COLORADO PERA®

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Statement of Meredith Williams
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Before the PCAOB Investor Advisory Group
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Washington, D.C.

I am submitting the following comments for the PCAOB Investor Advisory Group's consideration. These comments represent my perspective as an administrator and institutional investor of a large public plan.

Fraud Analysis and Investor Education: Create a PCAOB Fraud Center. Such an entity would conduct post mortems on corporate frauds to determine if there was an audit failure and if audit procedures and requirements should be revised going forward. A Fraud Center would provide the perfect platform for the PCAOB to educate investors on the role and responsibility of the auditing profession. It is clear that there is a substantial amount of confusion among investors regarding how the auditing industry actually functions and interacts with public corporations, particularly with the issue of fraud detection.

Auditor Notes: While there will always be some leeway in reporting financial statements, institutional investors want improved visibility into instances where management used its discretion. An audit quality score system approach may result in gaming techniques that have allowed deficiencies among credit scores. Perhaps audit firms should report a list of audit risks and deficiencies similar to the business risk section of 10-K filings. The business risk section of the financial statement notes are often the most and first-read section of the notes by investment staff. Notes on audit risks and deficiencies will be equally informative due to the incorporation of the auditor rotation recommendation discussed below, as it should discourage auditors from failing to report a risk or deficiency that would be highlighted by the subsequent auditor.

Better Recognition of Securitizations in the Audit Process: It is very difficult to condense all of the audit requirements for addressing securitizations at the issuer level. When a publicly held company holds the securitizations as an asset on their financial statements as a creditor, the accounting treatment and audit requirements are even more difficult and less transparent. Many risk factors can go unnoticed by the auditor and then ultimately to the institutional investor who invests in the securities of the creditor company. The concerns most often expressed by institutional investors on this issue can be summarized into the following four risk categories:

1. Inaccuracy of Valuation
2. Inadequate Treatment of Non-Performing Assets
3. Lack of Assessment of SPV Independence
4. Absence of Sensitivity Analysis

Valuation – Current audit standards do not specifically state what risks underlie the valuation in instances where quoted market prices are not available. Estimates of value are now based on the "best information available" and this can involve assumptions that can be inaccurate and based on subjective information.

Treatment of Non-Performing Assets (NPA) – Due to the complex structures of many securitizations and the lack of transparency in their reporting, auditors often fail to identify the treatment of non-performing assets. A more rigorous audit standard for NPA accounting at the securitization level, and an associated requirement for disclosure at the creditor level, would help create the necessary transparency in these NPA treatments.

Assessment of the Independence of Special Purpose Vehicle (SPV) – Auditors play a crucial role in ensuring that the SPV is providing full transparency with regard to all disclosures, including ownership, capital structure, size of issue, terms of offer, details of the underlying asset pool and its performance history, transaction structure, and service arrangements. Institutional investors rely largely on the assessment by auditors that these disclosures are accurate and complete. Strengthening audit procedures to provide further assurance that these disclosures are complete and specific risks are disclosed is imperative.

Need for Sensitivity Analysis – A proper accounting treatment should consider adverse trends such as changes in default rates, decreases in underlying asset valuations, higher prepayment and discount rates, changes in the timing of cash flows, early amortization triggers, and auditors should be provided with enough information to substantiate them. This problem could be addressed by adding a new stress-testing requirement for securitizations, such as a “best,” “probable,” and “worse case” scenario ratings. This requirement could be fulfilled as part of the required quarterly presentation of financial statements, and with enough supporting documentation to allow the audit process to adequately assess the analysis.

With these four primary risks in mind, it would be prudent to require auditors to more clearly identify these specific risk factors, and to fully express the potential extent they could undermine the validity of an audit’s results.

Auditor Independence: When a long-term engagement between an auditor and a company’s management exists, the auditing firm may become complacent and seek the approval of the management to the detriment of the independent inquiry investors expect. The best way to reduce the potential conflict of interest between management and auditors is to limit audit engagements to a specified period of time, perhaps three to five years. Limited term engagements help to ensure that firms will not be incented to ignore obvious shortcomings in reporting. Arguments against a limited engagement approach suggest that the cost of audit firm rotation outweighs its benefits. However, the investor’s confidence in the independence of the audit firm should not be ignored and is difficult to “price.” Requiring the senior partner of the audit firm to personally sign the audit letter will further ensure that the practice of audit partner rotation is occurring. Another mandate that would promote autonomy is to require the audit firm to commission independent contractors with specific expertise applicable to the audit. For instance, the auditing firm would hire a certified fraud examiner for a one-year engagement. This specialized auditor would search for fraudulent activity and independently report on identified risks as well as internal controls established to prevent fraud.

Thank you for the opportunity to provide comments on these important topics.

Sincerely,

Meredith Williams
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