auditor certainly would disagree. While the PCAOB does not view the proliferation of standards as a performance measure, we do take our standard setting role very seriously. In addition to the tremendous focus rightly being given to AS2 at present, there are several other standard setting priorities on the PCAOB's agenda. I'd like to take a moment to highlight three of those other initiatives:

(i) We are working closely with FASB to ensure that their accounting standards and our audit standards are closely aligned. An example of this work is our focus on changes to auditing literature that may be needed in order to conform with FASB's 2005 Statement of Financial Standards No. 154 (Accounting Change and Error Corrections) and their move to incorporate the "GAAP hierarchy" directly into their new accounting standard. Although this is largely a "housekeeping" matter, we do believe it is important for us to facilitate the FASB's projects in these areas and to bring the Board's standards in line with them.

(ii) Engagement quality review – The Sarbanes-Oxley Act requires the Board to include in the auditing standards it adopts a requirement that each registered public accounting firm provide a concurring or second partner review of each audit report. We refer to this as the engagement quality review. Over the past year, the PCAOB has taken time to more fully evaluate what we are learning in the inspections process about engagement quality reviews that are being conducted under the Board's interim concurring partner standard, and have made substantial progress on this project.

(iii) Risk assessment – Other standard setters recently made some improvements to certain "core" auditing standards we refer to as the "risk assessment" standards. Our staff is in the process of analyzing the work of those other standards setters for the purpose of making recommendations to our Board as to how we should amend certain of the Board's interim standards.

This is a large project that affects several of the Board's interim auditing standards. We have made progress in analyzing the issues, and are in the preliminary stages of our project. We plan to make substantial progress on this project over the next 12 months.

AUDITOR OVERSIGHT — THE PCAOB'S SUPERVISORY APPROACH

As some of you know first hand, the core of the PCAOB's supervisory model is its inspections program. PCAOB inspections are designed to identify auditing problems at an early stage and focus firms on correcting them. PCAOB inspections begin by looking at the professional environment in which audits are performed and focus on the influences – both good and bad – on a firm's audit practice. These influences include a firm's culture and the relationships between the firm's audit practice and its other practices, as well as between engagement personnel in field or affiliate offices and a firm's national office.

PCAOB inspections are also risk-based, in that they focus on the aspects of audits that present the greatest risk of undetected material misstatements of financial statements. When inspectors find an audit that is not satisfactory, they discuss with the firm precisely what the deficiency is. Often this dialogue leads to immediate corrective action. I place a great deal of emphasis on making this supervisory

dialogue – and therefore the PCAOB supervisory model – be as valuable as possible.

Since I joined the PCAOB in July, I have made it a priority to visit each of our field offices and talk with the inspection teams. As with any supervisory model, the field inspectors are our eyes and ears, and are thus the front line in our ongoing supervisory dialogue with registered firms. That dialogue takes place in a structured way through the inspection process and the inspection report process.

Let me talk briefly about a few of the areas on which our inspections focus. Those of you who are most familiar with our inspection process, or who have read our public descriptions of inspections procedures at large firms, will recognize that this list is only a subset of what we look at.

For one thing, of course, we are always looking to see whether audit teams are being sufficiently objective. We look at whether auditors are treating their role as that of merely trying to gather enough evidence to support the issuer's position, or whether they are rigorously evaluating both corroborative and contradictory evidence.

We look at whether strains on individual partner capacity may contribute to issues with audit quality, and whether a firm's compensation practices provide incentives likely to promote audit quality and technical competence.

With respect to consideration of fraud, we look to see whether audit teams are mechanically complying with the requirements of AU 316, which sets out the auditor's responsibility with regard to fraud, rather than with its substance and intent by applying appropriate professional skepticism.

- For example, we check to see whether auditors appear to be appropriately modifying the nature, timing, and extent of audit procedures directly in response to an identified fraud risk, and whether auditors are varying their audit procedures to bring an element of unpredictability to the audit process.
- In addition, we look at whether firms' information technology resources are being used to their fullest extent to aid in the efficient and effective identification of certain potential indicators of fraud.

We look at how the concurring partner review process is implemented. This includes an assessment of the quality of the execution of the concurring partner reviews, and whether the level of concurring partner involvement appears to correspond with the firm's assessment of the audit risk. We also are attentive to whether the concurring review is a genuinely independent and objective assessment of the significant auditing, accounting, and financial reporting matters.

We look at these and other issues, and seek to engage with a firm in a constructive manner rather than an adversarial one. While still evolving, I believe the PCAOB's supervisory model is working. Our approach avoids attempting to manage the firm's quality control systems through overly prescriptive remedies, and the process is based on the assumption that each firm knows best how to manage its operations and to define the specific methods by which it can address a particular quality control criticism. This approach also allows each firm to craft effective remedies based on its particular organizational structure and operations.

I believe this model provides the best framework to encourage firms to take action to improve audit quality, and I am encouraged by what I understand about the level of cooperation generally from most firms.

It is encouraging to note the substantial and meaningful changes that some firms have made to enhance audit quality, including improvements relating to internal inspection, partner evaluation, promotion and compensation, and the supervision of foreign affiliates. The Board described many of these changes in a release issued this past March, and I think any reader of that release would have to be encouraged that the PCAOB's supervisory approach is helping to focus firms on meaningful improvement.

Additionally, the PCAOB's investigations and enforcement program is an important component of our auditor oversight; it provides a necessary tool for addressing the more serious violations of professional standards and other applicable law that we encounter in our auditor oversight activities. While I am mindful that remediation efforts are our preferred tool in addressing most deficient auditing practices, I believe that our enforcement efforts are vital for assuring that public confidence is not undermined by firms or individual audit professionals whose conduct does not reflect the profession's high standards of quality, independence, and competence.

A View on Competition and the Direction of Audit Firms

The audit profession continues to evolve. Over the last few years, we have seen audit firms realign their business models to focus on quality audit services and services that are consistent with maintaining appropriate levels of independence. (Non-audit services have not gone away, but to be consistent with independence rules, some firms are structuring their practices to market prohibited non-audit services to non-audit clients.) We are seeing enhanced independence and a renewed focus on audit services, which is working to enhance the overall quality of audits. More immediately this has also resulted in a "repricing" of the audit that will take some time for the issuer community to absorb.

Since the early 1990s and well before the events of 2001 and 2002, audit firms have undergone a series of mergers which has resulted in a concentration in the number of large firms. Those mergers and the demise of Arthur Andersen in 2002 have resulted in four remaining largest audit firms that currently audit almost 99% of the market capitalization of companies listed in the United States. These mergers coincided with the global expansion of many Fortune 500 firms, which demanded that their audit firms have a global footprint. This increased the size of the large firms' clients, and the magnitude and complexity of their international operations. As a consequence, large firms now require large, global networks and significant investments in technology, personnel and other support functions. There is no easy solution to the current high level of concentration, and it is a global issue. Because of the demands of their business, certain large,

multinational issuers realistically are limited in their choice of auditor, and we have been told that the preferences of some underwriters also put pressure on issuers when selecting their auditors.

However, I am encouraged by the growth in size and skill taking place in firms following the Big 4. This will allow the market – in particular for small, medium, and even some larger issuers - to have additional choices, which I believe is important for the resiliency of the audit profession.

THE INTERNATIONAL OUTLOOK

There are two topics on the international outlook that I would like to raise with you today. First, is the importance of the PCAOB's international coordination in carrying out our mandate, and second, the topical issue of capital markets and foreign investment.

International Coordination

Due to the global footprint of large audit firms and the number of non-U.S. firms registered with the PCAOB, we view it as a priority to enhance our coordination with counterparts internationally.

With regard to the PCAOB's counterparts, countries have taken a variety of approaches in implementing their auditor oversight models, due in part to differences in legal and cultural foundations. This demands that the PCAOB take a flexible approach in carrying out its mandate. For the PCAOB, regulatory coordination is imperative: more than 700 of the firms registered with the PCAOB are in countries outside the United States, although they may be affiliated with large, U.S. based audit firms. Audit oversight bodies must continue to work together to minimize the burdens of duplicative or contradictory regulation at the same time that each organization fulfills its statutory obligations to investors and the public.

Fortunately, the PCAOB rules enable the PCAOB to rely on the work of the home-country regulator, and we are exploring the degrees of reliance that could be implemented. We continue to be keenly aware of the potential for duplicative regulatory costs and the sensitivity to having PCAOB personnel inspect the files of non-U.S. firms.

The PCAOB's degree of reliance on home-country inspections is directly based on the independence and rigor of the home-country system of oversight and agreement between the PCAOB and the home-country regulator on the inspection work program for individual firms. The more independent and rigorous the home-country system, the more the PCAOB can rely on its counterpart to conduct an inspection of a PCAOB-registered firm.

Let me use this as a segue to the important subject of how we, as overseers of the audit profession, see our work intersecting with the vitality and integrity of capital markets.

Global Capital Markets

Today, financial markets are more global than ever, and financial systems are increasingly more sophisticated and accessible. Cross border transactions have been greatly facilitated in recent years due to the removal of a number of barriers and technological advancements. This has, in turn, facilitated greater access by investors and companies to cross border markets, thus enhancing their ability to achieve greater overall returns while controlling risks through diversification of their portfolios. This increase in global mobility of funds means that we all have a stake in promoting vibrant, transparent markets. Supervisors and regulators must keep pace.

To this end, a healthy degree of competition among our markets should be embraced. Companies today are presented with more options when they are determining where to raise capital. Regulatory regimes, litigation systems, as well as local political and cultural influences, are often factored into this decision. Competition can force efficiencies, yet we should be wary of competition that is based on cost alone. Having the right balance of oversight and regulation promotes innovation and protects the long-term reliability, stability and depth of capital markets, so they can continue to attract investors and issuers worldwide. The health and competitiveness of U.S. capital markets have increasingly been a focus of attention among policy makers, business leaders, and the investor community. As one example, in late November, the interim report of the Capital Markets Committee reiterated the important fact that U.S. capital markets play a critical role in the global economy, and analyzed the U.S. market's competitiveness from both a macro and micro economic perspective.

While policy makers in the United States continue to place a high value on the growth and overall health of our capital markets, growth in other markets should also be viewed as a positive development, and one that certainly predates Sarbanes-Oxley. To be sure, many financial markets outside of the United States have risen to become global players, due to a number of factors, including, as I mentioned a moment ago, the ease of information exchange and the reduction of certain barriers to cross-border transactions.

What role does regulation play in this context? I firmly believe that regulation, if balanced, attracts capital and builds confidence in markets. In fact, from the U.S. perspective, we have seen that listings on the U.S. markets have continued to command a valuation premium. Although some evidence seems to indicate that the cross-listing premium for foreign companies listing in the United States has declined post-Sarbanes-Oxley, there remains a substantial premium for cross-listing in the United States.

I remain optimistic. Importantly, in the two years since companies have been reporting and obtaining audits on their internal control, the amount of capital raised by non-U.S. companies on U.S. exchanges has grown, not shrunk as it did in the years directly after the scandals. Moreover, the United States continues to be a leader in financial innovation.

CONCLUSION

The PCAOB oversees the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements. High quality financial disclosure by public companies is a cornerstone of capital markets in the United States and is necessary for the continued growth and competitiveness of the U.S. economy. Both the PCAOB and the audit firms themselves have direct roles in this important area.

To be effective, a supervisory model is premised on a relationship between the supervised and the supervisor, which, while always at a healthy arms-length, revolves around a constructive approach to a shared objective – the objective in this case being a culture of integrity, rigor, skill and good sense in public company auditing in order to maintain investor confidence. I believe that the firms and the PCAOB can be commended for having established strong roots in a very brief time frame.

Going back to a hot topic, next week, the PCAOB will hold its public meeting to consider changes to the auditing standard on internal control over financial reporting to provide for more efficient, risk-based, scalable implementation. It is important that you carefully consider this proposal and provide the PCAOB thoughtful feedback through the comment process.

Thank you in advance for that input, and thank you again for inviting me to speak with you today.