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Auditor's Reporting Model, Rulemaking Docket Matter No. 34
Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Members of the Board;

I'm pleased to have the opportunity to present my comments on the PCAOB's initiative to reconsider the audit reporting model. My comments are my own based upon nearly forty years in the accounting profession, twenty-five as an audit partner with KPMG and now serving as an adjunct at St. John's University teaching auditing and ethics to graduate students.

With the large number of books, studies and articles devoted to analyzing the various aspects of the financial crisis, it is apparent that we suffered from a massive systemic failure whereby the belief that institutions we once thought we could trust is no longer true. These Include legislators, financial institutions, rating agencies, directors (who were thought to represent the shareholders), pension fund managers and so called large sophisticated investors, all of whom have reportedly high powered analysis tools and techniques for managing the investments of their members, and yes, auditors. All of who failed to forecast or see the magnitude of the problems presented by excessive leverage and an unsustainable housing bubble.

Improved audit quality should be the main goal of this PCAOB initiative, and not the peripheral issues of an auditor's discussion and analysis, firm rotation, and individual signatures on reports. These are distractions that take time from the main issue of improving audit quality. I agree that the auditor's report requires some changes and updating. I'll suggest some in the following paragraphs or express my agreement with others who have commented rather than repeat similar comments.

Financial Reporting Council and Center for Audit Quality

The approach being pursued by the UK's Financial Reporting Council and should be adopted by the PCAOB, including the FRC's guiding principles (some of the FRC's wording will need to be adapted for US usage):

- Preparers, audit committees and auditors must ensure that all material issues are reported in a manner that is complete, neutral, free from error, fair and balanced.
- Auditors must exercise professional judgment when undertaking audits and adapt a challenging or appropriately skeptical approach to key issues, assumptions and evidence.
- Both the company and its auditor must be satisfied that the annual report, taken as a whole, is fair and balanced.

The Center for Audit Quality has also proposed a set of overarching Principles well worth adopting:

- Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved.
- Any changes to the reporting model need to enhance or at least maintain audit quality.
- Any changes to the reporting model should narrow, not expand, the expectation gap.
- Any changes to the reporting model should add value and not create investor confusion.
- Auditor reporting should focus on the objective rather than the subjective.

Although after reading the CAQ's proposed changes, it seems they violate some of their own principles with the examples presented.

While the FRC states that the primary responsibility for providing information rests with the company and its management, the FRC also proposes that the audit committee produce reports that fully describe those important judgments and other matters addressed during the course of the audit.

The FRC and CAQ's comments are consistent and present a clearly more productive avenue to pursue without introducing new reporting lines that would confuse the public as would an AD&A, which would most likely expand the expectation, gap, if not at initiation over time. As the FRC also plans to introduce standards governing the reports auditors provide to audit committees, the PCAOB also has this ability within its standard setting mandate and has taken some initial action to enhance the communications between auditor and audit committee. The audit committee's published report should also be addressed.

Adequacy of Management Disclosure

The issues at the center of this debate may well be the adequacy and credibility of the current information provided by management. Disclosures for public companies are an SEC matter and should be addressed accordingly, only if the SEC believes there is need for improved or more disclosure.

The issues related to other management disclosures such as those included in MD&A may be addressed by requirements to include GAAP and risk related information in the footnotes which will then be covered by the auditor's report. This is more desirable than opinions on individual pieces of management information scattered throughout a 10K. The premise is that if information is to be covered by some form of auditor assurance that information should be in the footnotes.

Audit Quality

Audit Quality is within the PCAOB's purview and may be greatly facilitated by increased transparency into what an audit involves, including the scope and generally accepted audit procedures. These should be addressed through PCAOB Auditing Standards and inspections processes. The PCAOB should also consider making public Part II of their reports on quality controls and related issues within the firms inspected on a timely basis.

The large US registered firms should adopt a form of transparency report similar to the UK and European Union to report on their efforts in the areas of governance, quality and internal control. I believe this will focus the firms on such controls and create an atmosphere in which all try to raise their game. Having been in charge of Risk Management and Quality Control for both the US and International network of a major firm for the last part of my career, I believe disclosing Part II and Transparency type reporting will help improve quality, if not initially over time as each of the major firms compete to demonstrate their controls are best.

The audit standard setting process should provide the definitional context for the current wording, principally reasonable assurance and materiality, so that the audit report need not always repeat. The belief being that once memorialized in a standard and clearly defined and discussed, the public including the investor community will have the context they desire.

Independence and Fraud Detection

Additionally, as I teach classes in both Ethics and Auditing, my students and I review the major investigations and studies regarding the profession dating back to the Metcalf Commission, the first significant investigation of the public accounting profession since the 1930's. It's interesting to note, that the profession, lawmakers and regulators have been debating independence (principally services related) and fraud detection for nearly the entire forty years of my career in public accounting and teaching. At some point a "reasonable person" might expect this debate to be concluded.

It now seems appropriate to conclude the debate on two points, independence and fraud detection. In so doing, it's recommended that some bright lines between auditing and advisory or consulting services be drawn, either by complete prohibition or separation into different legal entities with separate governance. During my long career in public accounting, I've observed that auditors and consultants have different mindsets, priorities and approaches to their relationship with their clients. There is also a cultural divide due principally to the auditors' education regimen and emphasis on professional standards. These differences cannot always be overcome and result in a divergence of priorities over competing business objectives centered around revenue growth and professionalism as manifested in the AICPA's Code of Conduct. Many auditing professionals would most likely applaud such a separation.

Concluding the fraud detection debate could be accomplished by explicitly identifying in the auditor's report the auditor's responsibilities for fraud detection. Consulting type skills are often used for valuation issues such a derivatives and IT controls. These skills could and should be imbedded in audit practices to avoid conflicting objectives and priorities.

Reporting Relationships

The PCAOB should thoroughly consider the all-important relationship triangle between shareholders as represented by the board and audit committee, the auditor and management. You should not confuse the participants by changing reporting responsibilities but strengthen those that already exist. Given the changes taking place in board and shareholder governance, investors, particularly large activist institutions, have access to management and the board that a retail investor does not. The NACD in fact encourages boards to communicate more often with their investors. This was the subject of an NACD Blue Ribbon Panel Report in 2008.

Audit Committee reports should be enhanced and include the key points that the auditor discusses with the committee including resolution. This may involve the SEC, NYSE and NASDAQ changing requirements for the audit committee report to shareholders. The PCAOB has embarked on improving auditor – audit committee communications and should continue to monitor and adjust based on inspections and conversations with audit committee members.

Standard Auditor Report

As for the current "pass/fail" report as it is dismissively referred to, such a report has met its purpose and objectives for comparability and reduced misunderstanding, as noted in the concept release, albeit, this is currently refuted by some. I confidently state the current reporting model was never a hindrance or constraint on reports I've signed and helped provide some leverage with clients in tenuous financial situations, particularly during the S&L crisis. However, it is most likely a good time to make changes and refresh the language, however, the goals of comparability and understandability remain; otherwise I fear a new level of confusion and expectation gap will be introduced. At that point, the investor groups will most likely be the first to note that the reports are confusing since they are no longer comparable.

As for the areas of emphasis and emphasis paragraphs, these are often discussed in the financial statements and footnotes, e.g. related party transactions, estimates and judgments; I see no purpose in repeating these in the auditor's report. This is true provided the initial disclosures are appropriate and informative, otherwise the auditor will comment to the audit committee or ultimately comment in the audit report. This reporting model works well in most cases and could be clarified for the investing public through an expanded audit committee report that addresses key elements of communications with the auditor. The PCAOB has the opportunity to observe compliance as part of the inspection process.

Costs

Costs will always be an issue. If the auditor's role and responsibilities are expanded, auditors should be compensated for any extra effort and responsibility assumed. A cost benefit analysis should be conducted. Most likely as a part of a test period for any proposed changes.

Other comments

Lastly, I endorse the comments submitted by my academic colleagues and former industry professionals at the Universities of Georgia and Notre Dame and do not propose to comment further

I thank you for the opportunity to comment on Rulemaking Docket No. 34.

Sincerely,

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