

**MEMO# 28014**

April 4, 2014

## **Summary of April 2-3 PCAOB Roundtable on Auditor's Reporting Model Proposal**

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 9-14  
INVESTMENT COMPANY DIRECTORS No. 4-14 RE: SUMMARY OF APRIL 2-3 PCAOB  
ROUNDTABLE ON AUDITOR'S REPORTING MODEL PROPOSAL

The Public Company Accounting Oversight Board held a two-day public meeting to gather input on its proposal to modify the auditor's report and the auditor's responsibility for other information included in annual reports. The Board heard input from speakers representing academics, audit committees, auditors, issuers, investors, representatives from foreign markets where similar reforms are being considered, and others. The two-day meeting was intended to inform the Board as it considers its next steps on its 2013 proposal that would represent the first major overhaul of the auditor's report in more than 70 years.

### **PCAOB Proposal**

The Board's proposal consists of two new audit standards that are intended to make the auditor's report more useful to investors (the Reporting Standard) and to clarify the auditor's responsibility for other information included in annual reports (the Other Information Standard). The Reporting Standard would require auditors to communicate critical audit matters (CAMs) which are defined as those matters that 1) involve the most difficult, subjective, or complex auditor judgments, 2) pose the most difficulty to the auditor in obtaining sufficient appropriate audit evidence, or 3) pose the most difficulty to the auditor in forming an opinion on the financial statements. For each CAM identified during the course of the audit the auditor's report would 1) identify the CAM, 2) describe the considerations that led the auditor to conclude the matter is a CAM, and 3) refer to the relevant financial statements accounts and disclosures that relate to the CAM. The Reporting Standard would also require the auditor's report to indicate the year the auditor first began service as the company's auditor. Finally, the Reporting Standard would also require the auditor's report to explain the auditor's responsibility for and the results of the auditor's evaluation of other information outside the financial statements that is included in the annual report.

The Other Information Standard would enhance the auditor's responsibility for other information that is included in the annual report. Under current PCAOB standards, the

auditor has a responsibility to “read and consider” other information in documents that contain audited financial statements and consider whether the other information is materially inconsistent with the financial statements. For mutual funds, this information is that which is contained in the fund’s shareholder report and Form N-CSR filing. While the auditor must read and consider the other information under current PCAOB standards, there is no requirement for the auditor to report on this aspect of his work. The Other Information Standard would enhance the auditor’s responsibility for other information by requiring, among other things, that the auditor evaluate whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both. The auditor’s evaluation would include reading the other information and performing specific procedures based on relevant audit evidence obtained and conclusions reached during the audit.

## **Two-day Meeting**

Investor representatives that participated in the two-day meeting generally supported the Board’s proposal. For example, Jeff Mahoney/ Council of Institutional Investors and Kurt Schacht/CFA Institute supported reporting on CAMs and urged the Board to go further by requiring the auditor to report on management’s critical accounting policies, and critical accounting estimates. Joan Amble, a member of the National Association of Corporate Directors and a public company board member strongly opposed auditor reporting on CAMs indicating that it would lead to much longer, but not more useful audit reports, by including information already provided by management in the notes to the financial statements or in the Management’s Discussion and Analysis portion of the annual 10-K.

Alan Beller, a public company board member and former Director of the SEC’s Division of Corporate Finance argued against reporting of CAMs as currently structured in the proposal. Beller indicated that CAM reporting will not convey meaningful information on the quality of financial reporting, that it would undermine the value of the pass/fail format of the auditor’s report, and that it would adversely impact the relationship between the audit committee and the external auditor. Beller noted that the proposal may also result in the audit report disclosing original information about the issuer not otherwise required to be disclosed under the securities laws. Beller suggested an alternative to the Board’s proposal in which the auditor would report on management’s critical accounting policies and critical accounting estimates as disclosed by the issuer in its MD&A.

Aulana Peters, a public company board member and a former SEC Commissioner expressed support for enhancing the informational value and relevance of the auditor’s report. Peters, however, expressed concern that the proposal appears designed to give the investor broader access to management information than is presently available, including information that is not required to be disclosed by the SEC’s rules and forms. Peters indicated that the proposal should be directed at providing a better understanding of the audit process and resulting opinion. Peters noted that the proposal to require disclosure of CAMs does not consider materiality and recommended that the Board consider a “risk based” approach to identifying CAMs. In particular, that the factors to be considered in identifying CAMs should be based on what the auditor determines to present the greatest audit risk and the greatest risk of material misstatement in the financial statements.

The audit firms generally expressed support for the Board’s proposal, provided that the definition of CAMs is more narrowly tailored and the resulting reporting is circumscribed. For example, Michael Gallagher, Managing Partner, Assurance Quality for PwC indicated that CAMs should be limited to matters that were material to the financial statements and

that resulted in the most significant interaction with the audit committee. Kevin Reilly, Americas Vice-Chair, Professional Practice and Risk Management for Ernst & Young indicated that the required reporting on CAMs should reflect a more pragmatic approach that (i) presents a very crisp, fact based outline of the issue that does not compete with the company's disclosures or reflect original information about the entity, (ii) outlines the *principal reason* (and not a checklist of any and all possible influences) why the auditor believes the matter is a CAM, and (iii) references where the matter is covered in the company's financial disclosures. It should be noted that each of the "big four" audit firms recommended in their comment letters on the proposal that investment companies be exempt from CAM reporting.

John Corcoran, President of the MFS Funds and Senior Vice-President of MFS Investment Management participated in a panel that considered application of the proposal to investment companies and broker-dealers. Corcoran reiterated several points made in a joint comment letter on the proposal filed by MFS Investment Management and the MFS Funds Board Audit Committee. Corcoran expressed support for those elements of the Board's proposal that require the auditor to affirmatively state its independence and articulate the auditor's responsibility to detect material misstatements due to fraud.

Corcoran, however, opposed CAM reporting indicating that it could be interpreted by shareholders as a sign that something is wrong with the fund, when in fact, judgments, estimates, and assumptions are an inherent part of the financial reporting process. Corcoran noted that the Board's proposal indicated that almost all audits would involve CAM reporting. This could provide the auditor with an incentive to identify CAMs in order to demonstrate the comprehensive nature of its audit and its compliance with the PCAOB's directive. If CAMs are perceived as a "red flag" by investors, the inclusion of CAMs may have unintended negative consequences in that investors are likely to use CAMs as a subjective "yardstick" with which to evaluate a fund versus its peers. This may raise competitive concerns if audit firms, or audit partners, inconsistently identify or report on CAMs.

Corcoran expressed concern that CAM reporting may inappropriately put the auditor in the role of management. Current auditing standards indicate that the financial statements are the responsibility of management and that the auditor's responsibility is to express an opinion on whether those statements are fairly presented. Corcoran noted that the proposal may require the auditor to include in the auditor's report information on an entity's operations or financial results that is not otherwise publicly available. For a fund, this could be information on immaterial, passed audit adjustments or immaterial differences in the judgments made in investment valuation. Any concept which requires auditors to disclose information on the financial statements beyond what is required to be disclosed by management, is counter to the auditor's defined role. If, in fact, management's financial statement presentation and disclosures are not sufficient, then the auditor should not be able to reach an unqualified opinion.

Corcoran indicated that the proposal may increase audit fees and time required to complete the financial statement audit. While the level of audit evidence and audit work required for the auditor to reach an opinion in theory would not change, a significant increase in hours would be necessary for the auditor to draft CAM disclosure and to complete the associated documentation in the audit work papers. CAM disclosure would introduce non-standard language into the auditor's report which will require additional levels of review by the audit firm, the fund's management, and quite possibly the legal counsel of both parties. The significant costs associated with those additional hours likely

will be tacked onto existing audit fees, resulting in higher fund expenses borne by investors. The additional hours would likely be incurred at the conclusion of the audit, putting additional pressures on already tight SEC filing deadlines.

Corcoran also commented on the Other Information Standard. He indicated that while it may be helpful to clarify which components of other information an auditor has evaluated, MFS does not believe the proposal, as written, is sufficiently detailed with respect to the scope or the expected level of auditor effort and documentation. The scope should be more specifically defined to ensure consistency in execution by audit teams and should be limited to other information for which the auditor has sufficient expertise. Corcoran indicated there will be an increase in costs for each additional element of other information that the auditor is required to evaluate, so there needs to be a corresponding level of benefit to shareholders. Corcoran recommended that the Board consider gathering more information before proceeding with this element of the proposal.

Jeffrey Burgess, Grant Thornton National Managing Partner of Professional Standards, joined Mr. Corcoran on the panel that considered application of the proposal to investment companies and broker-dealers. Burgess indicated his view that PCAOB standards should, in most circumstances, be applied uniformly to all issuers. He indicated that he shares what seems to be the general view of many other commenters that the primary focus of CAMs in the investment company context would be the valuation of investment securities. Valuation has been a significant focus of the SEC and investors in recent years, he stated, so a CAM related to this complex audit area could be relevant.

Certain Board members asked questions during the panel suggesting that it may be difficult to exempt investment companies from the proposed CAM disclosure. Instead, they noted that application of the disclosure could be “scalable,” whereby the Board would recognize that CAMs might not be present in all audits, depending on the facts and circumstances of the issuer. Panelists were divided on whether audit firms would still be incentivized to identify CAMs in all audits.

The [complete text](#) of Corcoran’s statement and the statements made by other participants is available on the PCAOB’s website.

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