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A NEW PUBLIC (BUT VERY PRIVATE) WATCHDOG: The Public Company Accounting Oversight Board Issues Its First Reports

By Avi Josefson

The epic frauds that unraveled in recent years revealed that, in many cases, the auditors—those most critical guardians of the company's financial statements and the public trust—operated with no meaningful supervision. The revelation of the financial scandals at companies such as WorldCom, Enron, Adelphia and Freddie Mac shook investor confidence in the auditing firms that were supposed to be scrutinizing those companies' financial statements, and, in one case, resulted in the implosion of one such firm, Arthur Andersen. Now, only four big auditing firms remain: Deloitte & Touche ("Deloitte"), Ernst & Young ("E&Y"), PricewaterhouseCoopers ("PwC") and KPMG (collectively, the "Big Four"). The sheer magnitude and number of frauds that have occurred on these firms' watch have proven, among other things, that the "peer review" system in place at the time—under which accounting firms periodically audited each others' work—was a complete failure.

Congress' response to these and other financial scandals—the Sarbanes-Oxley Act—created the Public Company Accounting Oversight Board ("PCAOB") in 2002. The Act required that accounting firms that audit public companies register with the PCAOB and submit to annual inspections of their audit work. The PCAOB recently released the results of its first annual inspections of the Big Four accounting firms. Unfortunately, a recent inspection by the PCAOB revealed that these big four accounting companies are under intense scrutiny for questionable auditing practices.

"Oh, *that* three billion dollars."

The Secret Findings of a Public Board

While the PCAOB may now be attempting to supervise auditors, investors are unable to fully evaluate the effectiveness of that supervision because the Sarbanes-Oxley Act provides that certain key deficiencies uncovered by the PCAOB will not be publicly released until the accounting firm at issue has had a full year to resolve that deficiency, a provision resulting from pressure applied by the Big Four firms. Now that the first inspections have been conducted, those firms are clearly reaping the benefits of the secrecy provisions for which they successfully lobbied. Although these inspections uncovered significant audit and accounting issues in the work of each of the firms, the specifics of those issues may never reach the light of day. As Lynn Turner, a former chief accountant at the SEC, observed,

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"Unfortunately, we don't know how many more infractions were not made public as a result of Congress allowing those to remain behind closed doors." Included in the non-public sections of the PCAOB's reports are discussions of the accounting firms' risk management policies, their internal inspection procedures and the tone set by each firm's management. So while William J. McDonough, chairman of the PCAOB, stated that "none of our findings has shaken our belief that these firms are capable of the highest quality auditing," investors still have nowhere to turn to form their own beliefs about the quality of the audits on which they are being asked to rely. Keeping key findings of the PCAOB under wraps may suit the auditors who would prefer not to share their dirty laundry with their clients (or their clients' investors), but it does little good to a market increasingly focused on improving transparency in the financial statements of public companies.

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KPMG Breaks The Silence – And The SEC's Rules

Deloitte, E&Y and PwC opted to hide behind the confidentiality provided by Congress, and refused to discuss publicly the results of the PCAOB inspections into their respective audit work. KPMG sounded a slightly more positive note by publicly responding to the PCAOB's secret findings; however, the substance of those findings appears to be anything but positive. The PCAOB found that KPMG performed accounting work on a contingency basis, charging fees to audit clients based upon the amount of tax savings the firm was able to generate for them. Such fees can violate rules intended to prevent conflicts of interest that can blur the objectivity of an independent audit firm. Indeed, SEC rules prohibit accountants from charging contingency fees to audit clients. KPMG claimed that it is in the process of restructuring its remaining contingency fee agreements. Yet, because of the secrecy provisions the audit firms forced into Sarbanes-Oxley, the market still does not know which companies may have benefited from those contingency fees, or which other firms charge contingent fees. Nor is the public likely to ever learn the full extent of the PCAOB's findings as to the audit work of the other Big Four firms.

An Across The Board Failure To Apply An Accounting Provision

The limited information that the PCAOB made public does little to bolster faith in the audits conducted by these firms. For example, the PCAOB identified a particular accounting rule that all four firms misapplied, leading twenty companies to restate previously issued financial statements. The provisions in question are those of Emerging Issues Task Force No. 95-22 ("EITF 95-22"). These provisions address the proper classification of outstanding balances under revolving lines of credit in certain circumstances. The PCAOB initially identified twelve of the Big Four's audit clients that had improperly classified such balances, errors that their auditors failed to detect. When asked by the PCAOB to investigate further, the firms discovered an additional eight companies with the identical problem. This finding begs the question of what other problems are waiting to be discovered, particularly when the PCAOB expands its inspections beyond the Big Four in the coming years.

Documented Failures In Basic Audit Functions

The PCAOB's findings also demonstrate that the Big Four are rife with problems of a far more basic nature. The PCAOB found the firms to be too willing to rely on their clients' representations in lieu of performing adequate tests of their own, and discovered significant problems in each of the firms' efforts to document their audit work. For example, in one case, the PCAOB found E&Y too dependent on its client's internal audit department, having failed to determine the effectiveness of the company's internal auditors. On another audit, the PCAOB found that an E&Y auditor replaced a missing management representation letter with another letter from the client dated as of E&Y's original audit report. At PwC, the PCAOB found that auditors had altered the dates of electronic work papers to circumvent the firm's automatic archival of work papers after the issuance of an audit report or the close of an audited period. While these are individual examples, they demonstrate the sort of basic breakdowns in the audit function that can facilitate the perpetration of corporate frauds.

Conclusion

The initiation of inspections by the PCAOB must, in the end, be viewed as a positive development resulting from the passage of the Sarbanes-Oxley Act. However, the issuance of the PCAOB's first reports indicate that there is significant room for improvement both in the amount of information being reported publicly, and in the quality of the audits being conducted. Without question, the secrecy provisions that provide for confidential treatment of the PCAOB's most damning findings benefit only the audit firms that pushed those provisions into the law. Greater transparency can only motivate higher quality audits by these firms, and increased public confidence in those audits.

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