



What To Expect From PCAOB's Ongoing Transition

By Robert Cox (June 14, 2018, 1:29 PM EDT)

Article appeared on Law360 and reprinted with permission

The Public Company Accounting Oversight Board is currently undergoing a significant transformation as the new board charts a new path. In December 2017, the U.S. Securities and Exchange Commission took the unprecedented move of replacing the PCAOB chairman and all of the then-currently serving board members. Prior to December 2017, the board members served staggered terms and were frequently reappointed to serve second five-year terms.

Since reaching full strength on April 9, 2018, the board has wasted little time in charting a new course for the audit regulator, starting with a 360-degree review, the departure of several senior staff, and Chairman William Duhnke's speech outlining "PCAOB transitions for the future." This article summarizes the recent changes in senior management and outlines the potential course for its future based on Duhnke's speech at the 2018 Deloitte/University of Kansas Auditing Symposium. Key takeaways are:

- Based on Duhnke's speech, the departure of several directors, the hiring of an outside consultant, and changes to the strategic review process, it appears that the board is conducting a 360-degree review, similar to the Financial Industry Regulatory Authority's review in 2017;
- The board has replaced several long-tenured heads of divisions and offices with "acting" directors, which suggest that further leadership changes will occur as permanent directors are hired;
- The board is considering changes to the PCAOB inspection process and the form and content of inspection reports; and

- Expect continuity in inspections, standard setting and enforcement in the near term, but changes may be coming in the next year in the inspections process.

Long-Tenured Senior Managers Exit

For years, the PCAOB was known for having some of the longest-tenured senior management among regulators. Many PCAOB directors and deputy directors of divisions have been with the PCAOB from its earliest days and have served more than five years in their current positions.^[1] This has provided the PCAOB with certain advantages in terms of developing extensive expertise among its staff, consistency in terms of policy and enforcement, and a lack of personnel turmoil that often afflicts some government agencies with the turnover of administrations.

However, in May, the new board announced the departure of key division and office heads at the rate of one to two per week, starting with the exit of General Counsel Gordon Seymour and followed by Director of Registration and Inspections (DRI) Helen Munter, Chief Auditor Martin Baumann, Information Technology Director Nirav Kapadia, and Director of the Division of Enforcement and Investigations (DEI) Claudius Modesti.^{[2][3]} Based on Duhnke's speech and these significant departures, it appears that the board intends to implement dramatic organizational changes across the entire PCAOB. In his speech, he stated, "We have reached a relative state of maturity. With that maturity comes an opportunity to consider where the journey has taken the organization and where the PCAOB should be headed in the future. As an organization, we cannot simply stand

on our prior successes and assume success will continue to come. We must, instead, take to heart lessons learned over the past 15 years and set a clear vision to guide us towards sustained success in the years to come.”

The PCAOB has two divisions (DRI and DEI) and 12 offices. The largest offices are the Office of the General Counsel, Office of the Chief Auditor, and the Office of Economic and Risk Analysis. DRI, DEI and these three offices are now under the leadership of “acting” directors. This suggests that further personnel changes may occur as the board hires permanent replacements.

The Chairman Previews Changes Under Consideration

On May 17, 2018, Duhnke outlined his vision for the future at a speech at the 2018 Deloitte/University of Kansas Auditing Symposium, focusing on potential changes in the inspections process. He noted that, for the first time since its founding in 2003, the board had five new board members join the PCAOB at the same time.^[4] Duhnke stated, “With such a significant change in the board’s composition comes a significant opportunity — a chance to reflect on lessons learned, to innovate, and ultimately to improve how we approach our oversight of the auditing profession in an increasingly dynamic environment.”^[5] Duhnke went on to outline a 360-degree comprehensive strategic planning and organizational assessment process that bears many similarities to the 2017 FINRA360 initiative launched by FINRA CEO Robert Cook shortly after he took office in August 2016.^[6]

PCAOB Strategic Planning Process Each year since 2007, the PCAOB has drafted a strategic plan with a five-year outlook through an inward-facing process that collected input primarily from senior PCAOB leadership. The new board significantly changed its approach to strategic planning for 2019 as follows:

- In April and May, the board used an outside consultant to survey the public regarding its strategic priorities receiving hundreds of responses from investors, public company management representatives, audit committee members and directors, academics, foreign audit regulators, and auditors.
- The outside consultant also conducted three dozen interviews of key constituents, including investors, academics, regulators, public company interest groups and audit firms.
- Rather than solely focusing on input from senior leadership, the board solicited input from every employee of the PCAOB.

The board will publish a draft of the 2019 strategic plan for public comment by the end of July and finalize the plan, along with its final 2019 budget, by November.

Organizational Assessment

The most significant portion of the speech focused on the board’s comprehensive organizational assessment. Duhnke noted that many PCAOB operations and programs maintain their original design, and “[i]t is time we give them a fresh look to consider whether their design continues to meet our needs in a rapidly changing environment and to support us in achieving our mission.”^[7] The first program for reform appears to be inspections. DRI is the largest division within the PCAOB in terms of personnel and percentage of its budget, accounting for more than 50 percent of the organization in terms of head count and expenses.

Inspections

Duhnke noted that “many firms appear to have ‘plateaued’ in their progress toward achieving improved inspection results” and that “now is an excellent time for us to consider the potential reasons for those plateaus.”^[8] Former PCAOB member Jeanette Franzel used this same “plateau” characterization in her Dec. 5, 2017, speech to the AICPA Conference on SEC and PCAOB Developments and her Dec. 7, 2017, speech to the International Institute on Audit Regulation.^{[9][10]} The most frequently identified audit deficiencies have been largely unchanged year to year: assessing and responding to risks of material misstatement; auditing internal control over financial reporting; and auditing accounting estimates, including fair-value measurements.^[11]

The board is considering several questions regarding the inspections process, including questions regarding the conduct of inspections, the approach to defining and presenting inspections findings, risk-based sampling, and the content of PCAOB inspection reports. From the tenor of the questions, it appears that the PCAOB may consider whether to:

1. Add a thematic review similar to the reviews conducted by the United Kingdom’s Financial Reporting Council, or FRC, and the Dutch Authority for Financial Markets, or AFM;
2. Decrease the number of individual audits it inspects at specific firms that have shown improvement in part one findings;
3. Increase the number of random selections of audits;

4. Refocus its inspections procedures to drill more deeply into firms' quality control systems, particularly firms that have shown improvement in part one findings;
5. Change the timing or frequency of its inspections of certain firms, based on the nature and degree of their demonstrated audit quality; and
6. Change the content and format of its inspection reports.^[12]

Similar to Franzel, Duhnke appears to be intrigued by the thematic approach to inspections taken by the FRC and AFM.^[13] The FRC takes a two-pronged approach to inspecting audit firms: (1) firm-specific inspections focused on reviewing a sample of individual audits and firm quality controls, and (2) thematic inspections across a sample of the firms it regulates. Duhnke notes, "Those thematic reviews allow the FRC to consider a variety of different firms' policies, procedures, and practices in defined subject matter areas and then to compare what they find across the population of firms reviewed."^[14]

The AFM approach to thematic review focuses on the "three pillars" of the audit firms: (1) control, (2) behavior and culture, and (3) internal supervision.^[15] Based on this review, the AFM creates a dashboard that monitors the performance of the largest audit firms in the Netherlands, which is available on the AFM's website.

Standards

While new standards have been implemented and others are in the standard-setting process, these are legacies of the prior board. I would not expect any significant changes in standard-setting in the short term. However, 2018 and 2019 will be significant for audit firms not only in terms of dealing with new Financial Accounting Standards Board standards on revenue recognition and lease accounting, but also addressing a new PCAOB standard and rule (AS 3101 and Rule 3211) related to the new audit reporting model. PCAOB changes include new organization and content for the audit report, reporting of auditor tenure, and inclusion of critical audit matters, or CAM, in the report.

In terms of legacy standard-setting projects, the PCAOB has issued proposals for new standards in auditing accounting estimates, the auditor's use of the work of specialists, and the auditor's use of other auditors. The board is also conducting outreach, monitoring and research regarding the auditor's evaluation of a company's ability to continue as a going concern.

The only new item on the new board's latest standard-setting agenda is whether the board should consider issuing guidance or revisiting Rule 3526, Communication with Audit Committees Concerning Independence, which governs the timing and manner of auditor communications with audit committees regarding independence.^[16] The SEC also appears to be looking at its own independence rules.^[17]

As part of the 360-degree review, the board is looking at whether it can improve the transparency of the standard-setting process and whether its standards are sufficient to withstand major changes in audit methodology, staffing and tools.^[18]

Enforcement

Beyond announcing a change in leadership, the board has not announced any substantive changes to its enforcement program. Under, Modesti's leadership, DEI grew significantly year over year in terms of numbers of settled orders and the size of civil money penalties. In 2017, the board issued 54 settled disciplinary orders, imposing a total of more than \$4.8 million in monetary penalties. In 2016, the board imposed its highest civil money penalty to date, \$8 million against Deloitte Touche Tohmatsu Auditores Independentes.

As part of its organizational review, the board is considering whether it is: (1) pursuing the right mix of enforcement cases and adjudicating them in a timely manner, and (2) imposing effective and appropriate remedies. In the short term, expect that DEI will continue its focus on its four priorities of (1) investigations involving significant audit violations, (2) audit matters relating to the independence and integrity of the audit, (3) matters threatening or eroding the integrity of the board's regulatory oversight process, and (4) cross-border (international) audits. I would also expect a continued focus on broker-dealer audits under the new broker-dealer standards and inspections process. A 2017 PCAOB report noted deficiencies at 97 percent of the auditing firms of broker-dealers that it inspected in 2016, compared to 96 percent in 2015.^[19] Broker-dealer enforcement actions comprised a significant portion of 2017 settled orders, including a \$1 million fine against PwC related to its 2015 audit of Merrill Lynch.

Conclusion

The board has signaled that significant changes are coming to PCAOB inspections in the near future. Quality control will clearly be a focus of inspections, and the board is contemplating refocusing its inspection procedures to drill more deeply into firms' quality control systems and adding a thematic review component. The topic of firm quality control standards has gained renewed focus on PCAOB's standard-setting agenda as a research project, and PCAOB staff is exploring whether there is a need for changes to PCAOB quality control standards.^[20] The time is right for auditors to re-evaluate and improve their own self-examination and quality control processes focusing on supervision, audit inputs, audit processes and audit results relevant to promoting appropriate professional skepticism and testing appropriate to the audit (particularly in the areas of revenue recognition, business combinations and goodwill). One way to improve the firm's system of quality control is through the development and use of audit quality indicators, or AQIs, at the engagement and firm level. In terms of enforcement, I would expect that cross-border audits, professional skepticism, improper alteration of work papers, and broker-dealer audits will continue to be a focus of enforcement in the coming year.

Robert H. Cox is of counsel at Briglia Hundley PC. From 2011 to 2017, he was an assistant director with the PCAOB's Division of Enforcement and Investigations.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

Notes

- [1] The PCAOB opened its doors in January 2003. At the end of 2003, it had more than 90 professional staff. For 2018, the PCAOB's budgeted headcount is 842.
- [2] See "General Counsel Gordon Seymour to Leave PCAOB," PCAOB Press Release (May 1, 2018); "Helen Munter, Director of Registration and Inspections, to Leave PCAOB after 14 Years of Service," PCAOB Press Release (May 18, 2018); "PCAOB Chief Auditor Martin F. Baumann to Leave the Board," PCAOB Press Release (May 22, 2018); "Information Technology Director Nirav Kapadia to Leave PCAOB," PCAOB Press Release (May 24, 2018); "Claudius Modesti, Director of Enforcement and Investigations, to Leave PCAOB," PCAOB Press Release (May 29, 2018). See also Michael Cohn, "PCAOB shakeup continues with departure of chief auditor" *Accounting Today* (May 22, 2018), <https://www.accountingtoday.com/news/pcaob-shakeup-continues-with-departure-of-chief-auditor-martin-baumann>; Michael Cohn, "PCAOB exits continue as Claudius Modesti departs" *Accounting Today* (May 29, 2018), <https://www.accountingtoday.com/news/pcaob-exits-continue-as-claudius-modesti-departs-as-director-of-enforcement-and-investigations>.
- [3] Seymour was employed with the PCAOB for 15 years, and was its general counsel since February 2007. Munter was with the PCAOB for 14 years and director of DRI since 2011. Baumann was with PCAOB for 12 years and chief auditor since 2009. Kapadia was the director of the Office of Information Technology and Chief Information Officer from 2011 to present. Modesti joined PCAOB in May 2004 as its first and only DEI director to date.
- [4] William D. Duhnke, "PCAOB Transitions for the Future," 2018 Deloitte/University of Kansas Auditing Symposium (May 17, 2018).
- [5] *Id.*
- [6] Similar to the PCAOB, FINRA has come under criticism for its rising compensation costs, increased compliance costs from new regulations, and aggressiveness of its enforcement program reflected in rising fines and penalties.
- [7] See William D. Duhnke, "PCAOB Transitions for the Future," 2018 Deloitte/University of Kansas Auditing Symposium (May 17, 2018).
- [8] *Id.*
- [9] Jeannette M. Franzel, "The State of Audit Quality and Regulatory Approaches to Achieving High Quality Audits," 2017 International Institute on Audit Regulation (Dec. 7, 2017); Jeannette M. Franzel, "Update on PCAOB Efforts to Enhance Audit Quality," AICPA Conference on SEC and PCAOB Developments (Dec. 5, 2017).
- [10] Of note, Franzel's former special counsel, Francis "Abe" Dymond, was named chief of staff for the PCAOB on Jan. 2, 2018. Therefore, Franzel's speeches and statements as a board member may provide some insight into the board's views going forward.
- [11] Jeannette M. Franzel, "Update on PCAOB Efforts to Enhance Audit Quality," AICPA Conference on SEC and PCAOB Developments (Dec. 5, 2017).
- [12] William D. Duhnke, "PCAOB Transitions for the Future," 2018 Deloitte/University of Kansas Auditing Symposium (May 17, 2018).
- [13] See William D. Duhnke, "PCAOB Transitions for the Future," 2018 Deloitte/University of Kansas Auditing Symposium (May 17, 2018); Jeannette M. Franzel, "The State of Audit Quality and Regulatory Approaches to Achieving High Quality Audits," 2017 International Institute on Audit Regulation (Dec. 7, 2017).
- [14] William D. Duhnke, "PCAOB Transitions for the Future," 2018 Deloitte/University of Kansas Auditing Symposium (May 17, 2018).
- [15] *Id.*
- [16] Tammy Whitehouse, "New PCAOB takes fresh look at auditor independence," *Compliance Week/Blogs/Accounting & Auditing Update* (April 11, 2018).
- [17] *Id.*
- [18] William D. Duhnke, "PCAOB Transitions for the Future," 2018 Deloitte/University of Kansas Auditing Symposium (May 17, 2018).
- [19] Michael Cohn, "PCAOB sees continuing problems with broker-dealer audits," *Accounting Today* (Aug. 18, 2017).
- [20] Jeannette M. Franzel, "Update on PCAOB Efforts to Enhance Audit Quality," AICPA Conference on SEC and PCAOB Developments (Dec. 5, 2017).

ABOUT US

Briglia Hundley was founded in 1993 and practices throughout the mid-Atlantic region. Our practice features attorneys who have been listed as "Legal Elite" by Virginia Business magazine, named to Super Lawyers, and listed in Best Lawyers.

We are a forward-thinking law firm that relies upon our experienced and energetic attorneys to reliably and responsibly meet the legal needs of our clients in Virginia, Maryland, and the District of Columbia.

Copyright © 2018 Briglia Hundley, P.C. All Rights Reserved.

CONTACT BRIGLIA HUNDLEY

Tysons Corner Office

1921 Gallows Road, Suite 750
Tysons Corner, Virginia 22182

Telephone: 703.883.0880

Fax: 703.883.0899