Center for Audit Quality

Summary of Workshop on the Evolving Role of the Auditor

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

Affiliated with the American Institute of CPAs

The role of the public company auditor and how it should evolve is a complex issue that involves consideration of the responsibilities of all stakeholders in our financial reporting system.

The system includes a series of checks and balances comprised of issuers, audit committees, internal and external auditors, regulators, rating agencies, analysts, investors, the media and others.

During a workshop held in New York, we encouraged an in-depth discussion of the ideas most frequently identified for further exploration during the CAQ's 2011 outreach on how the auditor's role might change and evolve to meet the needs of investors (summarized in our October 2011 report, *Observations on the Evolving Role of the Auditor*). Over half of the more than 30 workshop participants were investors and buy-side analysts; the remainder was a mix of audit committee members, preparers and auditors. Discussions were held under the "Chatham House Rule" and not for individual attribution.

Workshop participants spent most of a full day discussing the benefits of auditor involvement with financial information disclosed by management *outside* of the audited financial statements; specifically, Management's Discussion and Analysis, earnings releases, and key performance indicators. The give and take was lively, yet there was significant consensus within the group on the issue of auditor involvement.

The CAQ hopes to advance further consideration of these issues by all interested parties through publication of this workshop summary and through continued dialogue with stakeholders and policy makers. It is vitally important that investors understand and trust the work that auditors perform — and have confidence in our financial reporting system and the checks and balances that underly the system. These are goals to which the CAQ is committed.

Sincerely,

Cynthia M. Fornelli

Cindy Fornelli
Executive Director

INTRODUCTION

The Center for Audit Quality (CAQ) held a workshop on March 12, 2012 in New York City to explore in-depth how the auditor's role might evolve to meet the needs of investors. Discussions focused on financial information communicated by management outside of the audited financial statements.

Approximately 35 individuals participated, of which the majority were investors or buy-side analysts. The workshop was organized into a broad group discussion followed by break-out discussions. Each break-out discussion group included a majority of investor representatives as well as an audit committee member and/or preparer. An auditor also observed the discussion at each table and acted as a subject matter resource. Subsequent to the break-out sessions, an investor representative from each discussion group reported on the break-out discussions and a group discussion followed. At the end of the session there was a poll to capture participants' views on specific questions.

The workshop was moderated by Alan Beller, Partner, Cleary Gottlieb Steen & Hamilton LLP, and director on a board of a public company, and John White, Partner, Corporate Department, Cravath, Swaine & Moore LLP. Both gentlemen are former directors of the U.S. Securities and Exchange Commission's (SEC) Division of Corporation Finance and continue to act as thought leaders on policy issues pertaining to financial reporting. The workshop was observed by a member of the SEC staff and a member of the Public Company Accounting Oversight Board (PCAOB).

WORKSHOP TOPICS

The workshop topics were those most frequently identified for further exploration during five roundtable discussions on the evolving role of the auditor held in the United States and Canada during 2011: Management's Discussion and Analysis (MD&A), earnings releases, and key performance indicators (KPIs). Discussions from the roundtables are summarized in the CAQ report, *Observations on the Evolving Role of the Auditor: A Summary of Stakeholder Discussions.*

For each topic, participants were asked to consider what more auditors could do to meet the needs of investors. Importantly, rather than focus on the current regulatory framework or practice, participants were asked to consider "what is possible?" — acknowledging that a framework or regulatory guidance ultimately may be required to achieve such change in the auditor's role. Specifically, participants were asked to consider the information disclosed by management in MD&A and earnings releases, including KPIs that investors find useful in making investment decisions (e.g., inventory turnover, same store sales, market share), and consider whether investment decision processes would be enhanced as a result of some additional level of auditor involvement with this information. Workshop participants also discussed, more broadly, other areas that might assist investors' decision making processes through some level of auditor involvement.

Participants were encouraged to identify and consider all potential benefits and impediments of further auditor involvement with these disclosures made outside of the financial statements, including, for example, the impact on the roles of the audit committee and management, the quality of a company's disclosures, and the timing of reporting to investors.

LEVELS OF POSSIBLE AUDITOR INVOLVEMENT

For discussion purposes, participants considered the usefulness of several varying levels of auditor involvement:

- ***Written statement of association***, providing no assurance or an opinion, but stating that the auditor read the information for material inconsistencies with the financial statements or material misstatements of fact. If either were identified, the auditor would raise the issue with management and/or the audit committee, and if not addressed appropriately, the auditor would disclose the matter in the auditor's report.

- ***Specified procedures report,*** providing no assurance or an opinion, but rather a written statement that the auditor has performed certain procedures, as well as the findings of such procedures.

- ***Limited review report,*** providing negative assurance and no opinion, but rather a written statement that "nothing came to the auditor's attention" to indicate that the information disclosed is not accurately derived from financial information and/or that the underlying information does not provide a reasonable basis for disclosure, in all material respects.

- ***Examination report,*** providing positive assurance in the form of a written report expressing an opinion about certain information.

It was emphasized that for all of the topics and alternative levels of auditor involvement, there likely would need to be additional regulatory efforts by the SEC or the PCAOB (e.g., reporting frameworks for issuers, SEC rulemaking to require auditor involvement, and PCAOB adoption of new professional standards or guidance).

GENERAL OBSERVATIONS

The current financial reporting system is not "broken" but could be improved

Investors are confident in the current state of financial reporting because management is held accountable for the information disclosed through a series of checks and balances, including audit committees, internal and external auditors, regulators, rating agencies, analysts, the media, and investors themselves. Investors continue to find the audit valuable, and commented that their assessment of management (e.g., integrity, tone at the top) is informed by the auditor's report; they noted that they assume that the presence of the auditors helps to keep management "honest." Many in the group expressed frustration with overly complex accounting and disclosure requirements, and the fact that financial statements appear to be more focused on compliance than on effectively communicating the company's financial results and prospects.

Non-GAAP disclosures are important to investors' decision making processes

Investors noted that, increasingly, disclosures based on U.S. Generally Accepted Accounting Principles (GAAP) are not a primary input to investment decisions. There has been significant growth in the use and importance of non-GAAP measures. While investors still want assurance on GAAP disclosures in the financial statements, they place significant focus on non-GAAP measures (i.e., KPIs for purposes of workshop discussions), which allow management more flexibility to tell the story behind the GAAP disclosures and identify key metrics for the company. Accordingly, investors asked for more consistency in non-GAAP measures reported by management from period to period in MD&A and earnings releases, and improvements in comparability across companies in specific industries (although they acknowledged that some KPIs are company-specific). There was broad agreement that consistency and comparability should be driven by industry groups (not auditors), at least at the outset, although adoption of a more formal framework by the SEC ultimately may be needed. Some participants cautioned that "regulated" disclosures may become less flexible and candid.

"There are widely used non-GAAP KPIs that are computed in different ways by different companies and it's not necessarily clear from one company to the next how exactly they're computing them. That causes at least some residual doubt about the numbers. We also have broad concerns about KPI metrics changing from quarter to quarter."

Auditor involvement with information outside the financial statements would add an unwanted "filter" between management and investors

Investors emphasized the importance of hearing directly from management and how that dialogue impacts their ongoing process to evaluate the quality and integrity of management. There was wide concern that additional auditor reporting may place an unwanted and unnecessary filter between management and investors, impeding management's ability to speak "in its own voice." Additionally, investors were concerned that increased auditor involvement would result in more rote or standardized disclosures. The group noted that responsibility for the integrity of management's disclosures ultimately lies with the board and the audit committee (enforced by other checks and balances identified above).

"Most investors are really trying to get closer to management … we don't want more layers put between investors and management."

More audit committee reporting may be beneficial

The investors in the group were pleased to hear from the audit committee representatives about the role they play in overseeing a company's financial reporting processes for MD&A and earnings releases, and their communications with their auditors. There was general support for more public communication by audit committees about their processes and their interactions with the auditors.

More education is needed to close the expectation and information gap

The group acknowledged that not all capital market participants understand the current role of the auditor and the checks and balances that exist in the financial reporting system. There was general consensus that greater education efforts are needed to close this expectation and information gap, including efforts aimed at more sophisticated market participants.

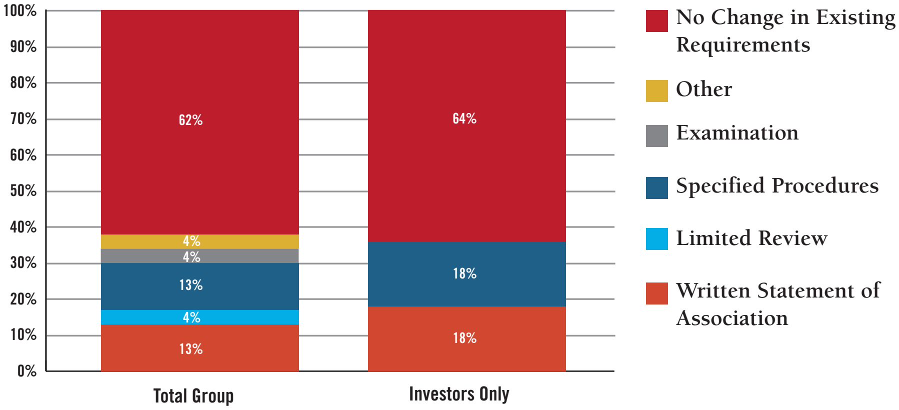
AUDITOR INVOLVEMENT WITH MD&A AND KPIS IN MD&A

Further auditor involvement with MD&A is unnecessary

Generally, the majority of the investors in the group had no appetite for further auditor involvement with MD&A in its entirety or with only KPIs included in MD&A. Participants believed the current requirement for the auditor to read MD&A for material inconsistencies with the financial statements or material misstatements of fact is sufficient, and questioned the value of auditor reporting on MD&A. Some participants noted that additional auditor reporting would not be important to investors because the quality and substance of MD&A disclosures vary greatly and, more importantly, the data contained in the MD&A is somewhat dated by the time the annual report is issued. At most, those in favor of any change from current practice believed that a written statement of association describing current professional requirements or a limited review were possible areas to consider. There was some interest by investors in determining what was not included in MD&A, but there was no consensus how auditors could play a role in providing that type of information. Participants noted that auditors can never have as much information on or insight into the company as management.

"The general sense was that we don't want any more auditor involvement in MD&A than we currently have: just a reading to make sure the auditor doesn't have any issues with it."

What is the appropriate level of auditor involvement with MD&A?



General observations

As noted above, while discussing MD&A investors emphasized, and other participants agreed, that further auditor involvement with MD&A, beyond current responsibilities, could add an unnecessary filter between investors and management. Investors also called for more consistency and comparability in the use of non-GAAP information contained in MD&A. They also believe that more audit committee reporting on its involvement with the MD&A and interaction with the auditor may be beneficial. Participants also recognized that there is a need for more education on the role of the auditor and the financial reporting system.

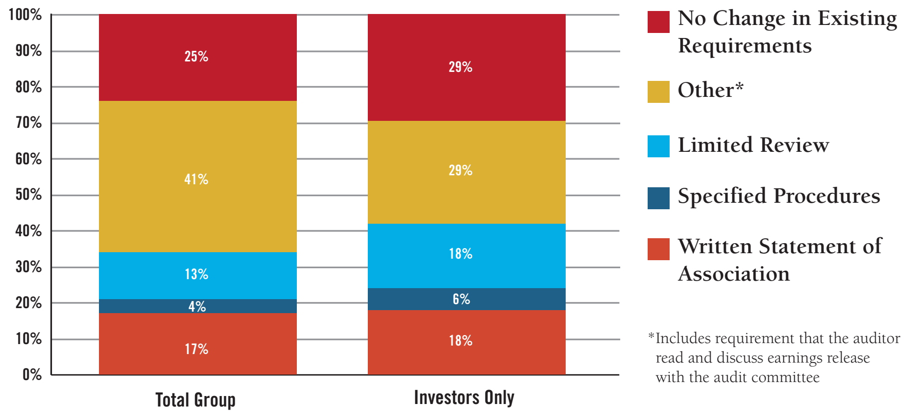
AUDITOR INVOLVEMENT WITH EARNINGS RELEASES AND KPIS IN EARNINGS RELEASES

Further auditor involvement with the earnings release is appropriate

Participants agreed that the earnings release is of keen interest to investors because it is the timeliest of management's communications about a company's performance. Given its importance, a majority of the group believed there should be some level of auditor involvement with the earnings release; however, there were differing views regarding the appropriate level. The majority supported a requirement for the auditor to read the earnings release and participate in robust discussions with the audit committee on the content of the release (a best practice today), but did not want a written report, noting that the robust dialogue between the auditor and audit committee provides confidence that the numbers reported in the earnings release are accurate. Several audit committee members stated that they discuss the financial information contained in the earnings release with the auditors to determine if anything is inconsistent with the underlying financial information available, acknowledging that the audit or review is typically incomplete at the time of the release. Participants also believed public reporting by the auditor would be unnecessary due to the market discipline that would occur should an issuer later restate the numbers contained in a release, pointing out that the Form 10-K or Form 10-Q is available within a few weeks time to compare to the earnings release. The minority in favor of some form of public reporting by the auditor on the earnings release preferred a written statement of association or a limited review.

"Because the earnings release is the first in a series of documents it tends to have the most weight or impact on the market."

What is the appropriate level of auditor involvement with the earnings release?



*Includes requirement that the auditor read and discuss earnings release with the audit committee

More audit committee reporting may be beneficial

Investors expressed discontent with inconsistencies in the scope and content of earnings releases. An audit committee member stated that boards and audit committees are becoming more effective in overseeing the content and presentation of earnings releases. Investors were supportive of requiring that the audit committee have a dialogue with the auditor at the time it is reading the earnings release that includes an overview of the results of the audit or review thus far (including where there may be higher "risk in the numbers"), and whether the earnings release provides a "fair and balanced view" of results, although such a standard would be difficult to implement. Audit committee members provided an overview of their current processes for reviewing earnings releases, including discussions with the auditor. Investors indicated that knowing these discussions occur would provide comfort on the information communicated by management in the release. An audit committee member also noted that certain information may not be disclosed in an earnings release for competitive reasons, which would be a subject of discussion between the audit committee, management and the auditors.

Non-GAAP information should be more consistent and comparable

As noted earlier, investors called for more consistency and comparability for KPIs (e.g., non-GAAP measures) contained in earnings releases. There was agreement that KPIs are "the metrics that matter most" to investors. Consistent with the "fair and balanced" discussion above, there was concern that issuers selectively choose KPIs that present the most optimistic view of a company's results. Often, the KPIs disclosed change from period to period without any discussion, leaving investors to investigate or surmise why such measures were no longer disclosed or whether the omission is an indication of underlying problems. Accordingly, investors stated that a requirement for issuers to explain why a particular KPI was changed or dropped (e.g., require that KPIs be used for two periods or explain why they no longer are deemed important), and how KPIs are defined, would be helpful. However, there was no appetite for auditors to report on KPIs. Again, there was the sense that consistency and comparability should be driven by industry groups, at least at the outset. Participants also recognized that adoption of a formal framework by the SEC ultimately may be needed, although some participants cautioned that "regulated" disclosures often become less flexible and candid.

Earnings releases should not be delayed

Importantly, there was a general view that auditor involvement would not be preferred if it delayed the communication of this information to the market, noting that a delay of anything more than "a couple of days" was unacceptable.

Concern about adding an unwanted "filter" between management and investors

As noted earlier, some investors were concerned that auditor involvement with the earnings release would add a filter to management's disclosures and would result in more rote or standardized disclosures in the earnings release. These participants believe that it is widely understood that earnings releases are not audited. One investor commented that opining on "more things" would not have an impact on investors' actions. Another investor pointed out that auditors already help to keep management "honest" and don't need to play a greater role to accomplish that.

WHAT ELSE?

While workshop discussions focused primarily on the auditor's role with regard to MD&A, earnings releases and KPIs, participants also briefly discussed the auditor's role with regard to other disclosures made by management. Participants raised the possibility that the auditor might provide assistance in identifying key risk factors, although there was no consensus across the group. Investors commented that risk factor disclosures tend to be focused on strict compliance with the requirements rather than providing meaningful discussion of the most significant factors that make an investment speculative or risky. The excessive number of risk factors disclosed by many companies also was criticized. Several investors suggested that management identify the key (e.g., top five) risks. While participants thought that evaluation of risk factors may be outside of the expertise of auditors, some suggested there may be a role for auditors to comment on management's process for identifying and prioritizing the risks disclosed.

Some participants suggested that the auditor could include paragraphs in the auditor's report to emphasize certain matters of importance, while others discussed possible alternatives to this approach. A second approach contemplated management providing a list of what it believes are the most critical accounting matters/estimates in the financial statements; the auditor then would opine on management's list. A third approach involved an independent analyst reading the financial statements and highlighting what they believe are the most critical matters.

WHAT'S NEXT?

This workshop was intended to further enable the CAQ to identify actionable recommendations regarding how the role of the auditor might change to better meet stakeholders' needs. Consistent with what was heard at the 2011 roundtable series, investors called for streamlined and balanced reporting with improved content focused on effectively communicating a company's financial results as opposed to strict compliance with regulatory requirements. We also heard that audit committee communication might be expanded. Additionally, we heard that further education about the role of those involved in financial reporting, including the auditor and audit committee, is necessary to narrow the expectation and information gap, even for sophisticated market participants.

With respect to further exploration of MD&A, earnings releases and KPIs, the majority of participants, including the majority of investors, are not in favor of further auditor involvement with MD&A, but expressed interest in a requirement for the auditor to read the earnings release and discuss that information with the audit committee or perform a limited review prior to public release. We heard a call for greater consistency and comparability in KPIs, although the majority of participants believed this should be accomplished through the work of industry groups, or perhaps enhancements to the current regulatory reporting framework, as opposed to a change in the auditor's role with this information.

The CAQ hopes to advance further consideration of these issues by all interested parties through publication of this workshop summary. We support continued focused discussion on investor disclosure needs and whether involvement by the auditor or by some other financial reporting stakeholder is called for. The CAQ agrees with investors who commented that confidence in auditors and financial reporting would be improved by providing additional education on the role of the auditor and the checks and balances in the financial reporting system. To be responsive to this need, the CAQ intends to expand its education programs and collaborative efforts accordingly.

"We need more education, not just about what the auditors do, but also about what the audit committee does."

WORKSHOP PARTICIPANTS

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