RE: PCAOB No. 2011-003

We are two sell-side equity analysts that publish reports on publicly traded financial companies in the United States, but our comments below are solely submitted in our personal capacity. These views do not reflect those of our employer, Credit Agricole Securities or affiliated company, CLSA.

We rely on financial statements from the companies we cover to gauge two key items: past performance (on an absolute and relative basis) and as means to test the veracity and quality of management. These financial statements are the life blood of our profession—something that we cannot live without and, when not working well, make our jobs and, in our view, all of finance perform well below its potential.

We rely on auditor reports as the key tool for making sure financial statements are accurate and fair. We also rely on the external auditors to make sure that contingent liabilities (such as credit guarantees, legal considerations, and long-term compensation plans) are accurately reported and capture all relevant long-term risks. Finally, we rely on the auditors to make sure all material risks are reported in the company’s quarterly and annual reports so independent analysts and investors can make sufficiently informed sensitivity analyses for both the short and long terms. In short, analysts and investors cannot do their jobs well without the auditors doing their jobs well too.

Yet, the only communication between auditors and investors is typically a standard three-paragraph report presented in a company’s annual report. Moreover, these reports are essentially identical for the overwhelming majority of all public companies with little or no variation regardless of sector, geography, etc. It is difficult to gauge the quality of the reporting process, except after firms fail when shortcomings are typically found in the financial statements, risk disclosures, and often the auditing processes. We believe more comprehensive communication between the auditors and analysts would be helpful for all parties involved—investors, the reporting companies, and the auditors as well.

To that end, we believe that the four most important changes to the audit report would require the auditor to: (1) discuss the auditor’s assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer’s accounting practices and policies.

In addition, we believe that the audit report should indicate the auditor’s responsibility for detecting material fraud. The standard audit report should clearly define that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should
indicate that reasonable assurance represents a high, although not absolute, level of assurance.

Please feel free to contact us for any more information.

Regards,

Mike Mayo, CFA
Chris Spahr, CFA