



STATEMENT OF

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BEFORE THE U.S. DEPARTMENT OF LABOR  
ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT  
PLANS

August 31, 2010



Thank you for inviting a representative of the Public Company Accounting Oversight Board (“PCAOB” or “Board”) to appear before the U.S. Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans (“the Council”).<sup>1</sup> I am Michael Stevenson, Deputy General Counsel for the Board, and we welcome the opportunity to assist the Council.

Based on conversations that Mr. David Evangelista and Mr. Kevin Wiggins have had with members of the PCAOB staff, we understand that the Council would like this presentation to focus on the authority that allows the PCAOB to evaluate the competence and qualifications of auditors engaged in certain types of audit work and, when necessary, to discipline those auditors. We also understand that you have an interest in the legal and professional requirements that may result in an auditor informing the Securities and Exchange Commission of an audit client’s illegal acts that come to the auditor’s attention during the course of an audit. My statement will address all of those issues.

### **Brief Overview of the PCAOB and Its Jurisdiction**

Before the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act” or “Act”)<sup>2</sup> created the PCAOB, auditing standards were set by the accounting profession, and audit quality was monitored through a system of “peer reviews,” in which firms reviewed and reported on the quality of other firms’ work. These activities were funded by the accounting profession and, according to critics, resulted in

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<sup>1</sup> Views expressed in this statement are those of the individual making this presentation and do not necessarily reflect the views of the Board, members of the Board, or other PCAOB staff.

<sup>2</sup> The Sarbanes-Oxley Act of 2002, 107<sup>th</sup> Cong., 2d Sess. (2002); 15 U.S.C. §7201, *et seq.*



auditing “standards that tended to be written to protect the accounting firms” and, in more than 20 years of peer reviews, no negative peer review reports on any major firm.<sup>3</sup>

In 2001-2002, questions about the sufficiency of that framework came into sharpened focus as audit failures at Enron, WorldCom, and other companies contributed to investor losses of billions of dollars. In response to these failures, Congressional committees conducted more than two dozen hearings and considered more than 20 bills intended to strengthen corporate reporting practices and to restore confidence in audits of public companies’ financial statements. Recognizing that the profession’s system of regulation had failed to protect investors, Congress sought to end the system of self-regulation in the accounting profession and to replace it with a strong independent accounting oversight board.

Accordingly, the Sarbanes-Oxley Act established the PCAOB to oversee audits of companies that are subject to the securities laws, and related matters, in order to protect investors and further the public interest in the preparation of informative, accurate and independent audit reports.<sup>4</sup> Under the Act, an accounting firm cannot engage in certain audit work without first being registered with the PCAOB. Once registered, any such work performed by the firm and its associated persons is governed by auditing and related professional practice

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<sup>3</sup> Accounting Reform and Investor Protection: Hearings Before the Subcommittee on Banking, Housing and Urban Affairs, 107<sup>th</sup> Cong., 217 (2002) (testimony of Lynn E. Turner); *see also id.* (testimony of Charles A. Bowsher and Harold M. Williams).

<sup>4</sup> Sarbanes-Oxley Act, section 101(a).



standards set by the PCAOB,<sup>5</sup> is subject to review in a PCAOB inspection, and could be a basis for sanctions imposed by the PCAOB.

As originally enacted, the scope of this authority related only to audit work in connection with the financial statements of “issuers,” a term defined in the Act to mean, essentially, public companies, whether located in the United States or abroad, that have registered or taken certain steps to register securities under the federal securities laws or that are otherwise subject to certain SEC filing requirements.<sup>6</sup> Recent amendments to the Act have broadened the scope of this authority to include audits of financial statements of securities brokers and dealers.

Accordingly, under the current version of the Act, it is unlawful for any person that is not a public accounting firm registered with the PCAOB to prepare or issue any audit report with respect to any issuer, broker, or dealer.<sup>7</sup> It is also

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<sup>5</sup> Pursuant to section 103 of the Sarbanes-Oxley Act, the Board establishes auditing, attest, quality control, ethics, independence, and other standards relating to audit work within the Board's jurisdiction.

<sup>6</sup> Specifically, section 2(a)(7) of the Sarbanes-Oxley Act defines “issuer” to mean an entity that is an issuer as defined in section 3 of the Securities Exchange Act of 1934 (“Exchange Act”) and that has registered any of its securities under section 12 of the Exchange Act, or is required to file reports under section 15(d) of the Exchange Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 and that it has not withdrawn. So defined, “issuer” includes, among other things, certain employee benefit plans that file reports with the SEC on Form 11-K, but does not include the large majority of the pension plans that are within the Council’s jurisdiction.

<sup>7</sup> Sarbanes-Oxley Act, section 102(a), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111<sup>th</sup> Cong., 2d Sess. (2010) (“Dodd-Frank Act”), at section 982. Under Dodd-Frank section 982(e), however, the Board may establish a program of inspection for auditors of brokers and dealers and may exempt certain auditors from that inspection program; auditors exempt from the inspection program would not be required to be registered with the Board. See also the Securities

unlawful for any person that is not a registered public accounting firm to play a “substantial role” in any such audit, as that term is defined in PCAOB rules.<sup>8</sup> As of August 12, 2010, there were 2,434 firms registered with the Board.<sup>9</sup> Not all of these firms issue audit reports, or play a role in audits, for issuers, brokers, or dealers, and thus not all of them perform work within the scope of the Board’s standard-setting, inspection, and disciplinary authority. Every registered firm, however, must file an annual report with the PCAOB, and also must file special reports if certain reportable events occur, to provide the PCAOB and the public with updated information about the firm and its audit practice.

The Board exercises its authority subject to the oversight of the SEC. The SEC appoints and can remove Board members. The PCAOB is subject to rules and orders promulgated by the SEC. Moreover, the PCAOB’s own rules, including its auditing and related professional practice standards, are not effective unless approved by the SEC. In addition, a firm may seek SEC review of adverse inspection results, and no PCAOB disciplinary sanction against a firm or person takes effect before the respondent has had an opportunity to seek SEC review of the sanction. The PCAOB’s annual budget also is subject to SEC approval.<sup>10</sup>

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Exchange Act of 1934 (the “Exchange Act”) section 17(e)(1)(A), 15 U.S.C. 78q(e)(1)(A), as amended by the Dodd-Frank Act, section 982(e)(2).

<sup>8</sup> See PCAOB Rule 2100(b), which implements section 102(a) of the Act (requiring registration for any firm that would “participate” in the preparation or issuance of an audit report) and section 106(a) (authorizing the Board to require registration of foreign public accounting firms that do not issue audit reports but play a “substantial role” in the preparation and furnishing of such reports). PCAOB Rule 1001(p)(ii) defines “substantial role” for purposes of the registration requirement.

<sup>9</sup> Of these firms, 924 are foreign firms located in 87 non-U.S. jurisdictions.

<sup>10</sup> The Act provides for the PCAOB’s budget to be funded through an annual accounting support fee assessed on public companies in proportion to their average

## **Evaluation of the Competence and Qualifications of Registered Firms and Their Associated Persons – Registration and Inspections**

To some degree, the Board evaluates a firm's qualifications by examining certain information during the registration application process. Registration is not automatic, and the Board takes into account, among other things, whether an applicant is appropriately licensed, an applicant's disciplinary history, and indications of possible pre-registration violations of the registration provision of the Sarbanes-Oxley Act. The Act requires the Board to take action on a completed application within 45 days.<sup>11</sup> If the Board acts to disapprove an application, the disapproval order is treated as a disciplinary sanction for purposes of reporting the action to the SEC, state and foreign licensing authorities, and the public.<sup>12</sup> The applicant may also seek SEC review of a contested disapproval order.<sup>13</sup>

The principal way in which the Board evaluates the competence of registered firms and their associated persons, however, is through its inspection process. The Sarbanes-Oxley Act gives the Board the authority and the responsibility to conduct inspections to assess compliance with certain laws, rules, and professional standards in connection with a firm's audit work that is within the scope of the Board's jurisdiction.<sup>14</sup> These inspections form the core of

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market capitalizations and, beginning in 2011, an accounting support fee assessed on brokers and dealers in proportion to their relative net capital.

<sup>11</sup> Sarbanes-Oxley Act, section 102(c)(1); see *also* PCAOB Rule 2106.

<sup>12</sup> Sarbanes-Oxley Act, sections 102(c)(2). PCAOB registration disapproval orders are available at <http://pcaobus.org/Registration/Firms/Pages/DisapprovalNotices.aspx>.

<sup>13</sup> Sarbanes-Oxley Act, sections 102(c)(2) and 107(c).

<sup>14</sup> Sarbanes-Oxley Act, section 104(a), as amended by the Dodd-Frank Act, section 982.



the PCAOB's oversight of registered firms, and registered firms and their associated persons have an enforceable obligation, rooted in the Sarbanes-Oxley Act, to cooperate in those inspections, including producing any work papers and other documents and information requested by the PCAOB.<sup>15</sup>

As mentioned above, many registered firms perform no work that is within the Board's standard-setting or inspection authority, and the PCAOB does not inspect those firms. The PCAOB regularly inspects firms that issue audit reports opining on the financial statements of issuers.<sup>16</sup> Currently, there are approximately 850 such registered firms, although the precise number fluctuates as some firms begin for the first time to issue audit reports for issuers and other firms cease to do so. In general, the PCAOB inspects each firm in this category either annually or triennially, depending upon whether the firm provides audit reports for more than 100 issuers (inspected annually) or 100 or fewer issuers (inspected at least triennially).<sup>17</sup> At any time, the PCAOB might also inspect any

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<sup>15</sup> Section 102(b)(3) of the Sarbanes-Oxley Act provides that a firm's application for registration with the PCAOB shall include a consent executed by the firm to cooperate in and comply with any request for testimony or the production of documents made by the Board in the furtherance of its authority and responsibilities under the Act, and shall also include an agreement to secure and enforce similar consents from each of the firm's associated persons as a condition of their continued employment or other association with the firm. PCAOB Rule 4006 also requires every registered firm and associated person to cooperate with the Board in inspections. The Board can impose, and has imposed, sanctions for failing to cooperate in inspections, including permanently revoking a firm's registration and permanently barring an individual from association. In one contested case, the SEC recently sustained those Board sanctions against a firm and its principal for failing to cooperate in an inspection. See *In the Matter of the Application of Gately & Associates, LLC and James P. Gately, CPA*, SEC Release No. 34-62656 (August 5, 2010), available at <http://www.sec.gov/litigation/opinions.shtml>.

<sup>16</sup> In light of the recent expansion of the Board's authority to include audits of brokers and dealers, the Board will also be developing a program for inspecting auditors of brokers and dealers.

<sup>17</sup> Sarbanes-Oxley Act, section 104(b); PCAOB Rule 4003. The Board may, by rule, adjust inspection schedules if it finds that different schedules are consistent with the



other registered firm that plays a role in the audit of an issuer, and the PCAOB has begun a practice of inspecting, in each year, some firms in that category.

Firms subject to triennial inspections vary considerably in nature and size. The U.S. firms in the triennial inspection category range from sole proprietorships to larger regional firms, some of which have multiple offices. The size and complexity of these domestic firms' audit clients also vary, and include small, unlisted companies, 401(k) or other savings plans of larger companies, shell companies, regional financial institutions, as well as local public companies that are listed on an exchange.

There are also approximately 250 non-U.S. firms in the triennial inspection category. Unlike the domestic firms that are subject to triennial inspections, many of the non-U.S. firms are members of a global network of firms that share a common name and certain policies, practices, audit methodologies and business interests. In addition, these non-U.S. firms can be quite large, with thousands of employees and multiple offices in their home country. These firms audit issuers based outside the U.S. that are subject to SEC reporting requirements because they choose to have their securities trade in U.S. markets. In addition, these non-U.S. firms audit financial information of subsidiaries and other branches of many U.S.-based multi-national public companies. Non-U.S. issuers and U.S. multinational public companies are some of the largest public companies in the world and the securities of these companies figure prominently in investors' retirement and other savings plans.

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purposes of the Sarbanes-Oxley Act, the public interest, and the protection of investors. See Sarbanes-Oxley Act, section 104(b)(2).



Since 2003, the PCAOB has conducted more than 1,300 inspections of registered firms. Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. To achieve that goal, Board inspections include reviews of certain aspects of selected audit work performed by the firm, and since 2003 PCAOB inspectors have reviewed aspects of more than 6,000 audits.<sup>18</sup> Inspectors also review the design and operation of firms' quality control policies and procedures. Once PCAOB inspectors identify a problem, they focus the firm on the need to address it, both in individual audits and systemically. Although PCAOB inspectors do not interact directly with public companies, firms' work following up on deficiencies identified in PCAOB inspections has led to restatements or other corrections to financial statements.

PCAOB inspectors select audits for inspection based on an assessment of audit and financial reporting risks, including risks identified by the PCAOB's Office of Research and Analysis ("ORA"). The PCAOB, through ORA, devotes considerable resources to collecting and analyzing data from public sources, vendors, registered firms, and other sources. ORA also uses an array of research and analysis to monitor financial reporting and auditing risks, such as by combining nonpublic data collected in the inspection process with publicly available data relating to public companies' financial reporting, debt and equity markets, and corporate governance, in order to identify, and assist PCAOB inspectors in focusing on, audits and aspects of audits that may pose significant auditing challenges or other risk factors. These surveillance activities also include monitoring news feeds and maintaining data-mining applications to

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<sup>18</sup> In 2009 alone, PCAOB inspectors reviewed portions of more than 350 audits performed by the 10 firms subject to annual inspection, and portions of more than 730 audits performed by 277 other firms inspected that year.

identify indications of risk that the financial statements of a particular company may be materially misstated.

As a result of this risk-based focus, PCAOB inspectors have in recent inspection cycles examined aspects of audits for several companies in the financial services industry. This involves, among other things, reviewing audit work related to complex financial instruments and transactions. In addition, PCAOB inspectors examined areas highlighted in the PCAOB's December 2008 Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment*, including areas requiring the use of estimates and fair value measurements. Many audit risks, of course, arose from or were exacerbated by the financial crisis, including risk relating to market volatility; the going concern assumption; revenue recognition; valuation of long-lived assets, including goodwill; management estimates, in particular those related to assets with potential impairment or loss of value; and fair value assumptions for complex financial instruments.<sup>19</sup>

In addition to reviewing audit performance, an inspection involves an evaluation of the firm's system of quality control. PCAOB inspectors generally have focused on the following functions and processes, among others, and as applicable in light of the nature and management structure of the firm:

- Management structure and processes, including tone-at-the-top;
- Practices for partner management, including allocation of partner resources and partner evaluation, compensation, admission and disciplinary actions;

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<sup>19</sup> In addition, PCAOB inspectors inspect audits of internal control over financial reporting under Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS No. 5).

- Policies and procedures for considering and addressing the risks involved in accepting and retaining clients, including the application of risk-rating systems;
- Supervision by U.S. audit engagement teams of audit work that foreign affiliates perform on the foreign operations of U.S. issuer audit clients;
- Processes for monitoring audit quality, including the firm's internal inspection program;
- Policies and procedures for considering independence implications of non-audit services; business ventures, alliances and other arrangements; personal financial interests; commissions and contingent fees; and,
- Practices for consultations on accounting, auditing, and SEC financial reporting matters.

The PCAOB gains an understanding of, and evaluates, the management processes used by each firm to monitor and control the quality of their audit practices. Inspection procedures for large firms also focus on areas that allow the Board to consider the design and operating effectiveness of specific aspects of firms' systems of quality controls. Among other areas, the PCAOB focuses on a firm's ability to identify, accumulate, evaluate, and respond to significant indications of weaknesses or deficiencies in audit quality on both an individual engagement level and on a firm-wide basis.

The Act requires the Board to prepare a written report of each inspection and to transmit that report, in appropriate detail, to the SEC and relevant state regulatory authorities.<sup>20</sup> The Act also provides that each report must be made available to the public, in appropriate detail, subject to certain limitations on what

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<sup>20</sup> Sarbanes-Oxley Act, section 104(g)(1).

may be disclosed publicly.<sup>21</sup> The Board's practice has been to make publicly available a portion of the report that summarizes anything that the inspectors viewed as a deficiency in a reviewed audit that was of such significance that, in the inspectors' view, the firm did not obtain sufficient competent evidential matter to support its audit opinion. This portion of every inspection report is available on the PCAOB's website.<sup>22</sup> The full inspection report issued to the firm may include additional detail concerning audit deficiencies and related issues and also may include criticisms of the quality control system of the firm.<sup>23</sup>

Under the Act, any portions of an inspection report that deal with criticisms of or potential defects in the quality control system of the firm must remain nonpublic if the firm addresses those criticisms or defects to the Board's satisfaction within 12 months of the report's issuance. If the firm fails to satisfactorily address a quality control criticism within 12 months, the Board expands the publicly available version of the inspection report to reveal that criticism. This provides what has appeared to be a significant incentive for firms to improve the quality of their audit practices. For example, this incentive has prompted management at the highest levels of the large firms to engage with the PCAOB in an ongoing dialogue, with the goal of satisfying the Board that the

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<sup>21</sup> Sarbanes-Oxley Act, section 104(g)(2).

<sup>22</sup> See <http://pcaobus.org/Inspections/Reports/Pages/default.aspx> for the public portions of PCAOB inspection reports.

<sup>23</sup> Other than what is disclosed through the public portion of an inspection report, PCAOB inspections are, by law, confidential and non-public. The Act, however, authorizes the Board to share information gathered in PCAOB inspections with the SEC, the U.S. Department of Justice, state attorneys general, appropriate state regulatory authorities, certain federal banking regulators (with respect to audits of institutions within their jurisdiction), securities industry self-regulatory authorities (with respect to audits of brokers or dealers within their jurisdiction), and foreign auditor oversight authorities (with respect to public accounting firms within their jurisdiction). Sarbanes-Oxley Act, section 105(b)(5)(B), as amended by the Dodd-Frank Act, sections 981 and 982.

firms are making meaningful progress to address identified quality control concerns. While this statutorily created framework deliberately restricts the public transparency that the Board may provide regarding the identified concerns, it is intended to promote long-term benefits to investors from the corrective actions the firms undertake to satisfy the Board.<sup>24</sup>

### **Imposing Sanctions on Registered Firms and Associated Persons**

The Sarbanes-Oxley Act authorizes the PCAOB to investigate auditor conduct that may violate auditing and related professional practice standards, the Act and PCAOB rules, and other laws and rules applicable to preparation and issuance of audit reports and related obligations and liabilities of accountants.<sup>25</sup> The Sarbanes-Oxley Act also empowers the Board to impose appropriate disciplinary or remedial sanctions on registered firms and associated persons who violate those laws, rules or standards.<sup>26</sup> In addition to authority to impose sanctions for such violations, the Act authorizes the Board to impose sanctions for failing to reasonably supervise another person who has committed such a violation, and also authorizes the Board to impose sanctions for failing to cooperate with a PCAOB investigation.

The PCAOB's enforcement program pursues investigations and disciplinary proceedings in significant matters. The PCAOB's inventory of

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<sup>24</sup> For additional information about the quality control remediation process, see The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports, PCAOB Release No. 104-2006-077 (March 21, 2006), available at <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

<sup>25</sup> Sarbanes-Oxley Act, sections 105(a) and (b).

<sup>26</sup> Sarbanes-Oxley Act, sections 105(a) and (c).

enforcement matters includes audits of varying sizes and complexity, including matters related to audits by large firms for issuer audit clients involved in the financial crisis.

PCAOB investigations are, by law, confidential and non-public, although the same provision of the Act that authorizes the Board to share non-public inspection information with other specified authorities<sup>27</sup> also allows the Board to share with those authorities information gathered in PCAOB investigations. In practice, the PCAOB closely coordinates its enforcement efforts with those of the SEC, which has concurrent enforcement jurisdiction over auditors of issuers' financial statements.<sup>28</sup> In certain instances, the PCAOB will investigate the auditor's conduct and the SEC will focus its investigation on the public company, its management and other parties. In other cases where the SEC takes responsibility for an investigation, the PCAOB has deferred certain investigations and has refrained from commencing certain disciplinary proceedings at the request of the SEC's Division of Enforcement.

Investigations may lead the Board to institute disciplinary proceedings to determine whether to impose sanctions on registered firms and their associated persons. Many such proceedings have been settled, either simultaneously with being instituted or sometime after the institution of proceedings. In those cases, the sanctions ordered by the Board take effect immediately and the sanction order is made publicly available on the Board's web site.<sup>29</sup> Settled Board

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<sup>27</sup> See footnote 23.

<sup>28</sup> See Sarbanes-Oxley Act, section 105(b)(4).

<sup>29</sup> See <http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx> for public PCAOB sanction orders.

disciplinary orders have imposed sanctions covering the range of sanctions available to the Board, from censure to permanent revocation of a firm's registration, permanent bar on an individual's association with registered public accounting firms, and civil money penalties. The Board's authority to impose sanctions is set out in the Act at section 105(b)(3) (for noncooperation with an investigation), at section 105(c)(4)-(5) (for violations of standards, laws, and rules), and at section 105(c)(6) (for failure reasonably to supervise a person who commits a violation).<sup>30</sup>

The Board has also instituted several proceedings that have been, and are being, contested. Under the Sarbanes-Oxley Act, contested proceedings are non-public unless the respondents consent to public proceedings and the Board finds good cause to order public proceedings.<sup>31</sup> Contested proceedings include a hearing before a PCAOB hearing officer, who issues an initial decision, and an opportunity to appeal the hearing officer's decision to the Board. If, in a contested proceeding, the Board issues an order imposing sanctions, the respondent has an opportunity to seek SEC review of the sanction. The Act provides that if the respondent files a timely petition for SEC review, the operation of the Board-ordered sanction is stayed. The sanction does not take effect, and cannot be publicly reported by the Board, unless and until the SEC lifts that stay.<sup>32</sup> Just recently, the SEC for the first time issued a decision on review of a contested Board-imposed sanction. The SEC sustained the Board's

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<sup>30</sup> The section 105(c)(6) sanctioning authority is the subject of a recent Board release, Application of the "Failure to Supervise" Provision of the Sarbanes-Oxley Act of 2002 and Solicitation of Comment on Rulemaking Concepts, PCAOB Release No. 2010-005 (August 5, 2010). See <http://pcaobus.org/Rules/Rulemaking/Pages/Docket031.aspx>.

<sup>31</sup> Sarbanes-Oxley Act, section 105(c)(2).

<sup>32</sup> Sarbanes-Oxley Act, sections 105(e) and 105(d)(1)(C).



findings and the sanctions imposed by the Board – permanently revoking a firm’s PCAOB registration and permanently barring the firm’s principal from being associated with any registered public accounting firm.<sup>33</sup>

### **Establishing Auditing Standards and Related Professional Practice Standards**

A discussion of the Board’s authority to assess auditors’ competence, and to sanction auditors for failures, would be incomplete without a brief discussion of the Board’s authority to set professional standards. It is principally those standards (in addition to relevant laws and rules) against which inspections measure an auditors’ performance and for violations of which the Board exercises its sanctioning authority.

The Sarbanes-Oxley Act gave the PCAOB the responsibility to set auditing and attestation, quality control, ethics and independence standards against which to measure the conduct of firms and associated persons in inspections and, as necessary, disciplinary proceedings. To this end, the Board maintains an active standard-setting program to protect investors with auditing and related professional practice standards that strengthen the reliability of public company audits. In doing so, the Board uses a notice-and- comment process similar to the process used by federal agencies, by which the Board proposes standards for public comment, sometimes multiple times and sometimes including public solicitation of comments on a concept release, before adopting new or amended standards. Standards adopted by the Board do not take effect

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<sup>33</sup> The SEC’s decision, *In the Matter of the Application of Gately & Associates, LLC and James P. Gately, CPA*, SEC Release No. 34-62656 (August 5, 2010), is available on the SEC’s web site at <http://www.sec.gov/litigation/opinions.shtml>.



unless they are approved by the SEC. The SEC's approval process generally includes another notice-and-comment process.

To receive additional input and advice as it develops standards, the Board uses a Standing Advisory Group ("SAG") comprised of individuals with backgrounds in investor advocacy, auditing, financial statement preparation, academia and other areas. A standard setting agenda, with projected milestones for several projects, is on the PCAOB website.<sup>34</sup>

An example of the Board's standard-setting process is the recent adoption of eight new auditing standards, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, which collectively update the requirements for assessing and responding to risk in an audit. The Board initially proposed these standards on October 21, 2008, re-proposed them on December 17, 2009, and adopted them on August 5, 2010. These standards have been sent to the SEC, which will consider whether to approve them in accordance with the process prescribed by the Sarbanes-Oxley Act.<sup>35</sup>

The risk assessment and response standards adopted by the Board include changes made in response to comments received on the original and re-proposed standards and other refinements. The standards supersede the Board's interim auditing standards for audit risk and materiality; audit planning and supervision; consideration of internal control in an audit of financial statements; audit evidence; performing tests of accounts and disclosures before

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<sup>34</sup> See <http://pcaobus.org/Standards/Pages/CurrentStatus.aspx> (under "Related Information").

<sup>35</sup> See Sarbanes-Oxley Act, section 107(b), and the Dodd-Frank Act, section 916.

year-end; and evaluating disclosures. The new standards are designed to provide for more robust risk assessments and more rigorous procedures to respond to identified risks. The standards also enhance the integration of the audit of financial statements with the audit of internal control over financial reporting. In addition, the standards emphasize the auditor's responsibility to consider the risk of fraud throughout the audit and contain new requirements intended to improve an auditor's evaluation of disclosures in financial statements.

### **Requirements for Auditors to Report Potential Illegal Acts**

The Council has expressed interest in a discussion of the legal and professional requirements that may result in an auditor informing the Commission of potential illegal acts that come to the auditor's attention during the course of an audit.

Section 10A of the Exchange Act requires, among other things, that the auditor of an issuer's financial statements report to the issuer's board of directors certain uncorrected illegal acts of the issuer, and that the issuer notify the Commission that it has received such a report. If the issuer fails to provide that notice, the auditor is required by section 10A to furnish directly to the Commission the report given to the Board.

At the time of its original adoption in 1995, Section 10A codified certain professional auditing standards, which remain a part of PCAOB interim auditing standards today,<sup>36</sup> regarding the detection of illegal acts by issuers.<sup>37</sup> It

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<sup>36</sup> See "Illegal Acts by Clients," AU 317.

<sup>37</sup> Exchange Act section 10A(f) defines the term "illegal act" broadly to mean "an act or omission that violates any law, or any rule or regulation having the force of

expanded obligations on auditors to report in a timely manner certain uncorrected illegal acts to an issuer's board of directors. It further requires the issuer or, if the issuer fails to do so, the auditor to provide information regarding the illegal act to the Commission.

Specifically, section 10A provides that any audit of the financial statements of an issuer by a registered public accounting firm must include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts. If, in the course of such an audit, the auditor detects or becomes aware of information indicating that an illegal act has, or may have, occurred, then the auditor is required to determine whether it is "likely" that an illegal act has occurred and, if so, its possible effect on the financial statements (including any contingent monetary effects, such as fines, penalties, and damages).<sup>38</sup> The auditor would be required to inform the issuer's management of the illegal act "as soon as practicable." In addition, the auditor must assure that the issuer's board of directors adequately is informed, by management or otherwise, of any detected illegal act, unless the illegal act is clearly inconsequential.<sup>39</sup>

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law." This definition is consistent generally with the definition in PCAOB auditing standards. See AU 317.02 (January 1, 1989), which states, "the term illegal acts . . . refers to violations of laws or governmental regulations."

<sup>38</sup> Exchange Act, section 10A(b)(1)(A). See AU 317.10-.15. AU 317.11 sets forth additional audit procedures that might be necessary once the auditor becomes aware of a possible illegal act.

<sup>39</sup> Exchange Act, section 10A(b)(1)(B). See AU 317.17.

Although PCAOB standards contain procedures for similar notification of illegal acts to management and the board of directors,<sup>40</sup> section 10A(b) contains the additional requirement that this notification occur "as soon as practicable."<sup>41</sup>

After the auditor determines that the audit committee or the board of directors has been adequately informed of an illegal act, if the auditor reaches the three conclusions described below, the auditor is required by section 10A(b)(2) to report those conclusions directly to the board of directors "as soon as practicable" –

1. The illegal act has a material effect on the issuer's financial statements,
2. Senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act, and
3. The failure to take remedial action is reasonably expected to warrant either a departure from the auditor's standard audit report, when made, or the auditor's resignation from the audit engagement.<sup>42</sup>

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<sup>40</sup> AU 317.10 and .17.

<sup>41</sup> The addition of this time period reflects the original legislative efforts in this area to provide an earlier warning to the SEC of registrants' potential illegal acts than may have occurred under then-existing Form 8-K procedures and in audit reports. See H.R. Rep. No. 102-890, 102d Cong., 2d Sess. 3 (1992), which contained the predecessor legislation to Section 10A and stated:

This legislation amends the Securities Exchange Act of 1934 (Exchange Act) to improve fraud detection and disclosure with respect to public companies by codifying auditing standards in certain specified areas and by providing a mechanism for earlier warning to the Securities and Exchange Commission of certain illegal acts by registrants.

<sup>42</sup> Exchange Act, section 10A(b)(2)(A), (B), and (C). See generally, AU 317.18-.22.



If the board of directors receives a report that the auditor has reached these conclusions, then the board has one business day to notify the Commission that it received such a report. If the auditor does not receive a copy of the board's notice to the Commission within that one business day period, then by the end of the next business day the auditor is required to furnish directly to the Commission a copy of the report given to the board (or the documentation of any oral report). The auditor's resignation from the audit engagement does not negate the auditor's obligation to furnish his or her report to the Commission in these circumstances.<sup>43</sup> Finally, section 10A provides that no registered public accounting firm shall be liable in a private action for any finding, conclusion, or statement expressed in any such report to the Commission.

## **Conclusion**

We hope that the information provided here supplies useful background as the Council considers issues relating to employee benefit plan auditing. We would be pleased to try to address any questions the Council has about these issues.

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<sup>43</sup> Exchange Act, sections 10A(b)(3) and (b)(4). See also Exchange Act Rule 10A-1; 17 CFR 240.10A-1.