

October 8, 2012

RE: IAASB Invitation to Comment: Improving the Auditor's Report

I commend the IAASB for considering substantive changes to the standard audit report. Based on my work on the PCAOB's Investor Advisory Group, investors view the auditor's role as important but view the standard audit report as lacking sufficient information value. Both boards now have the opportunity to make substantive changes to the audit report. I encourage the IAASB to think boldly and aggressively, and to fashion those changes desired by investors regardless of the preferences of auditors, audit committees, and management. Although it should go without repeating, investors never tire of reminding regulators and standard setters that external financial reporting and auditing would not be needed if it was not for investors. Therefore, in fashioning regulatory solutions to contemporary problems, the needs of investors should always be paramount.

My views are informed by my service as an accounting professor for the past 20 years, where I have taught auditing, corporate governance, and financial accounting, and conducted research on issues related to audit committees, fraudulent financial reporting, going concern reporting, and accounting and auditing regulation. In addition, I either am (or have) served on the PCAOB's Investor Advisory Group and Standing Advisory Group; a COSO task force charged with drafting guidance in applying the *Internal Control – Integrated Framework* to smaller public companies; and service chairing the audit committee of a mid-size government entity.

My comments on the Invitation to Comment (ITC) are (from most to least important):

1. Although I like the concept of an Auditor Commentary very much, I generally did not find the proposed disclosures in the Commentary to be very valuable. The disclosure around goodwill was okay, but the other three disclosures seemed quite sterile. For example, the illustrative disclosure on valuation of financial instruments stated, "Management's recorded amount fell within our range." Investors want to know how big management's range was and where did management's estimate fall within that range.

To provide a basis of comparison, I compared the Auditor Commentary to the draft report suggested by the Center for Audit Quality in its June 28, 2011 comment letter to the PCAOB (PCAOB Rulemaking Docket No. 034) (see pp. 3 and 4 of Example A). I found items 2 and 3 to generally be more helpful than the items in the ITC's Auditor Commentary (other than the ITC disclosure on goodwill disclosure, which was somewhat helpful). And item 4, included in the CAQ's draft report, was excellent – i.e., "No impairment was recognized because the Company's estimated fair value of this reporting unit exceeded its carrying value at that date; however, the comparison was close and a further decline in fair value of this reporting unit could give rise to

an impairment of the goodwill balance in the future”. This is the kind of wording that investors want in the audit report because it tells readers of the report something they did not previously know.

I continue to believe that investors need better information on material estimates and judgments, significant unusual transactions, and the quality of the entity’s accounting policies and practices. And I believe that the auditor’s perspectives on these issues would be useful to financial statement users. The draft report fails to address these concerns, and is essentially a “user’s guide” to the financial statement notes. I continue to believe that the profession can do better. This is the major shortcoming of the IAASB’s ITC.

The ITC seems to recognize that certain disclosures would have high value but face high impediments (for example, information about material estimates and judgments, significant unusual transactions, and the quality of the entity’s accounting policies and practices). It struck me that when faced with high impediments, the IAASB’s solution was to lower its sights. I believe that when customers have indicated that certain information would be of high value, that it is incumbent on standard setters to seek a means of overcoming impediments.

Notwithstanding the limitations of the Auditor Commentary as currently proposed in the ITC, any required Commentary should definitely apply to public-interest entities (PIEs) (paragraph 52). The ITC indicates that a definition of a PIE would need to be developed. In developing such a definition, I would encourage the IAASB to focus on whether a fiduciary relationship exists between the reporting entity and customers or other important societal groups (e.g., taxpayers).

2. Requiring the auditor to explicitly state that they have not identified any material uncertainties that would call into question the going concern assumption is a positive change. Making the lack of material uncertainties explicit rather than implicit is positive (i.e., the language in the Illustration of a Possible Improved Auditor’s Report is generally fine). But the last sentence in that paragraph struck me as an attempt to limit liability rather than an attempt to create value. The sentence read, “Because not all future events or conditions can be predicted, this statement is not a guarantee as to the Company’s ability to continue as a going concern.” Such language generally is not well received by investors and investor advocates.

In addition, with respect to reporting on the existence of any material uncertainties that might call the going concern assumption into question, the ITC indicates that the auditor may need to disclose entity-specific information not disclosed by management. Not only would providing additional information in this circumstance be desirable (paragraph 31), providing such additional information is what creates value.

3. The draft report’s requirement to require the identification of the engagement partner is positive. Investors clearly favor this requirement, as virtually every comment letter to the PCAOB from investors and investor advocates on the PCAOB’s similar proposal is strongly in

favor of requiring engagement partner signature or, at a minimum, engagement partner identification.

4. I think it is helpful to identify other auditors that play a substantial role in a group audit, so I am generally in favor of the proposed disclosure discussed in the Illustration of a Possible Improved Auditor's Report. However, to be more useful, the proposed disclosure should identify the names and country locations of other auditors that performed substantive audit work. The ITC expresses concern that the list of participating auditors may be so long as to diminish the value of the disclosure (paragraph 80). A possible compromise solution is to use a cutoff to require disclosure (e.g., 10% of audit hours) and/or only require the identification of those auditors not participating in an inspection regime where the entity conducting the inspection is a member of the International Federation of Independent Audit Regulators (IFIAR).

5. The draft report includes the following statement, "The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control." Again, this is an attempt to narrow the scope of the assurance provided by the audit report, and I don't think it will be well received especially because current auditing standards require the auditor to obtain sufficient appropriate audit evidence to provide reasonable assurance that the financial statements are not materially misstated, whether caused by error or fraud. It seems like the proposed language would provide a lower level of assurance related to misstatements that result from fraud.

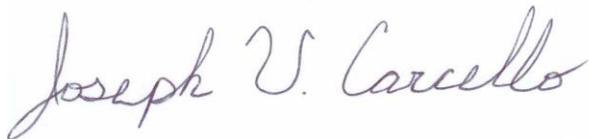
6. I'm not convinced that it is useful to confirm management's use of the going concern assumption. It seems to me that the alternative is the liquidation basis of accounting, and such a basis is not even that prevalent after a bankruptcy filing because companies typically try to reorganize in bankruptcy rather than liquidate.

7. The draft report leads with the audit opinion. In my view, leading with the audit opinion is a positive, although modest, change. (The change simply rearranges wording.)

8. I liked the statement in the ITC that "the auditor would not be prohibited from providing more subjective views in relation to particular matters" (e.g., estimates, quality of accounting policies and practices) (footnote #19 on p. 27). This language provides an opportunity for accounting firms to differentiate themselves, although my guess is that most will not. I think a fair question to ask is why would a supplier of a service voluntarily pass on the opportunity to meet the needs of customers? Perhaps there is insufficient competition for audits, certainly of large companies (competition often seems to be based primarily on price). Or, perhaps more likely, the customer is really client management and/or the audit committee, neither of which is optimal from the perspective of investors and speaks to more fundamental and systemic issues in corporate governance.

In conclusion, in Professor Schilder's statement accompanying the ITC he asks stakeholders to address this question – "Will the identified improvements to the auditor's report meet users' demands for greater transparency about the financial statements and the audit and provide the value that is sought?" Although the ITC is well-intentioned, it is too timid and incremental – the value that is being sought by investors is simply not provided if all investors are offered in a revised audit report is a roadmap to the financial statements. Informed financial statement users who are, after all, the marginal investor can effectively and efficiently navigate financial statements on their own. Rather, if the IAASB focused on having the auditor communicate facts that users otherwise would not know, then not only would the audit report be more useful but a positive, unintended consequence would result. I believe that writing the audit report from the perspective of investors would – in the words of PCAOB Chairman James Doty (speech of 10-1-12) – "... re-orient auditors to see public investors as their client." Such a focus on investors as the auditors' client would likely increase skepticism; the lack thereof is the profession's current Achilles heel.

Sincerely,

A handwritten signature in blue ink that reads "Joseph V. Carcello". The signature is written in a cursive, flowing style.

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