PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Public Meeting on the Auditor’s Reporting Model

Washington, D.C.

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I want to thank Chairman Doty and his fellow board members for inviting me to participate at this hearing on the Auditor’s Reporting Model. I believe this project of the Board has the potential to provide investors useful information that will improve their capital allocation decision making and returns. As such I consider it a valued project.

My comments today are based on the experiences I have gained during almost four decades in the accounting and auditing profession, as well as participating in the investment industry. This includes my experience as (1) an auditor and partner who has signed audit reports on large and small, public and private companies; (2) serving on the boards and audit committees of public companies; (3) serving on the boards and investment committees of two institutional asset managers; (4) overseeing the financial and proxy research of an internationally known research firm; (5) as a Chief Financial Officer, and; (6) serving as a regulator for over five years.

I also was honored by U.S. Treasury Secretary Paulsen when he chose me to serve on the U.S. Treasury Advisory Committee on the Auditing Profession (“ACAP”). This Committee included among others, one of the Chairman of the Big Four Auditing firms, the Chairman of the AICPA, CEO’s and CFO’s, leading corporate attorneys and corporate board members as well as Paul Volcker, the former Reserve Chairman and Arthur Levitt, the former and longest serving SEC Chairman.

The Committee’s and subcommittees’ work and recommendations were based on information the committee received over a number of working meetings as well as public hearings at which 57 people testified. Input was sought and received from many constituents of the US capital markets. Much of that information is cited in the report itself as a basis for its recommendations so I will not take the time to recite it all here.

In the end, the Committee made a number of valuable and useful recommendations. One of those was the Committee:

“Urged the PCAOB to undertake a standard setting initiating to consider improvements to the auditor’s standard reporting model.” The Committee further urged the “...PCAOB and SEC clarify in the auditor’s report the auditor’s role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.”

In making the recommendations on the auditor’s report, I recall a number of points of discussion among committee members. One was whether or not the report adequately conveyed exactly what the auditor’s responsibility was for detecting fraud. Clearly investors at times have expressed a view divergent from that of auditors, often in court documents. A point was made by members of the auditing profession and investors who served on the subcommittee, that some believed the “pass fail” model needed to be expanded upon. At the
same time, there was testimony from investors who believed auditors were aware of information that would be important and valuable to investment decisions, and yet were not conveying that information to investors, for whom the auditors supposedly ultimately worked.

The ACAP Subcommittee on Firm Structure and Finances also made a number of other important recommendations that would improve the transparency and governance of the auditing profession, enhance disclosures made to investors, and establish a sorely needed fraud center. I hope that the PCAOB will also act on those important recommendations before investors trust in the auditing profession succumbs to further challenges.

The Committee was almost unanimous in its support for these recommendations. However, I did note in my dissent my support for the recommendations that would improve audit quality including a project on the auditor’s reporting model and enhancing fraud detection. In fact, two years prior to the ACAP report, I had published a paper in Accounting Horizons also calling for revision of the auditor’s report.

**Approach to Auditor’s Disclosures**

There has been much discussion surrounding what disclosures should be made, and in what format, if an expanded auditor’s report is adopted. I believe the format, perhaps a preferred Auditor’s Discussion and Analysis, or simply expanding the current report, should not be a determining factor. Either is ok, provided whatever approach is used will provide the necessary information investors want for making efficient capital allocations.

As I have said before at meetings of the Standing Advisory Group (“SAG”), I believe that important information useful to investors is most often contained in what is commonly called “Critical Audit Matters” (CAMS) or “Matters for the Attention of the Partner” (“MAPS”). For as long as I have been associated with the auditing profession, significant issues that arise during the planning and/or fieldwork, and their resolution, have been documented in a summary memo that is typically signed by the audit partner, the concurring partner, manager and perhaps even the senior in charge of fieldwork. These summary memos’, which are almost always produced during discovery when litigation occurs, are well reasoned and thoughtfully constructed in a quality audit. Their purpose is to integrate key audit strategy decisions, the execution of that strategy by the audit team, and completion of the audit, all into one summary memo for consideration by the partner and other members of the audit team. I believe it will take small amounts of time and effort to turn the CAMs into disclosure in an SEC filing.

Critical Audit Matters vary greatly by company, as well as by industry in my experience. As such, a single comprehensive list of things to be included in CAMS is unlikely to be achievable or useful. However, using more of an objective approach with some guidance, the audit firm’s
own audit manuals often discuss or provide examples of significant matters that should be included in the CAMS. These include items such as:

1. Significant questions involving accounting principles and auditing procedures employed, including matters on which formal consultation was sought, including in instances in which the matter was properly disposed of.
2. Instances of noncompliance with generally accepted accounting principles (“GA (including matters of disclosure), changes in accounting principles, failure to comply with regulatory requirements, audit scope limitations, and other situations requiring consideration of a qualified or otherwise modified opinion.
3. Instances of suspected or proven fraud and other illegal acts.
4. Matters reflecting on the current year summary of unadjusted differences.
5. Resolved or unresolved disagreements with the management of the company on accounting and auditing matters.
6. Principal conditions and events leading to the conclusion, based on planned auditing procedures, that there is or may be substantial doubt about the entity’s ability to continue as a going concern, and after considering management plans, whether or not substantial doubt remains.
7. Any information, not otherwise obvious, that should be considered by the partner in evaluating the results of the audit or in discussing the financial statements with management or the audit committee of the company.

To this list I would add:

1. Material, unusual, complex transactions as discussed further in generally accepted auditing standards (“GAAS“).
2. Significant material related party transactions.
3. Consistent with the findings of ACAP and surveys of investors, the auditor’s assessment of significant and material management judgments regarding estimates and assumptions. I believe perhaps the Chartered Financial Analysts can provide greater input on this.

Provided the PCAOB adopts as I would encourage you to do, an objective “benchmark” and guidance for CAMS, such as above and used in the past by audit firms, I believe an approach for audit reports tied to disclosure of all CAMS for each audit can be successful. However, I caution, that if the decision of what is a CAM – or not – is left entirely to the discretion of the auditor, then it will be a fatally flawed approach. When the Independence Standards Board issued ISB No. 1 and left it to the discretion of the auditor as to when a matter impacted their independence or not, it was found that all too often the auditors found direct violations of SEC
rules did not in the opinion of the auditor, impact their independence. I believe the same result would occur if determination of CAMS were also left solely to the discretion of the auditor.

**Disclosure of Information from Auditors, Not Management**

It is clear that some oppose any disclosure of information not previously disclosed by management. But such an approach defies common sense and is intended to obfuscate and avoid disclosing the information investors want. I urge the Board to reject such an approach as it will result in disclosures that are not worth the time or cost.

What ACAP did hear from investors was that they wanted disclosure directly from auditors, and not information “filtered” through management. They want to hear the auditor’s perspective on matters that were critical to the auditor and the audit. Having performed audits in the past, I believe that is a unique perspective informed by a significant amount of work performed, and evidence obtained while complying with GAAS.

Since management does not perform the audit, they are not in the position of making such disclosures. Nor are members of the audit committee capable of providing disclosure of the auditor’s own perspective on the audit issues. An example of this would be the auditor’s perspective on critical judgments and assumptions used in the preparation of the financial statements.

**Avoiding Boilerplate Disclosures**

I certainly support avoiding meaningless boilerplate disclosures. All too often such disclosures are the result of attorneys trying to avoid litigation. Rather the required disclosures should be made in transparent, plain English manner that an average investor can comprehend. I believe any final rule should highlight such an objective in black and white.

I believe the disclosures by the auditor should encompass all CAMs prepared in any given year. Required disclosures should include:

1. A description of the nature of the issue in the CAM.
2. Why the auditor considers it to be a significant audit issue.
3. What the auditor did to complete the audit of issue.
4. Any change in scope of the audit of the issue that was required.
5. If the CAM involves a transaction, the dollar amounts of the transaction.

**Cost of Disclosing CAMS**
Some have stated having auditors include a discussion of CAMS in their audit reports would result in costs out-weighing benefits. Having prepared many a CAM in my past, I don’t believe there is a sound basis for such a view nor is there any data to support that – especially since it has not been done in the past in the U.S. On the other hand, I have found, as I have previously stated, that CAMS prepared in a quality audit, do integrate from beginning to end, the thinking, planning, execution and completion of an audit. They have often resulted in higher quality audits, in my opinion, as the entire audit team is focused on the key issues, how they approach and resolve those issues, ensuring compliance with both GAAP and GAAS. On the other hand, the lack of CAMS can result in a dysfunctional audit, where what is planned is not necessarily what is performed during the course of the audit, and items that should have been tested or persuasive evidence that should have been obtained, are missed. As such, I believe an approach tied to disclosure in the auditor’s report of CAMS, will:

1. Increase audit quality.
2. Reduce the likelihood of an audit failure – that is a failure to perform an audit in accordance with GAAS.
3. Provide useful information to investors, improving their capital allocation decisions AND increasing their investment returns.

For example, during the corporate scandals, there were instances where the auditors were aware of items that typically would have been included in a CAM, that were not disclosed at companies such as Xerox, Waste Management, Adelphia, etc. During the more recent financial crisis, similar examples occurred at financial institutions such as Indy Mac. If the audits had complied with GAAS, the CAMS properly prepared and made transparent to investors, I believe investors and auditors would have suffered significantly fewer losses.

*Transparency of Audit Partner*

As ACAP recommended, and I strongly support, the audit engagement partner’s signature of the report should be mandated. As ACAP’s report states, “The Committee notes the signature requirement should not impose on any signing partner any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of an audit firm.” I agree with that statement. As a former signing audit partner in an international firm, I think the requirement to sign one’s own name will certainly focus one’s attention and make one mindful of one’s duties, obligations and responsibilities to the investing public.

*Naming of Other Auditors of Significant Portions of the Financial Statements*

Finally, I would like to comment on disclosure of auditors, other than the primary signing auditor, who performs an audit of at least a significant portion of an audit. I believe an auditor who audits ten percent or more of the assets, liabilities, revenues, profits, cash flows or equity
of a public company, audits a significant portion of the financial statements. I believe a benchmark of twenty percent is too high.

When another performing auditor performs a significant portion of the audit, and is not subject to the normal inspection process of the PCAOB, or who has not agreed to provide work papers to the PCAOB, the (1) name of the audit firm including if it is an affiliate of the primary firm, (2) the portion of the audit they performed in terms of percentages of assets, liabilities, equity, etc., and (3) the fact they were not subject to the normal inspection process should be disclosed in the auditor’s report.

It is highly misleading to an investor, to have a “clean opinion” presented to an unknowing investor; if in fact the audit quality control system typically applicable to an audit does not exist. When problems arise, as they certainly have in the case of companies and their auditors in China, it can result in great harm to investors including losses on investments. Worse yet, it can cause trust in capital markets to evaporate driving up the cost of capital to those companies who play by the rules, deserve the capital, and who can generate positive returns for investors.

**Conclusion**

The auditor’s reporting model has not changed significantly since the last Ford Model A rolled off the production lines in the early 1930’s. In the intervening 80 years, the capital markets, information the market participant’s use, how they get that information, the quality of the information and how publicly traded companies conduct business have all gone through substantial evolution and changes.

The ACAP recommendations and call to action were issued over five years ago to the PCAOB. Yet today’s audit report remains stuck in a era long past. It is out of date and provides a minimal amount of information. It has led to questioning of the value of an audit to investors. The time for action by the PCAOB is now, if not past due, with respect to all the ACAP recommendations, including improving the audit report.

The purpose of an independent audit is to ensure investors receive timely, complete and credible information important to their decision making. They are not done for management who can get whatever information they need with respect to the company, in whatever format they desire.

When we find as we have in the past, auditors are aware of information important to investors, but fail to disclose it to investors, it stands to reason that any trust in an audit, and its value quickly evaporate. For that very reason, the Board should move forward in a timely fashion to adopt an expanded audit report, providing information they believe is important and useful. A
model that fails to provide independent auditor insights or simply repeats the disclosures made by management should not be accepted.