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IMPROVING THE AUDITOR'S REPORT

Joseph Carcello - University of Tennessee

Norman Harrison - Breeden Capital

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Ann Yerger - Council of Institutional Investors

We thank Robert Whited for his research assistance.

Origin of Audit Report

- ▣ First known written U.S. corporate audit report

OCTOBER 1827 BALTIMORE AND OHIO RAILROAD AUDIT COMMITTEE REPORT

Meeting of the Board
1st Oct 1827
Report of the Committee
Appointed to examine the
Treasurer's a/c

1827 Oct. 1 We have examined the foregoing a/c & find the same to be correct exhibiting the amount rec'd by the treasurer of the Railroad & the several disbursements authorized by the board by which it will appear there remains a balance of \$17,835.9/100 at the credit of the company as p[er] book balances on the 29th of September [with] satisfactory vouchers being produced to show the correct refs of the afore said disbursements.

Signed John B. Morris
 William Stewart

Source: Baltimore and Ohio Rail Road Company Board of Directors, *Minute Book A*, 24 April 1827 to 26 August 1830, Hays T. Watkins Research Library, B&O Museum, Baltimore, pp. 31-2.

Origin of Audit Report

- ❑ First U.S. audit report simply stated the findings of the account examination of the Baltimore & Ohio Railroad in 1827
- ❑ In the early 1900's, audit reports were very descriptive and lengthy. Auditors provided a detailed and comprehensive account of work completed
- ❑ The audit report was seen as a "certification" that clearly and precisely explained the auditor's opinions on the firm's accounts
- ❑ A standard form was not suggested until a 1917 article in the Federal Reserve Bulletin

Changes Proposed by Commissions

- ▣ Cohen Commission (1978)
 - Clearly describe the auditor's work and findings avoiding unclear technical terminology
 - Describe entire audit function more precisely and unambiguously
 - Explicitly state the limitations of the audit function and provide a clear distinction between the responsibilities of management and those of the auditor
 - Use standardized alternative phrases or paragraphs rather than a single standard report form

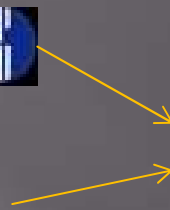
Changes Proposed by Commissions

- ▣ CFA Institute Survey (2008)
 - Include more specific information about how the auditors reached their opinion.
 - Identify key risk areas, significant changes in risk exposures, and amounts requiring judgment and involving uncertainty.
- ▣ Advisory Committee on the Auditing Profession (2008)
 - Clarify the auditor's role and limitations in detecting fraud
 - Consider mandating the partner's signature on the auditor's report
 - Consider making the report more descriptive

1990



TODAY



REPORT OF INDEPENDENT AUDITORS

To the Shareholders and Board of Directors of The BFGoodrich Company:

We have audited the accompanying consolidated balance sheet of The BFGoodrich Company and subsidiaries as of December 31, 1995 and 1994, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1995. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The BFGoodrich Company and subsidiaries at December 31, 1995 and 1994, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1995, in conformity with generally accepted accounting principles.

Cleveland, Ohio
February 2, 1996

ERNST & YOUNG LLP

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors of Goodrich Corporation

We have audited the accompanying consolidated balance sheets of Goodrich Corporation as of December 31, 2010 and 2009, and the related consolidated statements of income, cash flows, and equity for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of **the Public Company Accounting Oversight Board (United States)**. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Goodrich Corporation at December 31, 2010 and 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), Goodrich Corporation's internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 15, 2011 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP
Charlotte, North Carolina
February 15, 2011

Groups Surveyed

- ▣ Members of IAG taskforce (Becker – TIAA-CREF; Carcello – University of Tennessee; Harrison – Breedon Capital; Head – TD Ameritrade; Hill – Icon Blue; Nachtwey – Legg Mason; Sauter – Vanguard; Simpson – CalPERS; Vincent – Ospraie; Yerger – Council of Institutional Investors)
- ▣ Friends of the IAG – Blackrock; Capital Group
- ▣ Over 300 leaders from investment banks, hedge funds, private equity funds, mutual funds, pension funds and endowments
- ▣ Respondents include: CEO's, Presidents, Managing Directors, CFO's, CIO's, Equity Analysts, Portfolio Managers, Controllers and Credit Analysts at these major investment firms

Format of Survey

- ▣ Project background and instructions
- ▣ Background information (i.e., current use and value of the audit report, and potential changes)
- ▣ Substance of information in the audit report
 - More information about what the auditor did (i.e., the audit process)
 - More information about what the auditor found
- ▣ Form of the audit report
- ▣ Demographic information (employer, title)

Responses Received

- ▣ 73 respondents
- ▣ Multiple responses were received from:

Organization Name	Number of Respondents	Assets Under Management
BlackRock	7	\$3.6 trillion
Vanguard	6	\$1.4 trillion
Capital Group	4	\$1.3 trillion
TIAA-CREF	4	\$450 billion
Legg Mason	3	\$672 billion
Breeden Capital	3	\$1 billion

Current Usefulness of the Audit Report

- ▣ 45% of respondents believe the current audit report does not provide valuable information that is integral to understanding financial statements (23% of respondents believe the current audit report provides valuable information)
- ▣ 73% of respondents skim report quickly for departures from the standard unqualified report while 18% believe it is of no use to them at all (7% read the full report)

Comments on the Usefulness of the Audit Report

- ▣ “Over the years, the report has evolved into something that really communicates as little new information as possible.” -- Head of Fixed Income Portfolio Management, Money Management Firm
- ▣ “The audit report is largely boilerplate, and only provides meaningful information in extreme circumstances, usually around going concern issues.” - Chief Investment Officer, Mutual Fund
- ▣ “The statement feels very binary. Either a qualified opinion or not. Not a lot of incremental information once a company gets an unqualified opinion.” – Chief Executive Officer, Hedge Fund

The Other Side

- ▣ “The audit report is valuable both because of what it says, i.e., an opinion, and by virtue of what it does not say, i.e., an exception.” – Audit Committee Member, Mutual Fund
- ▣ “I read the auditor’s reports on financial statements and controls and in conjunction with other disclosures in the financial statements, MD&A and management’s (CEO and CFO) statements regarding controls and audit committee report – they represent a “package” and should be thought of as a connected triangle.” - Audit Committee Member, Mutual Fund

Substance of Information in Report – Disclosure of Risks

- ▣ 77% believe auditor should disclose areas with greatest financial statement and audit risk and the audit work performed in those areas (17% disagree with requiring disclosure)
- ▣ PRO -- “There needs to be an expanded discussion of risks, processes related to identification of risks, risk management, governance oversight, and auditor review; this goes beyond auditor assessment of risks related to financial statements.”
- Audit Committee Member, Mutual Fund
- ▣ CON -- “Unless this information is disclosed by the audit committee report and the auditor has some oversight regarding the accuracy of the audit committee report.” – Assistant Director, Insurance

Disclosure of Audit Hours

- ▣ 51% believe the auditor should not be required to disclose hours spent on individual financial statement accounts (21% would like this information)
- ▣ PRO -- “We believe this enhanced transparency by audit firms will provide valuable information to audit committees and shareowners. We believe with improved transparency, audit firms will have additional incentives to raise audit quality and disclose key performance indicators to distinguish their firm’s competitiveness.” – Chief Investment Officer, Public Pension Fund
- ▣ CON -- “Time is not necessarily a sufficient indication of quality.” – Anonymous Respondent

Disclosure of Materiality Thresholds

- ▣ 56% believe the auditor should disclose quantitative and qualitative materiality thresholds and considerations (17% disagree with requiring disclosure)
- ▣ PRO - “I think disclosing qualitative materiality is more important than disclosing the number.”
- Controller, Money Management Firm
- ▣ CON - “Should have a more standardized materiality threshold. SEC / FASB should address.” - Equity Analyst, Mutual Fund

Disclosure of Work Performed by Other Audit Firms

- ▣ 47% believe the auditor should disclose the nature and extent of work performed by other audit firms, including non-U.S. affiliates of the principal auditor, and the names of these firms (20% disagree with requiring disclosure)
- ▣ PRO - “Especially important in light of the fact that non-U.S. affiliates may not have been subjected to PCAOB audit.” – State Government Official
- ▣ CON - “It is the auditor’s responsibility to ‘get happy’ with the audits by other firms. Disclosure would add confusion since readers would have little ability to evaluate the information.” - Chief Compliance Officer, Hedge Fund

Summary – Information about What the Auditor Did

- ▣ Respondents would like additional information about:
 - Risk, including the auditor's response thereto (77%)
 - Materiality levels and factors (56%)
 - Nature and extent of involvement by other audit firms (47%)
- ▣ Respondents would not like additional information about:
 - Audit hours (51%)

Auditor's Evaluation of Significant Estimates and Judgments

- ▣ 79% of respondents believe the auditor should discuss significant estimates and judgments made by management, the auditor's assessment of their accuracy, and how the auditor arrived at that assessment (14% disagree with requiring this disclosure)
- ▣ PRO - "There are many judgments that ultimately determine the data on the financial statements. It's critical to understand how estimates were made and how much margin of error there might be in the estimates." - Chief Investment Officer, Mutual Fund
- ▣ CON - "This is the job of management." - Member of Board of Directors, Mutual Fund

Auditor's Evaluation of Accounting Policies and Practices

- ▣ 65% believe the auditor should discuss quality, not just acceptability, of the accounting policies and practices employed as well as the consistency of their application (15% disagree with requiring this disclosure)
- ▣ PRO – “This is very key. Substance over form is a lost auditing principle.” - Senior Portfolio Manager, Money Management Firm
- ▣ CON – “I’m not certain that the auditor should be opining too much on the quality of an accounting practice policy/practice if it is an acceptable policy/practice. I would have no issue with the auditor discussing the consistency of their application, however.” – State Government Official

Disclose Sensitivity Analyses Performed by the Audit Engagement Team

- ▣ 65% would like the auditor to include results of sensitivity analyses in significant areas of judgment (18% disagree with requiring this disclosure)
- ▣ PRO – “Could be useful if kept within reason.”
– Portfolio Manager, Hedge Fund
- ▣ CON – “This should be part of the disclosures in the company’s financial statements, e.g., impact on pension expense related to change in discount rate, not the auditors report per se.” –
Member of Board of Directors, Mutual Fund

Disclose Unusual Transactions, Restatements, and Other Significant Changes

- ▣ 67% believe the auditor should disclose unusual transactions, restatements, significant changes in segment reporting and significant changes in the entities consolidated (14% disagree with requiring this disclosure)
- ▣ PRO – “An unbiased and objective discussion of these issues by the auditor may provide the investor with information necessary to make an informed investment decision.” – State Government Official
- ▣ CON – “Management should do all of this, not the auditor unless the auditor does not agree or think disclosure is adequate.” – Former CFO, Hedge Fund

Disclose Key Issues Discussed in the Summary Audit Memorandum

- ▣ 54% believe the auditor should disclose the key issues discussed in the summary audit memorandum and how those issues were resolved by the auditor (18% disagree with requiring this disclosure)
- ▣ PRO – “Critical, investors should know.” – Equity Analyst, Mutual Fund
- ▣ CON – “Only if issues were NOT resolved; this is internal, confidential information and investors should respect that.” – Principal, Mutual Fund

Summary – Information about What the Auditor Found

- ▣ Respondents would like additional information about:
 - Assessment of issuer's estimates and judgments (79%)
 - Discussion of unusual transactions, restatements, and other changes (67%)
 - Assessment of quality of issuer's accounting policies and practices (65%)
 - Discussion of sensitivity analyses performed by auditor in significant judgmental areas (65%)
 - Discussion of key issues included in the summary audit memorandum including how resolved (54%)
- ▣ Respondents were less supportive of additional information about:
 - Disclosure of all audit adjustments discussed with company management (39% favor, 36% oppose)
 - Grade the issuer's aggressiveness or conservatism on a 10-point scale (42% favor, 44% oppose)

Form of the Audit Report – Auditor Responsibility for Detecting Fraud

- ▣ 43% of respondents believe that the report should state that the auditor has obtained reasonable assurance as to whether the financial statements contain a material misstatement, whether caused by error or fraud (15% disagree with requiring this disclosure)
- ▣ PRO – “Auditors should state that they looked for material fraud.” – Equity Analyst, Mutual Fund
- ▣ CON – “Seems to just provide potential legal protection to auditor, no extra insight or protection to shareholders / investors.” – Principal, Mutual Fund

Audit Partner Signature

- ▣ 44% support requiring the audit partner to personally sign the audit opinion (26% disagree with requiring this disclosure)
- ▣ PRO – “Accountability tends to focus the mind.” – Chief Investment Officer, Mutual Fund
- ▣ CON – “Liability limitations should be part of this requirement so to not drive up costs.” – Anonymous Respondent

Should an Auditor's Discussion and Analysis Report Exist?

- ▣ 52% believe there should be a separate Auditor's Discussion and Analysis section in the 10-K (18% do not believe that an AD&A should be added)
- ▣ PRO – “This would be a preferable approach to enhancing auditor information available versus changing the audit report rating system.” – Chief Audit Executive, Investment Firm
- ▣ CON – “I prefer one signed report.” – Equity Analyst, Mutual Fund

Communicating to Investors what is Communicated to the Audit Committee

- ▣ 56% believe the report (or AD&A) should include a narrative summary of issues communicated to the issuer's audit committee (20% disagree with requiring this disclosure)
- ▣ PRO – “Any insight into the disconnect between the company's and the auditor's assumptions gives a better sense of management, and management's willingness to engage in aggressive accounting.” – Credit Analyst, Mutual Fund
- ▣ CON – “The zeal for more specific information to be made public will, in my opinion, constrain quality dialogue among auditors and audit committees.” – Audit Committee Member, Mutual Fund

Summary – Form of Audit Report

- ▣ Respondents are supportive of including / requiring:
 - A narrative summary of the information communicated by the auditor to the audit committee (56%)
 - A separate Auditor Discussion & Analysis (AD&A) (52%)
 - Engagement partner to sign the report (44%)
 - A statement in the report that the FS are free of material misstatement whether caused by error or fraud (43%)
 - A “true and fair” view statement (41%)
- ▣ Respondents are less supportive of:
 - More information regarding respective roles of management and the auditor in preventing and detecting fraud (42% favor, 30% oppose)
 - Replacing the binary nature of the report with a report including multiple levels (45% favor, 40% oppose)

Most Desired Changes

- ▣ Auditor should discuss its assessment of estimates and judgments made by management, and how the auditor arrived at that assessment
- ▣ Auditor should disclose more related to areas of high financial statement and audit risk, and how the auditor addressed these risk areas
- ▣ Auditor should discuss unusual transactions, restatements, and other significant changes
- ▣ Auditor should discuss the quality of the issuer's accounting practices and policies