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**Before the PCAOB Investor Advisory Group**
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I would like to thank the PCAOB for this opportunity to provide my thoughts into how the audit process can be improved to provide greater transparency to the audit process and to better protect the investing public. My comments below will focus primarily on three issues: greater transparency in the auditor's report, investor outreach, and strengthening the audit process.

## I. Improve Transparency in Auditor's Report

The current auditor's reporting model is not very transparent, and provides the financial statement reader with little insight into the audit process and the underlying financial statements. In the *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury*,[1] the Advisory Committee urged the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model. As the Committee pointed out, the standard auditor's report has undergone very few changes since its adoption in the 1930s and is considered, by many, to be no more than a pass/fail model. Given the increased complexities in financial statements, I agree with the Committee that the auditor's report is no longer a viable model and should be changed to provide greater transparency to the investing public.

I believe the auditor's report should be revised in two ways. First, I believe the auditor's report should be expanded by including informative disclosures relating to both the auditor's responsibilities and the audit process itself. Second, I believe the auditor's report should be rewritten using language that is more easily understood by the average investor; in other words, in Plain English. I will address both issues below.

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[1] http://www.ustreas.gov/offices/domestic-finance/acap/docs/final-report.pdf, pp. VII:13 - VII:19.

## A. Auditor's responsibilities

### Fraud

The auditor's report should be expanded to include a discussion of the auditor's responsibilities with respect to detecting fraud during the audit process, and the limitations the auditor faces in detecting fraud. Under current audit standards, auditors are tasked with the responsibility of planning and performing the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. There are, however, inherent limitations on the ability of an outside auditor to detect fraud. For example, it is very difficult to detect fraud if management is colluding to hide the fraud. Despite the inherent limitations in detecting fraud, investors historically have attempted to hold auditors accountable for failing to detect frauds carried out by company management even in situations where the auditors have performed competent GAAS-compliant audits (i.e., the "expectations gap"). By expanding the auditor's report to include a discussion of the auditor's responsibilities in, and the inherent limitations with, detecting fraud, I believe the gap that now exists between what investors believe an audit's role should be and what the auditing profession believes an audit can accomplish will be narrowed. Even more important, however, I believe that investors will disavow themselves of the false notion that auditors are guarantors of financial statements and will take additional measures to protect themselves, including not placing all of their eggs in one basket.

### Materiality

The auditor's report also should be expanded to include a detailed discussion of materiality and the considerations, both qualitative and quantitative, that went into determining materiality for a given audit. Materiality is determined by what an auditor believes would have changed or influenced the judgment of reasonable persons relying on the financial statements. Given that the auditor is making a determination of what a reasonable financial statement user would consider material, I believe the basis for making that determination should be disclosed to the financial statement users.

The auditor's report should discuss generally the qualitative factors that are considered in an audit and, for the particular audit in question, the existence or absence of such factors. In addition, the auditor's report should discuss the quantitative materiality level set by the auditor and used in planning evidence accumulation and in determining whether the financial statements as a whole are materially misstated. What bases did the auditor use in determining materiality (i.e., net income before taxes ("NIBT"), total assets)? What percentage of the bases was determined to be material (i.e., 5% of NIBT)? For comparability purposes, I believe it is relevant whether the auditor set materiality at 4% of NIBT versus 6% of NIBT.

### Accounting Principles, Significant Estimates, and Key Risks

Finally, the PCAOB should consider expanding the auditor's report to include a discussion of the significant accounting principles used by management, significant estimates made by management, and key risk areas identified by the auditors. While some of this information may be incorporated into the notes to the financial statements, the information is often overlooked and, thus, should be moved to the front of the financial statements in summary format. While the current auditor's report states that auditors are tasked with the responsibility of assessing the accounting policies used and significant estimates made by management, the statement provides no insightful information to the financial statement user.

**B. Plain English**

Regardless of whether the auditor's report is expanded to include the disclosures discussed above or similar disclosures, the auditor's report should be rewritten in Plain English. The standard auditor's report currently uses terminology that is only understood by members of the accounting profession or by those financial statement users that have gained an understanding of the terminology through years of reviewing such reports. I would imagine that the average investor does not know what it means for an auditor to "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." For example, is it clear to the average investor that "reasonable assurance" means that the auditor is not guaranteeing that the financial statements are without a material misstatement? Does the "reasonable assurance" terminology provide the financial statement user with the level of assuredness provided by the audit? Does the average investor know what constitutes a "material misstatement" or that materiality is determined based upon the auditor's perception of what a reasonable investor would find material? Further, is it clear to the average investor that "examining, on a test basis" means that the auditor is testing only a sampling of a class of transactions and, based upon the sample testing, making conclusions about the account balance or classes of transactions being tested?

In summary, while ensuring that consistency is maintained among auditor's reports, the PCAOB should adopt standards to improve the level of information provided to investors through the audit report.

**II. Investor Outreach**

I believe the PCAOB should consider implementing an Investor Education program that is designed to provide investors with a greater awareness of the audit process, managements' and auditors' roles in the audit process, and the inherent limitations of the audit process. As discussed above, educating the public about the audit process and the limitations of the audit process will narrow the expectation gap that currently exists between the auditing profession and the public.

Additionally, the PCAOB should promote greater interaction between the accounting profession and investor groups. Senior-level members of the accounting profession should be encouraged to meet periodically with groups representing investors of all walks of life to discuss topics such as expectations of investors, improving audit transparency, the effects of new accounting standards on financial statements, and other issues affecting investors.

## III. Strengthening the Audit Process

The PCAOB should consider whether the current audit process should be strengthened to better protect investors from the frauds that have decimated investors' retirement funds over the past ten years. Specifically, the PCAOB should consider whether public companies should be subjected to a forensic or modified-forensic audit requirement or whether minimum audit procedure standards should be imposed.

In a report, *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks,*[2] issued in November 2006, representatives of the six leading international audit firms put forth, but did not necessarily endorse, the idea of imposing a forensic audit requirement upon public companies. Acknowledging that financial statement audits rarely, if ever, uncover fraud, which in many cases is perpetuated by senior management working in collusion to cover the fraud, the representatives suggested the ideas of requiring public companies to undergo forensic audits on a regular basis (i.e., every 3 to 5 years), or subjecting public companies to forensic audits on a random basis. Forensic audits are much more comprehensive and focused on uncovering fraud than are routine financial statement audits. Of course, the trade-off is the increased time and costs associated with conducting forensic audits. In light of the Worldcoms, Enrons and Madoffs of the world, however, the idea of requiring a public company to undergo a forensic audit on at least a random basis, or having portions of the audit subjected to forensic examination, may deter individuals from going down the wrong path and, in the long run, save the investing public billions of dollars.

Alternatively, the PCAOB should consider whether the audit process can be strengthened by imposing minimum requirements on the audit procedures performed by auditing firms. For example, in areas that are prone to fraud, such as revenue recognition, the PCAOB should consider whether auditors should, at a minimum, be required to test a sample size of, say, 30% of the total population, subject to even greater increase if circumstances warrant. Setting a minimum sample threshold will mandate that, in critical areas, auditors will be required to look at more transactions and increase the chances of discovering irregularities. If irregularities are discovered, the auditor then uses its professional judgment to determine what additional testing is necessary.

Sincerely yours,

*Kelvin M. Blake*

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[2] http://www.iasplus.com/resource/0611visionpaper.pdf, pp. 12 - 13.