

## Remarks of Bill Gradison Founding Board Member Public Company Accounting Oversight Board

At the Annual Banquet  
Department of Accounting  
North Carolina State University  
Raleigh, NC

September 16, 2008

Let me start by stating, as required by PCAOB's Ethics Code, that these views are my own and may not represent the views of PCAOB, its Board, or its employees.

Accounting and auditing in the United States are at a crossroads. There clearly is tension between developing, maintaining, and enforcing our own US standards and the powerful move toward globalization – whether we call this harmonization or convergence – of standards elsewhere around the world. Time will tell whether or not this tension will ultimately result in US standards being replaced by international standards. But in the here and now multiple standards will coexist. This presents significant challenges for students, educators, auditors, issuers, investors (especially analysts), rating services and, of course, regulators.

Tonight I want to touch on the implications of this new reality with special attention to the impact on the Public Company Accounting Oversight Board. The current state of play involves two sets of accounting standards: GAAP and IFRS (with its numerous local variations), and three sets of auditing standards, each of which is in a state of flux: the ISAs toward which many non-US jurisdictions seem to be moving, the ASB standards which apply to non-issuers in the United States (and are conceptually "ISAs plus"), and the PCAOB standards for issuers.

Starting first with students and educators it appears, based upon a recent survey by the American Accounting Association and KPMG (reported in the press a few weeks ago), that comparatively few US universities will be educating students in international accounting standards this academic year. Specifically, only 22% of 535 accounting professors said they would incorporate IFRS into their curricula in any significant way in the 2008-09 academic year. Sixty-two percent indicated they had not taken any significant steps toward doing so. This is understandable. After all, the textbooks do not yet exist and the CPA exams do not currently include IFRS. I should note that the Exposure Draft "Proposed Content and Skill Specifications for the Uniform CPA Examination" does reflect enhanced emphasis on regulatory reporting requirements (e.g., SEC reporting) as well as questions related to IFRS in the Financial Accounting and Reporting section of the exam.

Moreover, the SEC "roadmap" is just that, and whether and how quickly the move to IFRS will be permitted or required will be determined by the SEC in the future. Even if the textbooks were available and the faculty up to speed on IFRS, how to fit this into an already full curriculum is far from clear. Nonetheless at this time large accounting firms are increasingly interested in recruiting graduates with IFRS training and are seeking to shorten the learning period by sharing their own internal training materials with academia. This is a promising development and one which I commend. As I see it, from the point of view of current students, those who graduate with a working knowledge of international accounting standards will not only have an edge over other graduates who do not, but also over many current accountants who speak the "language" of GAAP and do it well but for whom IFRS is essentially a foreign tongue. Requiring students to learn two accounting languages (GAAP and IFRS), both at the same time, strikes me as an extraordinary challenge to all concerned. But the need to do so is not just coming – in many ways it is

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already here. The large accounting firms have an obvious advantage during this uncertain period because their international affiliates are already fluent in IFRS and can help teach their US brethren.

Nor are regulators untouched by these challenges. Currently 873 non-US firms are registered with the PCAOB and about 250 firms in 51 countries are subject currently to periodic inspections, which is to say they audit issuers. Now that foreign private issuers no longer need to reconcile their financial statements to GAAP, PCAOB inspectors will be reviewing audits based on IFRS alone. As a result, PCAOB is developing a robust training program which eventually will involve most of its divisions. But initially we will focus on making sure that our international inspectors are conversant with IFRS.

Turning to auditing standards, the challenges are even greater. I recognize that most auditing education – unlike accounting – is done on the job, and that accounting graduates typically take only one or two auditing courses. But what should auditing courses cover when there are three auditing languages (to continue the metaphor) being spoken? Even having two standards (ASB's and PCAOB's) presents challenges because most graduates don't audit public companies and the current CPA exam has been focused on private company (rather than public company) auditing standards.

My personal view is that in the long run adoption of a single high-quality auditing standard ought to be the primary goal. That, however, is not an endorsement of the ISAs. In fact, PCAOB is in the process of replacing its interim standards and the new PCAOB standards will go beyond the ISA's. As a practical matter, the chances of full convergence of these two standards are somewhere between zero and nil since there has not – to put it mildly – been a rush of non-US standards writers to adopt anything close to PCAOB's internal control over financial reporting standard -- AS5, which is required by Section 404 of Sarbanes-Oxley. At precisely the same time as PCAOB is revising its interim standards, according to John Kellas, Chairman of the International Auditing and Assurance Standards Board, International Standards of Auditing (the ISAs) "are used or being adopted by more than 100 countries" and are being applied by the larger firms to their international audit work.

Make no mistake, I want PCAOB standards to be the gold standards for auditing, but I am well aware that our regulatory counterparts may consider their standards to be the gold and ours to be the silver or bronze. PCAOB's Strategic Plan for 2008 commits PCAOB to playing "a leadership role in international efforts to improve auditor oversight and auditing practices worldwide and reduce duplication of effort" by examining "the implications for the PCAOB's mission of multiple auditing standards and varying audit environments across global capital markets and consider how the Board should respond." The Board is at an early stage in considering these issues and may hold a roundtable as part of a comprehensive effort to seek the views of stakeholders – including academia – on this subject.

I have had the honor of serving on the Board of the PCAOB for almost six years and one of my special interests has been to reach out to the academic community. We have had the good fortune of having outstanding accounting and auditing educators serve on our Standing Advisory Group and PCAOB has collaborated with the AAA in four symposia held in our offices in Washington. A valuable byproduct of these joint efforts has been the preparation of nine synthesis papers on subjects of importance to the PCAOB, papers which cover audit confirmations, audit firm quality control, the audit reporting model, auditor risk assessments, communications with audit committees, engagement quality review, fair value, financial fraud, and related party transactions. The Treasury Advisory Committee on the Auditing Profession is close to completing its work and I have been the PCAOB's observer on the Human Capital Subcommittee. While the draft recommendations of this subcommittee have already been widely publicized and therefore their proposals will not come as a great surprise, the very fact that such a high-level group is putting such emphasis on human capital is significant in itself and should foster robust discussion both on and off campus. For example, the subcommittee's current draft involves a number of suggestions for new tasks for the PCAOB.

Directly related to the points that I have mentioned earlier, the draft draws attention to assuring "a sufficiently robust supply of qualified accounting faculty...", emphasizes "the utility and effectiveness of cross-sabbaticals" between practitioners and academia, recommends "expanding faculty fellowship programs in agencies, such as those at the SEC and the FASB and making them available at the PCAOB." The draft also recommends implementing "market-driven, dynamic curricula and content for accounting students that continuously evolve to meet the needs of the auditing profession", and regularly updating "the accounting certification examinations to reflect changes in the accounting profession, its relevant professional and ethical standards, and the skills and knowledge required to serve increasingly global capital markets." The subcommittee also recommends that the PCAOB produce a public annual report including among other things key indicators of audit quality and effectiveness.

I cite all of this as an example of how we as regulators and you as practitioners, faculty and students are in this together. I have diligently searched the literature and have yet to find a generally-accepted definition of audit quality. Maybe you can help me. Most if not all attempts to define and measure audit quality focus on either inputs or outputs. Inputs might include the size, experience, and competence of the engagement team or the number of hours spent on the engagement. Another input might be compliance with applicable auditing standards. Regrettably, there is no guarantee that these inputs are indicative of audit quality. As for professional standards, even when they are scrupulously followed it may later develop that there was collusive management fraud hidden from and not detected by the auditor. Or a company might file for Chapter 11 even though the audit raised no going concern issues. Output measures might include providing reasonable assurance to investors that the issuer's financial statements fairly present the results of its operations. But this hardly measures audit quality. The reasoning is almost circular: a quality audit results from audit quality.

PCAOB's inspectors approach this conundrum (how to judge audit quality without a definition of "audit quality") by reviewing potential defects in a firm's quality control system, examining not only a firm's stated quality control policies and procedures but

also inferences which can be drawn from instances in the actual performance of engagements. This is actually consistent with the Sarbanes-Oxley Act, which does not mention audit quality at all but does hone in on quality controls. Thus the scope of PCAOB inspections includes tone at the top, partner evaluation, compensation, admission, and disciplinary actions; client acceptance and retention policies; the firm's internal consultation process; and its self-inspection program, among others.

To wrap up, PCAOB was created by the Congress "to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." Only the combined efforts of many, many people can accomplish that goal. Each of us in this room has an important role to play. So I close by thanking you for what you do every day to reach the objectives we all share.

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