

## SEC AND PCAOB SPEAKERS AT AICPA CONFERENCE URGE THE PROFESSION: STEP UP TO THE PLATE

**A**t the December 2010 AICPA National Conference on Current SEC & PCAOB Developments, representatives of the Securities Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) stressed themes of auditor independence, professional skepticism, audit quality, and restoring the public's confidence in the profession. From the SEC, Chair Mary Shapiro, Chief Accountant James Kroeker, and Deputy Chief Accountant Brian Croteau, as well as PCAOB Acting Chair Daniel Goelzer and Chief Auditor Martin Baumann, pounded a consistent drumbeat around these themes. Speakers also discussed inspection findings and the types of issues PCAOB inspectors will be watching closely.

This article discusses these comments, which urged the profession to be proactive in enhancing its reputation—in other words, to “step up to the plate.”

### INDUSTRY OR A PROFESSION?

Mr. Kroeker focused on the importance of public trust, asking whether the profession deserved its sometime reputation as an industry (not a profession) due to its commercial—as opposed to purely “public service”—bent. He and others referred repeatedly to the public's perception of the accounting profession, noting that,

*“...when dealing with the public trust, perception matters every bit as much as fact.”* As for perception, Mr. Croteau later referred to recent survey results released by the Center for Audit Quality (CAQ), which gauged individual investors' confidence in (among other things) public companies and their audited financial statements. According to that survey ([www.thecaq.org/newsroom/pdfs/2010toplineresults.pdf](http://www.thecaq.org/newsroom/pdfs/2010toplineresults.pdf)), auditors ranked fourth in terms of who (or what) does the best job protecting investor interests. Government regulations and oversight, financial analysts/brokers, and (interestingly) “none of the above” tied for first place, followed very closely by auditors and investigative journalists. The other possible responses (investors could select more than one) were: institutional investors, stock exchanges, corporate boards, corporate managements, and “other”.

### WHO'S YOUR CLIENT?

Despite SOX independence and corporate governance reforms, Mr. Kroeker said he believed more emphasis on independence and the auditor's duty to the public was needed. Though ingrained in the profession's standards and lexicon, he challenged auditors to seriously consider using the word “client” to refer to the company's shareholders, not its management, speculating the impact such change would have on young professionals. Mr. Kroeker suggested no less than a change in culture to enhance

transparency in financial reporting and bolster public trust—a message he directed to company accountants and auditors alike.

### MOVING BACKWARDS?

Sounding reminiscently like the late 1990s, the Chief Accountant also implored audit firm leaders to maintain and invest in audit quality and not allow the audit to become a cheap commodity that provides access to more lucrative nonaudit business. He said he hoped the firms would stay vigilant on auditor independence matters, and not let their consultancy practices quash objectivity.

### TIME TO BREAK THE CYCLE

Noting that inspection reports have identified similar deficiencies over each of the past three years (e.g., auditing fair value measurements and goodwill impairments), Mr. Croteau said it was important for firms and the board's inspectors to identify root causes of deficiencies found in inspections to “break the cycle of consistency in the findings” and help inform the PCAOB's standard-setting (e.g., quality control, auditing fair values).

### INDEPENDENCE REMINDERS

Mr. Croteau reminded attendees about two independence issues the staff is often consulted on: (1) when their clients file Initial Public Offerings (IPOs) or register an exchange of new

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public debt for a class recently placed in a 144A transaction, and (2) relationships with affiliates of their audit clients. On the first issue, Mr. Croteau said, *“Private companies and their auditors should consider their relationship and the possibility that the company might decide to raise public capital by filing a registration statement that requires audited financial statements that comply with SEC and PCAOB independence rules.”* In other words, the auditor must consider that many SEC and PCAOB independence rules are stricter than the AICPA rules. These filings generally include three years of financial statements and the auditor must be independent in accordance with SEC/PCAOB rules for all three years, even though the firm was not required to meet those requirements when the audits were performed. Mr. Croteau said the staff frequently sees situations in which auditors are not

independent for purposes of a filing because they performed bookkeeping and/or prepared the client’s financial statements (including the footnotes) during the preceding three years. Other nonaudit services and business relationships may also raise issues (**EXHIBIT 1** provides some examples). Proper planning is essential, he said, to prevent unnecessary delays and costs to clients.

On affiliates, Mr. Croteau said that auditors should not provide prohibited nonaudit services to affiliates of their audit clients. The definition of “affiliate” is more sweeping than some realize, particularly for private equity and venture capital firms. Mr. Croteau noted that “upstream” affiliates (such as a holding company, general partner, or trust) and “brother-sister” companies controlled by these firms are affiliates under the SEC rules. This holds true regardless of materiality;

thus, auditors are subject to the same services and other restrictions for these companies as their audit clients. **EXHIBIT 2** illustrates these rules. Lastly, Mr. Croteau urged auditors to consult with the staff on unique or complex independence matters.

### FEE PRESSURES

In discussing the PCAOB’s inspection program, Mr. Goelzer stated that inspectors will focus on whether audit fee pressures being exerted by their clients are reducing audit quality (i.e., are deficiencies caused by lower fees?). He said firms, especially the largest ones, need to be proactive in managing their practices and developing tools that allow them better control over their partners’ work.

### FOCUS ON NONAUDIT SERVICES

Mr. Baumann said he is aware that firms may be providing more nonaudit services to their audit clients than in the recent past. His office, he said, will work closely with the PCAOB Inspections division to determine whether the nature or extent of nonaudit services may be impacting firms’ independence, and if so, whether standard-setting would be appropriate.

### Q+A SESSIONS

All the references to independence, professional skepticism, and the public interest in the speeches left a question in some attendees’ minds as to whether

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the SEC or PCAOB planned to initiate independence standard-setting. In one Q+A session, an attendee asked “what is driving all the talk about independence?” Mr. Kroeker’s response: a desire to see auditors’ status as “public watchdogs” enhanced, citing the results of the CAQ survey discussed earlier. Neither the SEC nor the PCAOB has independence on its standard-setting agenda although both plan to monitor independence closely.

Another attendee commented that the downward pressure on audit fees was coming from audit committees; the SEC panelist responded that auditors should not accept or continue audit engagements if the fees don’t allow a quality audit to be performed. If firms wish to accept or continue such engagements, the panelist’s expectation was that lower fees would reduce partner compensation, not audit quality. A

panelist also commented on whether a firm should ask its client’s management to weigh in on the assignment of a new audit partner to the engagement. If more than one partner is equally qualified, the panelist thought it might be appropriate. However, he questioned why management, and not the audit committee, would be consulted in that situation (since engaging the auditor is the audit committee’s job).

### EXHIBIT 1:

#### Examples of SEC/PCAOB Independence Rules that are Generally More Strict than Comparable AICPA Rules

*NOTE: This is only a partial list; see the SEC / PCAOB rules for complete information.*

#### **Nonaudit services:**

- Bookkeeping and financial statement preparation
- Valuation, appraisal, actuarial services, fairness opinions, and contribution-in-kind reports
- Tax services, i.e., certain aggressive/confidential transactions and personal tax services
- Financial information systems design
- Human resource services
- Legal and expert services
- Internal audit outsourcing

#### **Business relationships between the company and its auditor, including the company’s officers, directors, and substantial shareholders:**

- Joint business ventures
- Limited partnership agreements
- Leasing interests (except for immaterial landlord-tenant relationships)

*Note: The SEC’s rules also apply to affiliates of audit clients, a requirement that does not apply under AICPA rules although the AICPA’s Professional Ethics Executive Committee has agreed to issue a rule proposal on affiliates in 2011.*

#### **The following SEC/PCAOB requirements do not apply under AICPA rules:**

- The company’s audit committee must pre-approve all services
- Audit partners must rotate off an engagement after a specified number of years and remain off the engagement for a specified period
- Audit partners are prohibited from being directly compensated for selling nonaudit services to their audit clients

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### EXHIBIT 2:

#### Affiliates of Audit Clients (SEC/PCAOB rules)

The following entities are affiliates of Audit Client “XYZ”:

- (1) An entity that XYZ controls (e.g. subsidiary).
- (2) An entity that controls XYZ (e.g. parent).
- (3) An entity that is under common control with XYZ (e.g. brother-sister company).
- (4) An entity that has significant influence (generally 20-50 % ownership) over XYZ and XYZ is material to the entity.
- (5) An entity over which XYZ has significant influence and the entity is material to XYZ.
- (6) Entities in an “investment company complex” with XYZ, e.g., if XYZ is an SEC registered mutual fund, all of the other funds in that fund family are affiliates. Certain other entities in the complex, e.g., banks or brokerage firms, may also be affiliates.
- (7) Entities in a Private Equity Structure with XYZ, e.g., if XYZ is an SEC registered portfolio company held by a Private Equity Fund, the following entities (whether private or public) would be considered affiliates:
  - The Private Equity Fund (Fund), if it controls XYZ (regardless of materiality), or has significant influence over XYZ and XYZ is material to the Fund.
  - The general partner (GP) of the Fund under two possible circumstances:
    - The GP controls the Fund, which controls XYZ, or
    - If the Fund has significant influence over XYZ and XYZ is material to the Fund, XYZ is also material to the GP.
  - All entities that control the Fund (directly or indirectly).
  - Other portfolio companies that are under common control with XYZ.



### ABOUT THE AUTHOR & PUBLISHER

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