SAG Presentation
November 20, 2014

Dear Members of the Standing Advisory Group:

I am honored to have been asked to participate in this panel today, and I welcome the conversation on these important topics.

By way of introduction, and I am happy to see some familiar faces before me, I was with Deloitte for 24 years, in the UK and US firms, until 2004. I was in the audit group, becoming a partner in our Boston office. I transitioned to form and lead the forensic group in that office, and then ultimately to lead our national forensic practice. In that role, my team developed and implemented the Forensic Audit Assistance program, designed to enhance the forensic aspects of the firm's audit approach.

I left Deloitte to co-found StoneTurn Group in 2004, a specialized consulting firm that has eight offices and 80 professionals in the US and UK, specializing in forensic accounting, investigations and expert witness matters. Our work includes audit or special committee investigations, where we interact with the company's audit teams, evaluation of the performance of audits retained by either firms or regulators, and consulting with counsel on matters of GAAP and GAAS.

My comments today are a reflection of my experiences as an auditor and as a forensic accountant.

Admittedly, in our forensic work, we see the failures, the issues that have escaped detection, the problems, and this is not a balanced view of the work that auditors do. Nevertheless, it is often in the failures that there is something to be learned.

In our work, we often see how audit teams deal with the problems identified in investigations, at the local and national levels, before and during the SEC involvement. We discuss our findings with them. We have interacted with firms' defense counsel.

We all recognize that there are people in the world who are crooked or incompetent, and sometimes both. Auditors regularly identify client errors in their financial reporting and require client adjustments be made. Additionally, there is no system or framework that can be expected to achieve a 0% error rate: that is, the cost to eliminate all risk of fraudulent financial reporting is likely too high for the capital markets to bear.

Also, to state the obvious, there are not some magic steps or procedures for auditors to perform, forensic or otherwise, that will lead to frauds being detected. However, experienced, talented auditors with sufficient independence of mind and the strong support of their firms and the profession are critical to the processes of detecting financial reporting errors and frauds.

One recent example illustrates the point that, while forensic investigations are very different to an audit, the critical elements of both are the same. The SEC asked a registrant CFO to meet with them, out of the blue, without notice or agenda, in two weeks' time, likely the result of a whistleblower tip. The company board retained counsel to assist, and we were asked to help identify possible sources of SEC concern. Within two weeks, we had identified the likely concern, and why the issue, which might be of interest to a whistleblower, had been properly accounted for, as well as five other areas where there was a problem. Ultimately, the company restated for the combined effects of the errors.

Certainly our process was not, and could not be, typical of a recurring audit process. It was very fast, disruptive to the company personnel, and had a board authority that was not typical. However, the information required for our analysis and work was in the company, and there was no work that we performed that could not have been performed by the recurring audit team.

The key differences though were an effective risk analysis of the most likely areas of error or issues, of a mindset that all assertions had to be fully supported without an over-reliance on controls, and the knowledge that we had the full support of the Board. I summarize these differences into three elements: **talent, mindset and support**, all of which are required for an audit too.

To briefly address each in turn -

Talent. As businesses, business tools and processes and financial reporting overall become more complex, so too does the profession have to keep increasing the talent level brought to bear. Is being an audit partner today as attractive to a high-talent newly qualified CPA? Do the risks and rewards of the role, the compensation and prestige, sufficiently outweigh the risk of missing a problem, the pressures of a regulatory review that highlights differences of conclusion, or of having to go through a client restatement process? Has the compensation and prestige kept up with the increase in those risks over the past 5-to-10 years? In short, is being an audit partner a "good job?"

I don't want to be seen as a "grumpy old man" who thinks everything was better in the old days, but I do wonder if the balance between the benefits and risks of the audit partner role have become tilted to the risk side in the past 5-to-10 years, and potentially causing higher talent losses at the manager and senior manager levels.

Second, **mindset**. There has been a clear change in auditor empowerment. After passage of Sarbanes-Oxley if a client risk profile was not acceptable, if the fee was not commensurate with the professional risk, if a client was a hostile or a very difficult client, then firms decided not to continue the relationship. There was a shift of empowerment, where the audit team and leadership felt they had the authority to push back on clients and client positions, and to challenge a client relationship. We now see that the pendulum has swung back, that auditors are more willing to rationalize, to explain away a problem or inconsistent facts, and are challenging management decisions less. In the problems we see, the auditors are frequently aware of the underlying fact patterns but have not adequately pursued or challenged the issue.

Finally, and I believe all three elements are connected, is **support**. Auditing is a team sport. Maintaining independence of mind requires absolute knowledge that your colleagues support you, your decisions and your actions. I have no doubt that is the case in reality that firms do support their partners. Yet there appear to be countervailing forces, which lead audit partners to not only resist restatements, but to rationalize away inconsistent audit findings, to be willing to not dive further.

Rationalizing away potential problems is a natural response for an audit partner. Unlike forensic investigations where the assumption is that everything is suspect until affirmed, audits are predicated on the assumption that the client has integrity.

Finding a problem at a client is, at best, a neutral event for the audit partner. Problems mean the client relationship becomes strained, and management's judgments or capabilities are questioned. At the firm, questions arise about the how and when, what about last year, questions of client integrity and the risk of the client changing firms. There is no doubt that the process of raising errors, including possibly questioning prior audits or quarterly reviews, is also emotionally wrenching. This can often lead to rationalization. For example, we had a partner argue a 25% error in previously reported quarterly net income was not material, as he had a client with a much greater error that did not restate. The full support of the firm and the profession is needed to ensure issues are raised and fully considered.

As a result, I believe there are some factors that could be addressed, by the profession to consider.

The economic pressures on firms, and therefore partners, are significant. Audits are being seen more as commodity functions, with pricing following the inevitable slide associated with such market conditions. This is inconsistent with maintaining audit quality, with having the time to address audit issues properly, and with paying audit partners and staff sufficiently well to compensate for the current career risk environment.

The option of becoming an audit partner has to be made more attractive for talented mid-career professionals. To do so requires improving the upside, compensation and prestige, and reducing the perceived or actual lottery effect of career ending reviews and client errors.

The audit firms, and the profession, need to bring back the pendulum of independence from the client, to risk losing clients, to forsake the race to reduce audit fees and therefore increase the time that the skilled, experienced auditors can spend on any client.

An element of this change could be to require more of the Audit Committee, in not just overseeing, but fully owning the appointment, retention and work of the auditors; in effect to take away the client relationship from management, who, after all, should be challenged by a proper audit process.

These conditions need to change to support more talent staying in the profession, to re-empower (if that is a word) the auditor, and to demonstrate the level of support that is required so auditors can do their job effectively.

Thank you again for the opportunity to speak here today, and I look forward to our discussion.