

Statement on Proposed Auditing Standards Regarding the Auditor's Report and the Auditor's Responsibilities Regarding Other Information

DATE: Aug. 13, 2013
SPEAKER: Steven B. Harris, Board Member
EVENT: PCAOB Open Board Meeting
LOCATION: Washington, DC

RELATED INFORMATION

- [Event Details and Documents](#)

Mr. Chairman— I am on record about the critical importance of changing the auditor's report. I support publication of the proposed standards to stimulate public discussion about their content. But I remain concerned that the proposals are not strong enough to meet the needs of investors.

My views are based in significant part on what our PCAOB Investor Advisory Group has told us. The IAG working group on "The Auditor's Report and The Role of the Auditor" presented survey results in March 2011 on the usefulness of the current auditor's report. The survey respondents included officials of various institutional investors, representing well over eight trillion dollars of funds under management. The results illustrate the changes to the auditor's report investors believe are appropriate. Seventy-nine per cent of the respondents identified a need for information about the auditor's assessment of management's estimates and judgments, 67 per cent sought a discussion of unusual transactions, restatements, and other changes, and 65 per cent identified the auditor's assessment of the quality of the issuer's accounting policies and practices. [\[1\]](#)

The proposals we are considering today have several parts. First, they would require additional information about the auditor's (1) independence, (2) tenure, and (3) responsibilities for fraud and financial statement notes. These are welcome changes, especially in light of the history of concerns about the impact on independence of the issuer-pay model, the potential for auditor capture in long-running engagements, and the need for clear understanding of the auditor's role.

In addition, and most significantly, the proposals require an auditor to report on what he or she has identified as "critical audit matters." These are issues "addressed during the audit" that the auditor determines involved the most difficult, subjective or complex audit judgments, posed the most difficulty in terms of obtaining audit evidence, or posed the most difficulty when forming his or her opinion on the financial statements.

Such a change, if conceived and expressed carefully, might well alter the landscape of the audit report and go a substantial way to meeting the need for communication of areas of high audit risk. The language in today's proposals, however, does not appear to me to create a rule that will be sure to do that.

There are three reasons. First, the language endorses a subjective standard in determining what a critical audit matter is. It is what the auditor determines it to be, not what it might be seen to be objectively. Significantly, although it is expected that in most audits the auditor would determine that there are critical audit matters, the

proposals make clear to an auditor that he or she need not report any, if the work papers document the reason for not doing so. Therefore, even if a matter were important enough to "appear to be" a critical audit matter, and were communicated to the audit committee, discussed with the Engagement Quality Reviewer, or documented in the engagement completion document, it could be left out of the auditor's report. Second, whether the new disclosures will really tell investors anything will depend a great deal on how plainly and directly they are written. Third, I have some concern that effective inspection and enforcement of compliance with a subjective "critical audit matters" standard will not be possible.

I agree that auditors are not, and should not become financial analysts or investment advisors. But the events of 2006-08 continue to reverberate through the world economy, and they are a cautionary tale. When companies plunge in value or require government takeover shortly after receiving the same clean audit report year after year, investors can lose confidence, understandably, in the audit process.

Dealing with that problem means going further in changing the audit report. Sir David Tweedie, the former Chairman of the International Accounting Standards Board and national technical partner of KPMG, suggested that investors should learn through the report: (i) what kept the auditor awake at night, (ii) what arguments the auditor had with the CFO, (iii) what the big estimates are, (iv) what the contentious accounting policies are, and (v) what the going concern assumptions are?^[2] I do not believe that the proposals we are considering this morning deal with some of the important questions he raises.

Indeed, having the auditor concisely discuss a precise list of issues of interest to investors, as suggested in the IAG survey^[3] and similar surveys by the CFA Institute^[4] (an Institute comprised of more than 115,000 certified financial analysts), may well be preferable to a discussion of only issues that auditors, in their discretion, determine to be the most difficult, subjective or complex ones in an audit. Of course the two sets of issues may overlap, but they may well not. I believe we should be seriously considering a requirement that auditors also report on "any matter that would otherwise be of greatest significance to a reasonable investor in understanding the import of the financial statements." And, we should be considering requiring specific discussion in the auditor's report for particular items of the sort Sir David, and the IAG survey and CFA Institute's surveys, have identified. I hope we will receive detailed suggestions on these questions.

We also are considering this morning a proposed standard on the auditor's review of other information contained in annual reports made under the Securities Exchange Act of 1934. The proposed standard would require the auditor to communicate his or her responsibilities regarding the information included in the annual report that is outside the audited financial statements and the related auditor's report, and the results of his or her evaluation of that other information. The proposed other information standard requires that the auditor "read and evaluate" the other information as opposed to the current requirement of "read and consider."

The scope of the proposed other information standard would continue to only apply to annual reports filed under the Exchange Act. Registration statements filed under the Securities Act of 1933, in connection with the sale of securities to the public, are not subject to the proposed procedures. I hope we will receive comment on this difference of treatment, which I view as difficult to justify given that the Securities Act registration statements contain information for investors considering making an investment decision in the first place.

I would like to offer a final thought. The challenge of this project is to find a way to balance the need for a different, more useful and communicative, model of the auditor's report with the need **not** to change what auditors do, but to change how they

report on what they do. Today's proposals are a step in that direction. As I have said, however, I am not sure they meet the challenge as well as it needs to be met in light of the Board's mission to protect investors. I know investors will speak for themselves in filing comments that address the issues that the proposals raise, and that I have tried to highlight this morning, and I look forward to a careful consideration of all comments we receive.

I want to thank all the staff in the various offices and divisions that have contributed to getting this project before the Board. I want to particularly thank Marty Baumann and the staff members in OCA, OGC and ORA that have been involved. Most people are not aware of the tremendous staff time and effort that goes into these proposals. I would be remiss if I did not single out Jessica Watts' contribution. Jessica has been the lead OCA staff member from the project's inception and her dedication and hard work, including putting in many long nights and weekends for many months, has been critical. I also want to thank the staff at the SEC for their thoughtful input.

Another person that I want to acknowledge today is Bob Burns. Bob is leaving the PCAOB at the end of this month after being with us for nearly five years. Bob's public service spans 30 plus years, beginning with the Judge Advocate General Corps in the Army, then at the SEC, where he served for over 20 years as chief counsel to the chief accountant. Bob's work while at the SEC and here has always been with the view towards investor protection. Bob was especially helpful when we were establishing the Investor Advisory Group in 2009. I have never met a more dedicated, self-effacing, and competent public servant. We will miss you Bob and your wise counsel.

Thank you, Mr. Chairman.

[1] See Report of the Investor Advisory Group Working Group on "The Auditor's Report and The Role of the Auditor" (March 16, 2001), located at: http://pcaobus.org/News/Events/Pages/03162011_IAGMEETING.aspx. See also the recommendations and conclusions of the Department of the Treasury's Advisory Committee on the Auditing Profession (October 6, 2008) and the CFA Institute's survey on the Usefulness of the Independent Auditor's Report (May 4, 2011), located at <http://www.cfainstitute.org/about/research/surveys/pages/index.aspx>.

[2] See David Tweedie, *Ask the President Live Q&A* (April 19, 2013), located at: <http://forums.icas.org.uk/default.aspx?q=posts&t=64>.

[3] See Report of the Investor Advisory Group Working Group on "The Auditor's Report and The Role of the Auditor" (March 16, 2001), located at: http://pcaobus.org/News/Events/Pages/03162011_IAGMEETING.aspx.

[4] See CFA Institute's surveys: *Usefulness of the Independent Auditor's Report* (May 4, 2011), *Independent Auditor's Report Survey Results* (February 26, 2010), and *Independent Auditor's Report Monthly Poll Results* (March 12, 2008). The surveys are available at <http://www.cfainstitute.org/about/research/surveys/pages/index.aspx>