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Improving Global Audit Quality and Transparency

Presentation of the Working Group Subcommittee on
Global Networks and Audit Firm Governance

PCAOB Investor Advisory Group
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Improving Firm Transparency and Governance

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Improving Firm Transparency and Governance

- In recent decades, transparency and independent governance have been established as basic principles that promote more effective and efficient organizations.
- The large audit firms are loose affiliations of audit firms from throughout the world, whose transparency varies greatly throughout the organizations.
 - EU eight directive
- They lack the basic independent governance most public companies have around the globe.
- ACAP recommended greater transparency through annual reports.
- ACAP and others have also recommended improving governance.

Improving Firm Transparency and Governance - Recommendations

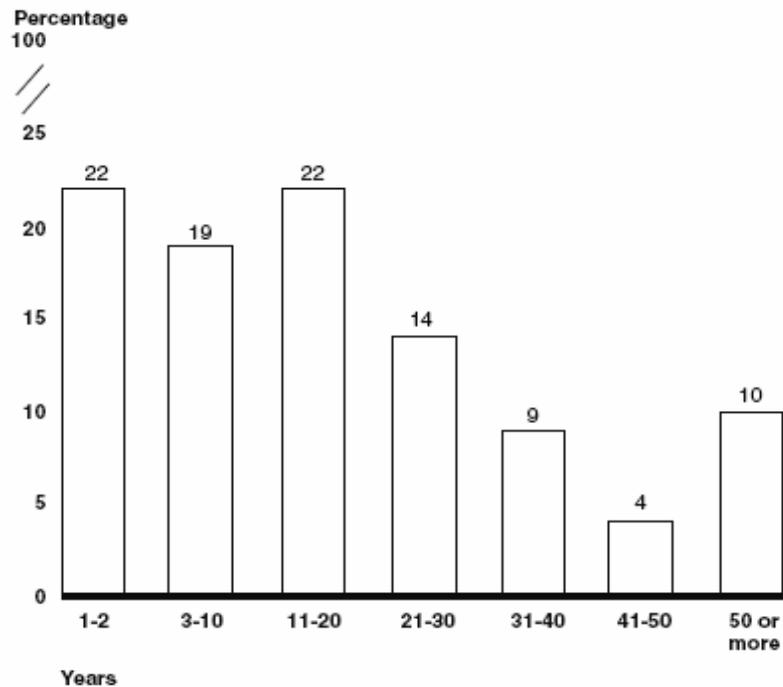
- The firms produce an annual report filed with the PCAOB that is made public and certified to by the executives of the firm. We also believe the report should include the annual financial statements of the audit firm prepared in accordance with GAAP.
- We support the PCAOB requiring the governing boards of the firms, either on the board itself or on an advisory board, appoint no less than 3 independent members. These independent members should include in the annual report of the firm, a report on their activities for the year.
- We urge the new chairman of the PCAOB, as well as the entire board, to continue to ask congress to pass legislation make its disciplinary proceedings public.

Independence of Audit Firms

- Firms are increasingly moving back into consulting.
- Concerns over “Coziness” of the firms.
- Firms appear reluctant to disclose material information to investors unless a specific requirement exists.

Independence of Audit Firms

Figure 1: Estimated Audit Firm Tenure for Fortune 1000 Public Companies



Source: GAO analysis of survey data.

Independence of Audit Firms

	Post Andersen*
Companies changing auditors	6,543
% of public companies	51.9%
Total auditor changes	7,629
Auditor-turnover rate	60.6%

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

Independence of Audit Firms

- We believe the PCAOB should undertake a project to establish periodic mandatory rotation of the auditor, for example every ten years. During that time period, to strengthen auditor independence and avoid any “opinion shopping”, we would recommend that any rules adopted permit the auditor to be removed only for cause, as defined by the PCAOB.
- We believe that any costs of mandatory rotation will be outweighed by the benefits that are likely to be achieved, including increased confidence in financial reports, if not outright improvement in the accuracy and completeness of these reports.

Increasing Global Audit Quality

- Business today is global
 - IBM, GE and Coca Cola derive a majority of their revenues from outside the US.
- Investors are increasingly allocating capital to foreign markets as their GDP growth and investment returns are higher.
- Global audits and inspection of those audits has not kept pace – has fallen behind – with the globalization of capital markets, business and trade.
- Firms continue to rely on outdated, low quality process of “credentialling”

Increasing Global Audit Quality

- the “...inspection team identified what it considered to be audit deficiencies. The deficiencies identified included a deficiency of such significance that it appeared to the inspection team that in one of the audits the Firm did not obtain sufficient competent evidential matter to fulfill the objectives of its role in the audit. That deficiency was the failure to report to the principal auditor waived audit adjustments that exceeded the threshold specified in the principal auditors' instructions.”

Increasing Global Audit Quality

- Problems with audits of Chinese companies.
- Inability to perform joint inspections.
 - Uninformed investors.

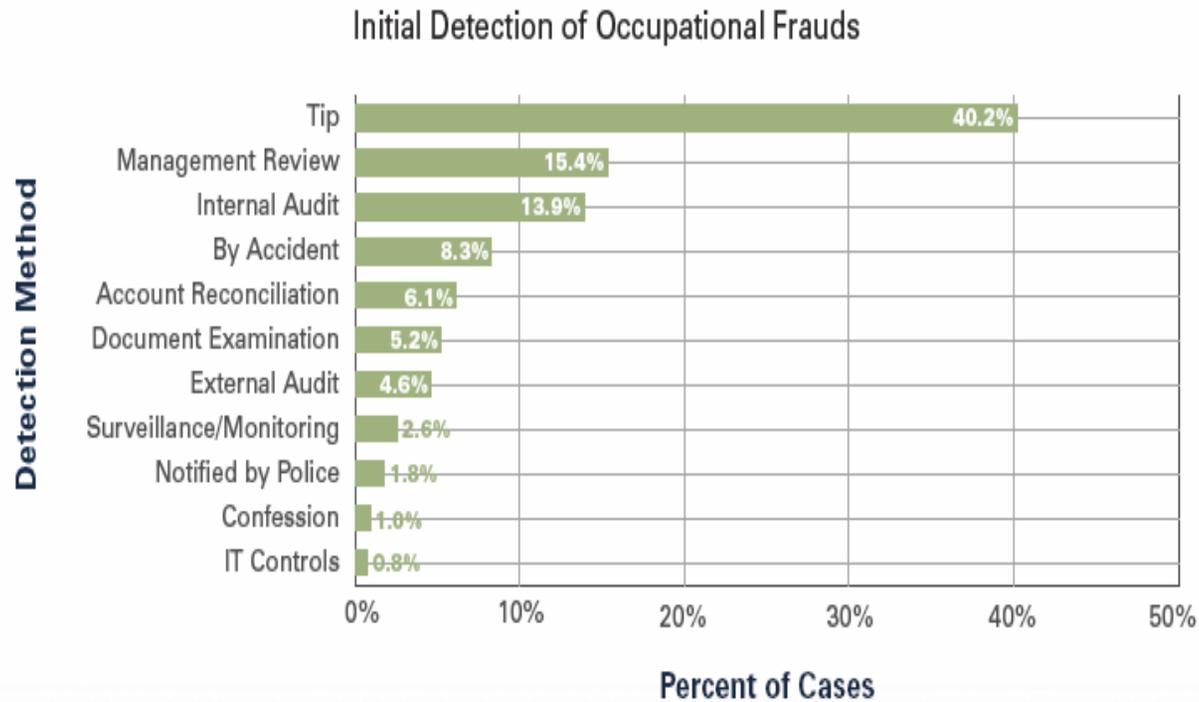
Increasing Global Audit Quality

- We recommend inclusion in the annual report of the audit firm, of its key quality control factors, global quality control processes, and how it is structured and operate should contribute to the transparency and quality of global audits.
- We recommend the PCAOB, as it updates its standards, undertake to study and strengthen the supervision by the lead responsible partner, of the foreign audit work performed. We do not believe mere acceptance of the foreign auditors “credentials” is sufficient to ensure high quality audits are performed, and the interests of investors are adequately protected.
- We believe the auditor’s report should be modified to state the amount or percentages of assets and revenues that have been audited by any auditor, who has refused to be inspected by the PCAOB. We support the PCAOB’s efforts to negotiate joint inspection agreements with foreign regulators. However, we do not believe mere reliance on those regulators inspections, without first determining and monitoring their quality, is an acceptable protection for investors.

Improving Fraud Detection Through Forensic Audit Procedures

- A study by the Association of Certified Fraud Examiners found that companies may be losing up to 5% of their revenues to fraud. That study also found that independent audits fair fairly poorly when it comes to detecting fraud.

Improving Fraud Detection Through Forensic Audit Procedures



Improving Fraud Detection Through Forensic Audit Procedures – Panel on Audit Effectiveness Recommended

- Introduction of a “forensic-type fieldwork phase.” Not unlike the traditional planning, interim, final and review phases of audits, this new forensic-type phase should become an integral part of the audit, with careful thought given to how and when it is to be carried out.
- Auditing standards should require in this phase:
 - Performance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal control by management (recognizing that management includes many levels of personnel in an entity, including personnel outside of the United States, and not just top corporate-level management.”

Improving Fraud Detection Through Forensic Audit Procedures

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