Remarks on Auditor Commentary—Moving Beyond Boilerplate at the International Auditing and Assurance Standards Board (IAASB) Roundtable: Improving the Auditor's Report

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Thank you Mr. Chairman and good morning. I very much appreciate the opportunity to participate at this roundtable on the important topic of improving the auditor's report.

The views and opinions I will express this morning, unless otherwise noted, are my own, and do not necessarily represent the views or opinions of the Council of Institutional Investors' ("Council") membership, board, or staff.

The Council is a U.S based nonprofit association of public, corporate, and union employee benefit plans with combined assets of more than $3 trillion. Our member funds are major shareowners with a duty to protect the retirement assets of millions of American workers. While most of our member funds' assets are invested in securities of U.S. companies, based on our most recent member survey, on average approximately twenty-five percent of our member fund assets are invested in non-U.S. equity and fixed income securities.

Perhaps not surprisingly, the Council's membership approved policies explicitly express support for the view that the efficiency of global markets depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. Our policies also recognize, that the quality, comparability and reliability of the information contained in audited financial reports depends, in part, on the quality of the standards issued by bodies like the International Auditing and Assurance Standards Board ("IAASB") and the U.S. Public Company Accounting Oversight Board ("PCAOB"), among others.

In evaluating the quality of the IAASB's Invitation to Comment ("ITC") and more specifically the ITC's auditor commentary, I believe it is appropriate to begin the analysis by acknowledging the following three facts:

First, as noted in Council policy, investors (not corporate officers, directors, or audit firms) are the primary customers of audited financial reports.

Second, the auditor's report is the primary vehicle, in some cases the only source, of communication between the independent external auditor and investors.

Finally, the existing standard auditor's report does not fully meet the needs of many of its primary customers. This third fact becomes apparent when you review the recent history of U.S. efforts to improve the standard auditor's report.

From as early as 1978, with the Commission on Auditor's Responsibilities, to 2008 with the U.S. Department of Treasury's Advisory Committee on the Auditing Profession ("ACAP"), blue ribbon panels comprised of not only investors but current and former leaders of the auditing profession, have consistently concluded that the standard auditor's report should be improved to enhance the communication of relevant information about the audit of the company from the external auditor to the user of the external auditor's report. That view is also generally consistent with the PCAOB staff's own recent extensive research in connection with the development of their related Concept Release in which they observed that "there was consensus among investors that the auditor has significant insight into the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful."[1]

There are many reasons why investors would invite better communication with the external auditor through the auditor's report, but for investors who are shareowners there is at least one practical and powerful reason: Consistent with Council policy and the recommendations of ACAP, shareowners at many U.S. public companies, including approximately ninety percent of the Russell 3000, annually vote on whether to retain the external auditor. Yet, as indicated, the standard auditor's report, which is often the only communication between the auditor and those shareowners, provides little, if any, information of value when assessing the quality of auditor performance and differentiating between audit firms—information that might be very useful to shareowners in making a more informed vote on whether to retain the external auditor.

A recent academic study published in *The Accounting Review*, provides empirical evidence confirming, what many of our members have long believed, that companies with shareowner auditor ratification votes have higher quality audits—measured by fewer restatements and fewer abnormal accruals—than companies that do not provide for such a vote.[2] Thus, the ITC, in my view, presents an opportunity for the IAASB and the auditing profession to potentially further improve audit quality by communicating information that could result in a more informed shareowner vote.

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[1] Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Release No. 2011-003, 34 PCAOB Rulemaking Docket Matter 7 (June 21, 2011), http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

[2] Mai Dao et al., Shareholder Voting on Auditor Selection, Audit Fees, and Audit Quality, 87 Acct. Rev. 149, 149 (2012) (on file with Council).

Turning back now to the specifics of the auditor commentary, I generally support the overarching objective described in paragraph thirty-nine of the ITC. I particularly support the language indicating that the purpose of the auditor commentary is to provide transparency about matters that are "likely to be most important to users' understanding of the audited financial statement or the audit."

I also generally support the three matters listed in paragraph forty-five of the ITC that "at a minimum," should be considered in determining the information to be included in the auditor commentary. I particularly support the first of the three matters referencing "areas of significant management judgment" as information that the independent auditor should present in the auditor commentary. This first matter is generally consistent with the results of both a 2011 CFA survey and a 2011 PCAOB Investor Advisory Group survey finding that eighty-six and seventy-nine percent of respondents, respectively, generally believe it is important for the auditor's report to include the independent auditor's assessment of management's critical accounting judgments and estimates.

While I generally support the ITC's framework and the matters to be included in the auditor commentary, I believe the examples on page ten of the ITC are generally not responsive to what many customers of auditor reports and other stakeholders have been requesting.

As indicated, a reoccurring theme in the surveys and studies on the standard auditor's report suggests that investors and other stakeholders would like to see the standard auditor's report, or some supplement thereto, include information about the independent auditor's unbiased expert assessment of matters of the type described in paragraph forty-five of the ITC. Unfortunately, of the five examples of auditor commentary on page ten of the ITC, four of the five provide no real insights by the independent external auditor.

The one exception is the ITC example on "Valuation of Financial Statements" where the auditor commentary states that management's "recorded amount fell within our range." I would note that even this disclosure falls far short of what many investors and other stakeholders have asked for, and that I would hope that this standard setting project could produce.

As one example, a recent opinion piece appearing in *CFO.com* (generally not viewed as an advocacy arm of investors) describes the potential benefits of the ITC in the following terms:

> *"It looks like a development that will not only change corporate behavior but also improve auditor independence. Instead of an audit firm approving a set of accounts, signing off on them through gritted teeth after wrangling over some edge-of-the-envelope valuations pushed hard by its fee paying client, the audit firm could have the ability—in fact, the requirement—to reveal that the assumptions underlying the financial statements are far from conservative, though they may just fall within what the auditor regards as an acceptable range of valuations."*[3]

In my view, the *CFO.com* opinion piece reflects the type of reform that many investors and other stakeholders have long been demanding when it comes to improving the auditor's report. I am hopeful that the IAASB will use this standard setting project as a means to respond to those demands. Failure to do so, may further devalue the standard auditor's report and the vital role of the auditing profession as financial gatekeepers.

Thank you again for inviting me to participate at this roundtable, and I look forward to today's discussion.

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[3] Andrew Sawers, Suddenly, Audit Reports Get Sexy, CFO.com, June 27, 2012, at 1, http://www3.cfo.com/article/2012/6/auditing_auditors-report-iaasb-ifrs-financial-statements-goodwill-accounting.