**THE PCAOB IS TOO SOFT ON AUDITORS**

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Congratulations to Jonathan Weil for recently unmasking KPMG’s shoddy audit work at Alterra Capital Holdings Ltd. (ALTE) in Bermuda. Once again we are left questioning whether the Public Company Accounting Oversight Board (PCAOB) is fulfilling its stated mission “to protect the interests of investors and further the public interest” when it refuses to disclose the names of companies whose auditors failed to conduct proper audits. Even though fewer investors today actually rely on the current audit report for assurance on financial statement quality, all would appreciate knowing that a specific company’s auditors “did not obtain sufficient competent evidential matter to support its opinion on the issuer’s financial statements,” as occurred in Alterra’s case.

We question the PCAOB’s policy of withholding the name of an audit firm whose report is worthless and its partner in charge of the audit. Among other things, the shame that comes from public announcements of unworthy audits might serve to motivate auditors to perform better audits. We are at least heartened by recent comments by James Doty, Chairman of the PCAOB, that he too favors public disclosure of disciplinary proceedings.

Jonathan Weil’s expose also provided insight into Alterra’s apparently cozy relationship with KPMG, as the Company apparently felt some pressure to report the following in a March 31, 2011 8-K:

*KPMG Bermuda has represented to Alterra and its Audit Committee that it believes it properly and appropriately followed GAAS as defined at the time of the audit. KPMG Bermuda confirmed in its response to the PCAOB report that "none of the matters identified by the PCAOB required the reissuance of any of our previously issued reports." Alterra reaffirms its belief that the asset values ascribed to its available-for-sale securities in 2008 and subsequent periods remain appropriate.*

Shouldn’t we be concerned that Alterra’s Audit Committee finds nothing wrong with KPMG’s ineffective audit procedures? We would have hoped that the 8-K instead would have reported KPMG’s termination and announced the search for a replacement firm. It is probably not surprising in today’s unethical world that Alterra would stick with an auditor who can’t audit, particularly when the audit bust related to highly subjective available-for-sale securities which account for half of the Company’s balance sheet. After all, members of Alterra’s audit committee probably believe that they are serving the interests of management, particularly when the audit committee chair and chief financial and accounting officers are all KPMG alumni.

While this situation is bad enough, the full extent of KPMG’s audit failure is worse than one might imagine. For almost half-century, the U.S. auditing profession has been guided by certain general principles outlined in the very first Statement on Auditing Standards No.1: the general standards, the standards of field work, and the standards of reporting. These guidelines are so critical to effective auditing that instructors generally require auditing students to memorize them as part of their academic training. It is the third standard of field work that KPMG violated:

*The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.*

However, KPMG’s failure to obtain sufficient audit evidence also raises serious questions about their compliance with other standards. For example, if KPMG didn’t gather enough audit evidence, was the audit work really planned and supervised adequately? Did KPMG possess an adequate understanding of the client’s internal controls so as to design appropriate audit tests? Apparently not, since the PCAOB questions the sufficiency of the audit evidence gathered. The PCAOB’s report on KPMG also leaves unanswered possible questions about the audit firm’s compliance with the general standards. If KPMG didn’t gather sufficient evidence, shouldn’t we also be concerned about the training and proficiency of the auditors involved, as well as their use of professional care?

The PCAOB’s silence on these questions is deafening, if not unexpected. As former chief accountant for the SEC Lynn Turner stated in a recent Rolling Stone article:

*I think you've got a wrong assumption…that we even have a law enforcement agency when it comes to Wall Street.*

KPMG’s performance in the case of Alterra, and the related regulatory response, is just the latest in a series of PCAOB failures to adequately police the large accounting firms. As Francine McKenna notes, there were no PCAOB disciplinary actions:

* Against Deloitte Netherlands for the Ahold fraud, despite Dutch accounting regulators censuring the firm and engagement partner.
* Against Deloitte & Touche International, Deloitte US, Deloitte Italy, or Grant Thornton for the Parmalat fraud, even though they all settled with the company and shareholders.
* Against PwC or its Japanese firm for the Kenebo and Nikko Cordial scandals.
* Against PwC for the Yukos scandal in which they withdrew ten years of audits as part of a Russian government prosecution of former Yukos chief Mikhail Khodorkovsky and his business partner Platon Lebedev.

We encourage the PCAOB to adopt several of Mark O’Connor’s rules for maintaining ethical standards as it attempts to enforce audit quality:

* First, *trade secrecy for transparency*. Tell the investing public which auditor failed to comply with generally accepted auditing standards (GAAS), which company was affected, how the GAAS failures affected the audit report, what actions the PCAOB is taking against the individual auditor and firm, and what specific remedial actions the offending firm is taking to address the audit failure.
* Next, *shun them*. The PCAOB should require an auditor change for each instance where GAAS failures do not support an audit report.
* Finally, *stop feeding them*. The PCAOB should institute mandatory suspensions for all accounting firms, as well as individual auditors, for each instance in which a GAAS failure occurs. Multiple suspensions should also lead to a “death penalty” in which a firm is permanently banished from auditing public firms.

Why such a tough stance? We agree with Warren Buffet who stated the following in his July 2010 biennial letter to Berkshire Hathaway CEOs on reputation and ethics, republished in its 2010 Annual Report:

*Culture, more than rule books, determines how an organization behaves.*

Repeated GAAS failures of the magnitude that the PCAOB is uncovering suggest that the Big Four culture is the problem. Only tough action will change these cultures so that investing public will get what they desire: *a real audit*!

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*