

September 29, 2011

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

**RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

**Executive Summary**

As members of the PCAOB’s Investor Advisory Group, we believe that the current auditor’s report is deficient as a communication vehicle, and that significant changes to the auditor’s report are needed to remediate these deficiencies. The only communication between the auditor and investors is typically a standard three-paragraph report that is essentially identical for the overwhelming majority of all public companies.

We believe that the four most important changes to the audit report would require the auditor to: (1) discuss the auditor’s assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer’s accounting practices and policies. We believe that the disclosure of this information will improve investors’ ability to make informed buy/sell decisions, which should result in higher returns to investors and improved capital allocation within society.

We believe that an Auditor Discussion & Analysis is the best means for providing this information. However, we are not opposed to the required use of emphasis-of-matter paragraphs, as long as the above information is included within these paragraphs.

In addition, we believe that the audit report should explain the auditor’s responsibility for detecting material fraud. The standard audit report should clearly state that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should indicate that “reasonable” assurance represents a high, although not absolute, level of assurance.

**RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

Dear Messrs. Doty, Ferguson, Goelzer, Hanson, and Harris:

“Rather than managing investors’ expectations about the auditor’s opinion, a better approach would be for the auditing profession, with the support of standard setters and market regulators, to take on a greater level of responsibility than they have today.”<sup>1</sup>

1. As members of the PCAOB’s Investor Advisory Group (IAG), we are writing to provide comments on the PCAOB’s June 21, 2011 Concept Release entitled *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*. The undersigned members of the PCAOB’s IAG have collaborated in drafting this comment letter to the Board.<sup>2</sup> We discuss below the results of an investor survey we recently conducted on the topic of the auditor’s report, and offer numerous suggestions regarding possible changes to the format and content of the report that would provide much greater value to investors than the current auditor’s report provides.

2. The IAG is an “expert advisory group” that the PCAOB has convened under the statutory authority of Section 101 of the Sarbanes-Oxley Act. The IAG’s mandate is to “provide its views and advice to the Board on broad policy issues, and other matters that affect investors and are related to the work of the Board.”

3. The IAG believes that the current auditor’s report is deficient as a communication vehicle, and that significant changes to the format and scope of the auditor’s report are needed to remediate these deficiencies.<sup>3</sup> The IAG has devoted substantial efforts to improving the auditor’s report throughout its limited life. In May 2010, at the initial IAG meeting, we identified improvements

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<sup>1</sup>DiPiazza, S. A., Jr., and R. G. Eccles. 2002. *Building Public Trust: The Future of Corporate Reporting*. New York, NY: John Wiley & Sons. Mr. DiPiazza is a former CEO of PricewaterhouseCoopers (PwC).

<sup>2</sup>Hereafter when we refer to a position of the IAG, we are only referring to those IAG members who have chosen to sign this letter. The views expressed herein are those of the individual IAG members who have signed this letter and do not necessarily reflect the opinions of the companies or associations with which they are affiliated or any other officers, employees, or members thereof.

<sup>3</sup>Other international auditing standard setters recognize this deficiency in the communications value of the auditor’s report. For example, the International Auditing and Assurance Standards Board (IAASB) has noted, “Users recognize there is richer information about the entity and about the audit itself than is currently being provided through the audited financial statements and other corporate disclosure mechanisms, and through the auditor’s report.” (IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 7.)

to the audit report as one of our highest priorities. Moreover, in advance of our March 2011 meeting, we conducted a survey of investors to measure their perceptions of the value of the current audit report and to solicit their input as to needed changes. We presented our findings at the PCAOB's March 2011 IAG meeting and discuss the survey results in greater detail below.

4. Audits of public companies can involve scores of auditors, thousands of hours, and millions in fees. The documentation in support of the auditor's opinion is voluminous. Indeed, with the possible exception of senior financial management, in most cases the auditor knows more about the financial statements and financial reporting risk of the audited company than other individuals, both inside and outside the company (including members of the audit committee). Notwithstanding this significant accumulated knowledge, the only communication between the auditor and investors is typically a boilerplate three-paragraph letter (hardly a "report," despite the commonly used title) that is essentially identical for the overwhelming majority of all public companies.

5. The members of the IAG believe that this reporting model fails to meet the legitimate needs of investors. PCAOB board member Steve Harris succinctly summarized our position in his comments at the PCAOB's June 21 open board meeting -- the IAG "believes public company auditors know much more about their audit clients than they currently are telling investors."<sup>4</sup> The IAG isn't asking for auditors to gather more audit evidence. We aren't asking for a fundamental change to the audit process. We are simply asking auditors to share with investors more of what they already know.

6. It is worth noting that a number of other parties agree that the current form of the auditor's report fails to meet the legitimate needs of investors. First, the U.S. Treasury Advisory Committee on the Auditing Profession (ACAP) called for the PCAOB to undertake a standard-setting initiative to consider improvements to the standard audit report. The ACAP members support "... improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements."<sup>5</sup> Second, surveys conducted by the CFA Institute in 2008 and 2010 indicate that research analysts want auditors to communicate more information in their reports.<sup>6</sup> Finally, even leaders of the accounting profession have acknowledged that the audit report needs to become more relevant. In testimony before ACAP, Dennis Nally, Chairman of PwC International stated, "It's not difficult to imagine a world where the ... trend to fair value measurement -- lead one to consider whether it is

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<sup>4</sup>Steve Harris' statement at the PCAOB open board meeting on June 21, 2011.

<sup>5</sup>U.S. Department of the Treasury Advisory Committee on the Auditing Profession. 2008. *Final Report of the Advisory Commission on the Auditing Profession*.

<sup>6</sup>CFA Institute. 2008. February Monthly Question Results. Cited in *Final Report of the Advisory Committee on the Auditing Profession*. VII: 16; CFA Institute. 2010. *Independent Auditor's Report Survey Results*.

necessary to change the content of the auditor's report to be more relevant to the capital markets and its various stakeholders."<sup>7</sup> Finally, leaders of the accounting profession have previously stated that changes to the audit report should reflect investor preferences. In their 2006 White Paper, the CEOs of the six largest accounting firms stated, "The new (reporting) model should be driven by the wants of *investors and other users of company information ...*" (their emphasis).<sup>8</sup>

7. Before we turn to a discussion of the IAG investor survey, we believe it is important to underscore the fundamental but often overlooked fact that the issuer's *investors*, not its audit committee or management team or the company itself, are the auditor's client. It is therefore not only appropriate, but essential, that investors' views and preferences take center stage as the PCAOB considers possible changes to the format and content of the audit report.

### Information Desired by Investors and How Such Information Might Affect Decisions

8. The IAG survey of investors identified the following as the four most highly desired changes to the audit report: (1) a discussion of the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclosure of areas of high financial statement and audit risk and how the auditor addressed these risk areas in planning and conducting the audit; (3) discussion of unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discussion of the quality, not just the acceptability, of the issuer's accounting practices and policies.<sup>9</sup>

### *Auditor Assessment of Estimates and Judgments*

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<sup>7</sup>Written testimony of Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers, LLP Before the Federal Advisory Committee on the Auditing Profession, United States Department of the Treasury, December 3, 2007.

<sup>8</sup>DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks*.

<sup>9</sup>Some might argue that this type of information should be communicated to investors by management and not by the auditor. However, the Companies Act in the United Kingdom requires additional narrative disclosures by management. The Financial Reporting Council (FRC) finds that these narrative disclosures have not been particularly forthcoming. The FRC states, "... the majority of risk reporting is a list of boilerplate disclosures which do not provide a meaningful discussion ..." and, based on work by Deloitte referred to by the FRC, "... descriptions of principal risks are too generic, that there is a lack of detail on trends and factors, and that there are too many KPIs and no explanation of the link between strategy and objectives" (FRC, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit*, p. 9). There may be a role for the audit committee in communicating some of the information desired by investors, but audit committee communication should not be a substitute for communication from the auditor. The arguments for and against requiring expanded audit committee communications are beyond the scope of this letter, as any such policy decision rests with the SEC and not the PCAOB.

9. Investors who responded to the IAG survey want the auditor to provide an assessment of the estimates and judgments made by management in preparing the financial statements and to describe the process the auditor followed in arriving at that assessment. Seventy-nine percent of the respondents to the IAG survey want the auditor to provide this information. As one representative example of investor sentiments on this issue, the chief investment officer of a large mutual fund stated, “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.”<sup>10</sup> In addition, the CFA Institute’s 2008 survey of research analysts found that 84 percent of their respondents wanted the auditor to communicate additional information about management’s estimates and judgments.<sup>11</sup>

10. As financial reporting has become more subjective -- as evidenced through the expanded use of fair value measurement, more complex revenue recognition issues, evaluation of impairments with respect to investments, fixed assets, intangible assets, and deferred tax assets -- the ultimate reliability of an issuer’s financial statements depends increasingly on management’s estimates and judgments. As a result of these changes in financial reporting, the FASB has increased the nature and scope of required disclosures about estimates and judgments. Some will argue that if investor needs are not being met, then the FASB should simply require more disclosures from management. However, this argument ignores the expressed desire of investors for additional, independent communication on these issues *from the auditor*.<sup>12</sup>

11. Obtaining an independent evaluation of management’s estimates and judgments would add significant value to the audit process in several respects. First, management’s evaluations of its own estimates and judgments are inherently biased; the auditor is uniquely positioned to provide an independent, objective assessment.<sup>13</sup> The rationale for obtaining the auditor’s evaluation of management’s estimates and judgments is the same as that which applies to the entire process of obtaining the auditor’s assessment of the overall fairness of the financial statements. In other words, management’s self-interest inherently precludes them from reporting in an unbiased fashion on either the financial statements taken as a whole or on the reasonableness of their material estimates and judgments. As the CEOs of the global network firms stated in their White

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<sup>10</sup>The IAG survey was primarily composed of Likert-scaled questions, but also afforded respondents the opportunity to provide narrative comments.

<sup>11</sup>The CFA Institute’s 2008 survey was based on 1,474 respondents.

<sup>12</sup>The IAASB recognizes the value in having information about estimates and judgments communicated directly by the auditor. The IAASB states, “Some investors and analysts in particular, however, view the auditor’s insight into the entity and its business obtained through the audit of the entity’s financial statements as being especially relevant information for their needs” (IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 9).

<sup>13</sup>AU ¶ 342.12 indicates that the auditor may independently develop an expectation of the estimate when evaluating the reasonableness of the issuer’s estimates.

Paper, “Given our independence and experience, we are in an ideal position to provide value to investors throughout the world.”<sup>14</sup> Also, the IAASB states in its Consultation Paper on the auditor’s report: “... the fact that such information would be communicated by the independent auditor adds a degree of credibility to the information communicated.”<sup>15</sup> We believe that financial statement users would be willing to pay incremental audit fees to obtain information to which they attach high value.<sup>16</sup>

12. Finally, the auditor already gathers and communicates much of the information investors wish to obtain relating to estimates and judgments. Under AU ¶ 380.08, “[t]he auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor’s conclusions regarding the reasonableness of those estimates.” Since the auditor already gathers and communicates this information to the issuer’s audit committee, there is no reasonable basis, in the IAG’s view, for the auditor not to share this information with investors, who as the owners of the corporation are the auditor’s true client.

#### *Financial Statement and Audit Risk*

13. Investors who responded to the IAG survey also expressed a strong desire that the auditor communicate areas of high financial statement and audit risk and explain how the auditor addressed these risk areas in planning and conducting the audit.<sup>17</sup> Seventy-seven percent of the respondents to the IAG survey want this information. As an equity analyst from a large mutual fund stated, “This would make me read the report instead of just skim it.” The chief investment officer of another large mutual fund stated, “This would be very helpful. Understanding the issues the auditor recognizes as being difficult to measure enables us to focus our analysis on these issues.” In addition, the CFA Institute’s 2008 survey indicated that 84 percent of their respondents wanted the auditor to communicate additional information about risks.

14. Beyond the audit risks associated with management’s estimates and judgments, overall financial statement and audit risk may be elevated because of: (a) the existence of certain

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<sup>14</sup>DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks*.

<sup>15</sup>IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 10.

<sup>16</sup>Investors’ willingness to pay for additional auditor disclosures presupposes that the auditor’s communication would serve to meaningfully *differentiate* between the estimates and judgments made by different companies. If all companies’ estimates and judgments are treated as equally reasonable, then this new communication will devolve into boilerplate that is of little use to investors. Differentiation is key.

<sup>17</sup>The failure of the audit report to communicate information about audit and financial reporting risks and how they were addressed is a perceived deficiency by other auditing standard setters as well (IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 8).

structured transactions (e.g., special purpose entities, particularly those where the business purpose is suspect);(b) related party transactions;(c) weak corporate governance structures, including concerns about tone-at-the-top or inadequate management oversight; and (d) the challenges involved in discovering suspect transactions in businesses where a particular type of transaction occurs in high volumes. As an example of the last category of risk, an unusually large amount of revenue recognized near period-end -- particularly if the transactions are not recorded through normal channels, involve new customers, and/or are recorded in round dollar amounts -- significantly raises the risk of fraudulent financial reporting.<sup>18</sup>

15. The auditor already gathers and assesses information relating to financial statement risks; in fact, it would be impossible to perform an audit in compliance with PCAOB standards without assessing risks (e.g., see PCAOB Auditing Standards No. 12 and 13). More importantly, under existing rules and practices the auditor already communicates most, if not all, of the desired risk-related information to the audit committee. AU ¶ 316.81 requires that “[t]he auditor also should consider communicating other fraud risks, if any, identified by the auditor. Such a communication may be part of an overall communication to the audit committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the quality of the entity’s accounting principles.” Moreover, the auditor is required to document significant findings and issues, which would include significant risks and how the auditor addressed these risks, in an engagement completion document.<sup>19</sup>

16. Some parties believe that providing this information to investors would introduce new risks into the audit process. This concern is grounded in a belief that because the auditor and the audit committee have the opportunity to engage frequently in a private, two-way discussion, the auditor has more of an opportunity to provide additional context around its process and findings in its interactions with the audit committee than it would if periodic public disclosures were required. For example, the Center for Audit Quality (CAQ) states, “... we believe that providing investors with the same information that is provided to the audit committee, without the context obtained from a two-way dialogue may be incomplete, generate greater confusion and not enhance the overall understanding of the readers of such a report” (Center for Audit Quality comment letter on PCAOB Release No. 2011-003, p. 3). However, since all investors are invited to attend the Annual Shareholder Meetings, and given that the external auditor typically attends this meeting as well, it would seem that a productive two-way dialogue between investors and the auditor could occur in this context. And although the CAQ cautions against providing the same information to investors that is provided to the audit committee, the former CEO of one major accounting firm envisions a world where auditors communicate to investors about risks and estimates and judgments. DiPiazza and Eccles state:

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<sup>18</sup> Beasley, Carcello, Hermanson, and Neal. 2010. *Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies*. COSO.

<sup>19</sup> AS #3, *Audit Documentation*, ¶ 13.

“Making the future better requires responding to the market’s demand for audit opinions that say more about the information on the health of the business. Today, a great deal of this information is already reported by management, and for certain purposes is considered in the course of the audit, including such issues as management estimates, the possibility of fraud, risks, liquidity, and future scenarios. *The audit opinion could be expanded to address this information, as well as how all the pieces fit together as a whole.*”<sup>20</sup>

17. To summarize, the substantial majority of investors who participated in the IAG survey would derive great value from receiving the same communications from the auditor regarding audit and financial statement risk which the auditor provides to the investors’ representatives – the members of the issuer’s audit committee. In our view, this change to existing practices would introduce significantly improved transparency into the audit process, which would benefit investors, the capital markets, and corporate governance generally.

#### *Unusual Transactions, Restatements, and Other Significant Changes*

18. The IAG survey respondents also want the auditor to report to investors any unusual transactions, restatements, and other significant changes. Sixty-seven percent of the respondents to the IAG survey want this information. A state government official stated regarding this proposed change, “An unbiased and objective discussion of these issues by the auditor may provide the investor with information necessary to make an informed investment decision.”

19. In addition to the potentially fraudulent transaction types previously discussed (revenue transactions that are not recorded through normal channels, that involve new customers, and/or that involve even dollar amounts), unusual transactions in general may increase the risk of material misstatements in the financial statements. For example, round-trip transactions involving revenue, aggressive capitalization of expenditures, and transactions without a clear business purpose (particularly if entered into in a country with a weak rule of law and opaque disclosure regime), all pose heightened risk. Investors would benefit from knowing if an entity meets its earnings targets only as a result of engaging in these types of transactions, and also from understanding the auditor’s evaluation of the economic substance of such transactions and how the auditor reached its conclusion.

20. The auditor already gathers and communicates information about unusual transactions to the audit committee. AU ¶380.07 requires the auditor to “... determine that the audit committee is informed about the methods used to account for significant unusual transactions ...”

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<sup>20</sup>DiPiazza, S. A., Jr., and R. G. Eccles. 2002. *Building Public Trust: The Future of Corporate Reporting*. New York, NY: John Wiley & Sons. (Emphasis added.)



21. The auditor already communicates information about restatements. Auditing Standard No. 6, ¶ 9 requires that, “The correction of a material misstatement in previously issued financial statements should be recognized in the auditor’s report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.” However, rather than relying only on the relatively uninformative boilerplate language currently required, investors would benefit from knowing more about the auditor’s views regarding the nature and consequences of the misstatement, including, for example, the failures in internal control that permitted the misstatement to occur, whether in the auditor’s judgment these internal control weaknesses have been satisfactorily remediated, whether the responsible parties for the misstatement remain in their positions, and whether the issuer’s governance mechanisms have changed as a result of the misstatement. This type of information is typically not disclosed. Even when it is disclosed, the disclosure is not provided by the auditor.

22. Investors told us also that they want the auditor to discuss significant changes in the financial statements, especially those that are not apparent from reading the financial statements. For example, an entity may have changed its sales distribution channel from selling directly to end users to selling through value added resellers. Such a change increases the complexity of revenue recognition and hence raises financial statement and audit risk. Or perhaps a financial institution that historically has invested in conservative securities is now investing in structured debt instruments. The risk profile of these investment choices is quite different. The list of potentially significant changes is endless; the important point is that investors want the auditor to communicate its evaluation of significant changes, an assessment that the auditor would already have completed as a result of performing the audit.

#### *Quality of Accounting Policies and Practices*

23. The IAG survey respondents also want the auditor’s report to include a discussion of the quality, not just the acceptability, of the issuer’s accounting policies and practices. Sixty-five percent of the respondents to the IAG survey want this information. A senior portfolio manager at a money management firm stated regarding this proposed change, “This is very key. Substance over form is a lost auditing principle.”

24. Critical accounting policies are likely to vary by company and industry, in areas including, for example, revenue recognition, asset capitalization and amortization, asset impairment, and investments. In these and other areas, companies often have discretion in applying GAAP. This discretion can have a material effect on reported amounts in the financial statements. For example, companies can have very different policies for when they begin to capitalize software development costs and how they amortize such capitalized costs to expense. Although various alternatives may be acceptable under GAAP, not all alternatives are of equal “quality” in terms

of reasonableness, transparency, and accuracy. The auditor's judgment on the quality, not just the acceptability, of an entity's critical accounting policies would be useful to investors. This issue is particularly relevant when management decides to make a discretionary accounting change – the auditor's opinion as to the quality of the change would be of significant relevance to investors.

25. As noted previously, auditors already gather and communicate significant information about the issuer's critical accounting policies. Section 204 of the Sarbanes-Oxley Act, and the resulting SEC implementation rules, require the auditor to communicate to the audit committee the entity's critical accounting policies. Moreover, AU ¶ 380.11 requires that, "In connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting." This rule further provides that "... the discussion should be open and frank ..." and should include discussion of "estimates, judgments, and uncertainties" and "unusual transactions."

26. Thus, AU ¶ 380.11 already requires the auditor to communicate his or her *judgment* about the quality, not just the acceptability, of the entity's accounting principles. Since the auditor is forming his or her own professional judgment about this issue, this puts the auditor in the position of communicating new information, rather than simply attesting to a statement made by management (i.e., management does not opine on the quality of its accounting choices). The distinction between the auditor communicating new information, which we believe is required by AU ¶ 380.11, and attesting to information reported by others is important because some parties have argued that auditors should not be placed in the position of being the original source of information provided to financial statement users. For example, according to the Center for Audit Quality (CAQ), the following overarching principle should guide any change to the auditor's report, "Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard."<sup>21</sup> However, we find it curious that the CAQ, an entity that speaks for the public accounting firms that audit public companies, would oppose a standard that required the auditor to be the original source of information about the entity when the present and former CEOs of the global accounting firms essentially advocated such direct reporting in their 2006 White Paper. The CEOs stated:

"... users of financial information may demand from public companies the ability to receive more finely nuanced opinions from auditors about the *degree* of a company's compliance with a given set of standards, or the relative conservatism of judgments

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<sup>21</sup>Center for Audit Quality. 2011. Comment letter on PCAOB Release 2011-003.

compared to peer groups. Or more boldly, investors even may want the auditor's views about the overall health and future prospects of the companies they audit."<sup>22</sup>

27. AU ¶ 380.11 already requires the auditor to be the *original source* in assessing the quality, not just the acceptability, of the entity's accounting principles. However, under current rules and practice the auditor delivers this assessment only to the audit committee, not to investors. Since both audit committees and investors are users of financial statements, the existing framework requires the auditor to communicate new information to some users of the financial statements but not to others. In this Orwellian-manner of thinking, all financial statement users are equal, some are just more equal than others. As representatives of the investor community, either as individuals or in our institutional capacities, we urge the PCAOB to include in any new rules relating to the audit report a requirement that the auditor discuss its assessment of the quality of the issuer's accounting policies and practices.<sup>23</sup>

#### *How an Improved Audit Report Would Add Value to the Investment Process*

28. A company's stock price reflects primarily the market's assessment of its future earnings stream discounted at a risk-adjusted rate. A key predictor of future earnings is current earnings, and the quality of currently reported earnings affects the reliability of investors' projections of future earnings. Disclosures about financial reporting risks, estimates and judgments, unusual transactions, and accounting policies would enable investors to better assess the quality of current earnings. Moreover, these disclosures would better inform investors' perceptions of the entity's risk, which may affect the discount rate used to value future earnings. Therefore, enhanced auditor disclosures should lead to more efficient pricing of equity securities, either through changes in expected future earnings and/or changes in the discount rate used to value future earnings. The present and former CEOs of the global public accounting firms agree, stating, "Better information about public companies ... in a more user-friendly format, will improve the ability of investors to assess the value of companies. In this process, markets will become more efficient, and improve the allocation of capital and talent ..."<sup>24</sup>

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<sup>22</sup>DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks*.

<sup>23</sup>Although we believe that the auditor should communicate much of the same information now communicated to audit committees, we recognize that certain communications between the auditor and audit committee should be confidential. For example, communication between the auditor and audit committee involving information that is proprietary, or that involves unresolved legal or personnel issues, among other items, should not be disclosed in the auditor's report.

<sup>24</sup>DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks*.

29. Perhaps more fundamentally, we believe that creating substantive disclosure requirements for the auditor's report will enhance investors' efforts to price debt and equity securities and improve their and other stakeholders' ability to assess management's stewardship, risk management practices, and overall corporate governance effectiveness. These outcomes would promote more informed investment decisions and create a further incentive for management of corporations to adhere to sound practices in managing the company's business and reporting its results of operations.

#### Other Desired Changes

30. Other proposed changes to the audit report that our survey respondents support include auditor discussions of: (a) sensitivity analyses in significant areas of judgment; (b) quantitative, and especially qualitative, materiality thresholds; (c) the key issues discussed in the auditor's summary audit memorandum; and (d) the nature and extent of work performed by other audit firms, including global affiliate firms of the primary auditor.

31. In addition, we believe that the audit report should explain the auditor's responsibility for detecting material fraud. Auditing standards currently require the auditor to plan and perform the engagement to detect material misstatements, whether caused by error or fraud.<sup>25</sup> Yet in the scope paragraph of the standard audit report, the auditor simply 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."<sup>26</sup> The standard audit report should clearly state that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should indicate that reasonable assurance represents a high, although not absolute, level of assurance.<sup>27</sup>

32. We further believe that the audit report should indicate the auditor's responsibility for auditing the financial statement disclosures (notes) as well as the primary financial statements.<sup>28</sup> Additionally, the auditor's report should indicate that the auditor is independent of the company and that the auditor has complied with the independence requirements of the SEC and PCAOB.

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<sup>25</sup>AU ¶ 110.02, AU ¶ 230.10, and AU ¶ 316.01

<sup>26</sup>AU ¶ 508.08

<sup>27</sup>AU ¶ 230.10

<sup>28</sup>Since note disclosure is far too often boilerplate, auditors should specifically indicate why a disclosure has remained the same in a given year compared to the previous year when there has been a substantial change in the financial statements – e.g., a significant increase (decrease) in the allowance for doubtful accounts or warranty repairs with little or no additional disclosure by management. Such a lack of incremental disclosure should prompt a review by the auditor and the results of that inquiry should be communicated to users of the financial statements.

We are not opposed to amending the audit report to indicate that management has the primary responsibility for the fairness of the financial statements, nor to clarifying the auditor's responsibility with respect to other information in documents containing audited financial statements.

#### Manner in Which Additional Information Should be Communicated

33. We believe that investors would be best served if new auditor reporting requirements were communicated to investors in a new report that the PCAOB's Concept Release describes as an Auditor Discussion and Analysis (AD&A). The majority of respondents to the IAG survey believe that additional substantive communications should be included in an AD&A rather than in required explanatory paragraph(s) appended to the existing auditor report.<sup>29</sup> In addition, we believe, and our survey respondents supported, a requirement that the engagement partner sign his or her name (in addition to the firm name) to the audit report.

34. Even if the PCAOB adopts an AD&A requirement, we believe that the standard three-paragraph audit report should still be revised to more clearly communicate the results of an audit (e.g., referring to reasonable assurance, and discussing the auditor's responsibility for detecting material misstatements whether caused by error or fraud).

35. In our view, the key challenge to the PCAOB is to prevent an AD&A from reverting into boilerplate disclosure – in other words, becoming only a lengthier version of the existing auditor's report, which, as our survey respondents overwhelmingly believe, provides no useful substantive information. If this initiative results in nothing more than additional boilerplate disclosure, then it will have failed and any additional costs will represent a dead weight loss to investors and society. But that is not a reason for abandoning the effort, but rather for ensuring that it is implemented effectively.

36. We believe that the best way to prevent an outbreak of boilerplate disclosure is by setting clear expectations for auditor behavior through adopted standards and upholding them through a rigorous inspection and enforcement program. Toward that end, we suggest that the Board require certain topics to be addressed in the AD&A (e.g., financial statement and audit risk,

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<sup>29</sup> The key issue to investors is that the additional communication between auditors and investors occurs, the mechanism for this additional communication is of secondary import (i.e., the additional communication could be through our preferred AD&A or through required emphasis of matter paragraphs in the standard auditor's report). However, in order to be an adequate substitute for an AD&A, emphasis paragraphs would have to be used very differently than how they are currently used. Professor Carcello analyzed the most recent audit report for every company in the S&P 500 and only five emphasis paragraphs existed. Even more troubling, these emphasis paragraphs were quite limited in their information content (see Appendix 2 where the five audit reports containing emphasis paragraphs are reproduced). Moreover, simply using emphasis paragraphs to highlight important matters already disclosed by the issuer – i.e., to provide a roadmap to the financial statements – would clearly fail to meet the needs of investors for incremental disclosures from the auditor.

estimates and judgments, accounting policies, unusual transactions, etc.), but that it not prescribe the required language within each section. The accounting profession has expressed concern about “free writing” audit reports, but investors are well positioned to efficiently process and analyze such additional disclosures.<sup>30</sup> Investors’ interests will be best served by designing a new AD&A in a manner that requires the auditor to express judgments and assessments in a relatively subjective manner, based on the unique facts and circumstances of each audit, rather than in accordance with tightly prescribed language. We agree with Mark Newsome, Managing Director of ING Capital, who stated during the PCAOB’s Roundtable on the Auditor’s Reporting Model: “And so, if management financials are different even within peer groups, then why should the audit opinion be identical for companies within a peer group?”<sup>31</sup>

### Challenges to Changing the Audit Report

37. PCAOB board member Jay Hanson has expressed concern about the ability of audit firms to provide additional disclosures, particularly in view of the 60-day filing deadline for the Form 10-K for large accelerated filers. To examine this issue, Professor Carcello gathered the most recent annual earnings announcement date for each company in the S&P 500 (a good proxy for the universe of large accelerated filers). The median earnings announcement lag – the number of days from year-end to the earnings announcement date – was 33 days. Given that the auditor often “signs off” on earnings before the earnings announcement, this suggests that much of the work involved in auditing the financial statements (or at least of the income statement and balance sheet) is completed within this time period. We also gathered the most recent 10-K filing date for the same S&P 500 companies. The median filing date was 21 days longer than the median earnings announcement date. Therefore, if the audit of the earnings number is substantially complete within 33 days after year end, we see no reason for concern about the ability of the auditor to write an AD&A in the remaining 15 days, especially since much of the information that would be included in an AD&A would already have been gathered in conducting the audit of the financial statements and communicated by the auditor to the audit committee.<sup>32</sup>

38. PCAOB board member Lew Ferguson has expressed concern about the cost associated with changing the standard audit report and whether any additional cost would be justified by the

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<sup>30</sup>Indeed, our entire system of securities regulation is premised on investors’ ability to effectively process complex disclosures. Those investors who read financial statements are arguably those most likely to be able to make such judgments.

<sup>31</sup>Transcript of the PCAOB’s Roundtable on Auditor’s Reporting Model (September 15, 2011).

<sup>32</sup>We recognize that substantial audit evidence is gathered before year end (i.e., interim testing). But as this interim testing is performed, the information needed for the AD&A will be gathered as well and the firm could begin drafting the AD&A well in advance of year end.

anticipated benefits. As we have emphasized, the investors we surveyed are merely asking that auditors communicate more of the information they already have compiled and, in many cases, have already communicated to the audit committee. Any cost associated with communicating additional information should reflect only the time required to draft and review the communication. We expect these costs to be relatively modest given that the information to be communicated already exists and, more importantly, in our view the benefits of additional disclosure clearly outweigh the costs.

39. The PCAOB, with its passage of AS #5 and its statements at that time, established a precedent for evaluating both the effectiveness and efficiency with which audit services are provided. If the Board can evaluate, and hold firms accountable, for their efficiency in auditing internal control, the Board presumably could exercise its authority in a similar fashion with respect to the drafting an AD&A.<sup>33</sup>

### Conclusion

40. We believe that expanding communications between auditors and investors in the manner described above will offer other salutary effects for both investors and auditors. Requiring the auditor to discuss risks, estimates and judgments, accounting policies, and unusual transactions should strengthen the auditor's position in negotiations<sup>34</sup> with management and lead to an improvement in the quality of the numbers reported in the financial statements. Areas of disagreement between the auditor and management that are not material enough to result in a qualified opinion, but which would be discussed in an AD&A, would provide the auditor with additional leverage to encourage management to improve its reporting.<sup>35</sup> In fact, DiPiazza and Eccles make this very argument: "More expansive audit opinions would provide a greater level of assurance to stakeholders, while creating an incentive for companies to improve their

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<sup>33</sup>Much, if not all, of what has been proposed as AD&A content should be data and inferences used by auditors to evaluate the level and change in client risk. Therefore, the incremental cost of an AD&A should be limited to the cost of internal drafting, review, and discussion with management and the audit committee of the final content of the AD&A.

<sup>34</sup>During an audit, areas of disagreement related to how transactions are recognized, measured, and disclosed can sometimes arise between the auditor and the issuer. If the disagreement is not material enough to require the auditor to issue a qualified opinion, the resolution of these disagreements is the result of a negotiation process between the auditor and the issuer.

<sup>35</sup>Some representatives of the public accounting profession have argued that if the auditor prepares an AD&A then management will simply adopt whatever estimates, judgments, and policies that the auditor prefers, and this may be suboptimal because management may have greater insight into these issues than the auditor. Although this argument can't be conclusively refuted, we would ask one simple question in reply – in today's reporting environment, does management or the auditor have more leverage? In our view, the existence of an AD&A would simply put the two parties on more equal footing.

corporate reporting practices.”<sup>36</sup> Moreover, as the United Kingdom’s FRC argues, more transparent auditor reporting to investors should lead to enhanced auditor skepticism, which is a bedrock trait of effective auditing.<sup>37</sup>

41. We also believe that expanded communication between the auditor and investors would provide a recurring reminder to auditors that investors are their true clients. As a result, the auditor should disclose in the AD&A what investors need to know to understand the entity’s financial position, results of operations, and cash flows, including related financial reporting risks. The resulting change in mindset would, in the words of PCAOB Chairman James Doty, “... change auditing from a culture that emphasizes client service to a culture that emphasizes public service.”<sup>38</sup> Such a change in culture aligns with the PCAOB’s mission “... to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.”

We, as members of the PCAOB’s Investor Advisory Group, jointly submit this comment letter.

Sincerely,

*Kelvin M. Blake*

Kelvin Blake  
Investment Advisor / Broker-Dealer Unit and Assistant Attorney General  
Maryland Division of Securities



Joseph V. Carcello  
Ernst & Young and Business Alumni Professor

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<sup>36</sup>DiPiazza, S. A., Jr., and R. G. Eccles. 2002. *Building Public Trust: The Future of Corporate Reporting*. New York, NY: John Wiley & Sons.

<sup>37</sup>FRC. 2011. *Effective Company Stewardship: Enhancing Corporate Reporting and Audit*, p. 14.

<sup>38</sup>James Doty’s statement at the PCAOB open board meeting on June 21, 2011.




Director of Research – Corporate Governance Center  
University of Tennessee

A handwritten signature in black ink that reads "Norman J. Harrison". The signature is written in a cursive style and is followed by a long horizontal line.

Norman J. Harrison

A handwritten signature in black ink that reads "Michael J. Head". The signature is written in a cursive style.

Michael J. Head  
Managing Director of Corporate Audit  
TD Ameritrade Holding Corporation

A handwritten signature in black ink that reads "Barbara Roper". The signature is written in a cursive style.

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America



Damon A. Silvers  
Director of Policy and Special Counsel  
AFL-CIO



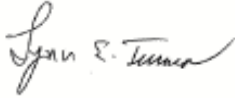
Anne Simpson  
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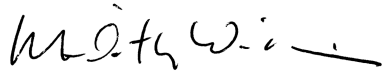
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Ann Yerger  
Executive Director  
Council of Institutional Investors

cc: PCAOB

James R. Doty, Chairman  
Lewis H. Ferguson, Member  
Daniel L. Goelzer, Member  
Jay D. Hanson, Member  
Steven B. Harris, Member

SEC

The Honorable Mary L. Schapiro, Chairman  
The Honorable Luis A. Aguilar, Commissioner  
The Honorable Troy A. Paredes, Commissioner  
The Honorable Elisse B. Walter, Commissioner  
James L. Kroeker, Chief Accountant  
Paul A. Beswick, Deputy Chief Accountant  
Brian T. Croteau, Deputy Chief Accountant  
J.W. Mike Starr, Deputy Chief Accountant

Appendix 1 – Response to the Questions Posed in PCAOB Release No. 2011-003

1. Many have suggested that the auditor’s report, and in some cases, the auditor’s role, should be expanded so that it is more relevant and useful to investors and other financial statements.
  - a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor’s reporting model? Why or why not?

**We believe that the Board should undertake a standard-setting initiative to improve the auditor’s report. We believe that the current auditor’s report is deficient as a communication vehicle, and that significant changes to the auditor’s report are needed to remediate these deficiencies. See paragraphs 4-6 for an elaboration of our position.**

- b. In what ways, if any, could the standard auditor’s report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

**We believe that the four most important changes to the audit report would require the auditor to: (1) discuss the auditor’s assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer’s accounting practices and policies.**

- c. Should the Board consider expanding the auditor’s role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

**The IAG did not consider this issue in our investor survey related to the auditor’s report and, as such, we do not take a group position on this issue at this time.**

2. The standard auditor’s report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a “pass/fail model.”
  - a. Should the auditor’s report retain the pass/fail model? If so, why?

**The auditor's report should retain the pass/fail model. There was not a consensus among the investors we surveyed as to whether removing the pass/fail model would improve the quality of the auditor's report. A number of our survey respondents found the binary nature of the audit report to be of use to them.**

- b. If not, why not, and what changes are needed?

**We believe that the current pass/fail model should be retained.**

- c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

**We believe that the standard audit report, with the pass/fail model being retained, should be supplemented with an Auditor Discussion and Analysis (AD&A). The additional information that should be communicated by auditors to investors (see our response to question 1b) would be included in an AD&A.**

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

**As the Board recognizes, some preparers and audit committee members argue that additional information about the company's financial statements should be provided by management (or by the audit committee). But the investors who responded to the IAG survey indicated that they want to receive additional communications about the company's financial statements from the auditor. Investors want direct communication from auditors because management's evaluations of its own estimates and judgments are inherently biased, whereas the auditor is an independent, objective third party. See paragraphs 9-11 for an elaboration of our position.**

4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and are they necessary?

**The IAG did not consider this issue in our investor survey related to the auditor's report and, as such, we do not take a group position on this issue at this time.**

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

**We believe that investors would be best served if additional auditor reporting were to take the form of a new report that the PCAOB's Concept Release describes as an Auditor Discussion and Analysis (AD&A). However, the key issue to the investors surveyed by the IAG is that the additional communication between auditors and investors occurs. The mechanism for this additional communication is of secondary import (i.e., the additional communication could be through our preferred AD&A or through required emphasis of matter paragraphs in the standard auditor's report). The respondents to the IAG survey believe that additional substantive communications should be included in an AD&A rather than via required explanatory paragraph(s) appended to the existing auditor report.**

- a. If you support an AD&A as an alternative, provide an explanation as to why.

**The additional communications that investors want from auditors involves the analysis and discussion of various financial statement issues. As such, it appears most appropriate to include this communication in a new narrative document, designed for this purpose, rather than to include these disclosures in a required emphasis of matter paragraph. Moreover, under current auditing standards, emphasis-of-matter paragraphs are used to elaborate on information that is already disclosed in the financial statements. We believe that auditors should communicate to investors information that is already communicated to audit committees but that is not generally communicated to investors. Therefore, since the additional communication contemplates information that is not currently disclosed in the financial statements, an emphasis-of-matter paragraph may not be the best method of auditors communicating this information to investors.**

- b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

**We believe that an AD&A should comment on both the audit and the company's financial statements, although commentary on the company's financial statements would predominate. For example, investors want the auditor to: (1) discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; and (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas. Both of these disclosures include information about the company's financial statements and the audit of that information.**

- c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

**As stated previously, we believe the information most useful in making investment decisions, and that should be included in an AD&A, would require the auditor to: (1) discuss the auditor’s assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer’s accounting practices and policies.**

**The types of disclosures desired by investors would be used to assess the company’s future earnings potential, to assess the company’s risk, and to evaluate the stewardship of management and the board of directors in overseeing the company’s affairs. See paragraphs 28-29 for an elaboration of our position.**

- d. If you do not support an AD&A as an alternative, explain why.

**We support an AD&A.**

- e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company’s financial statements, or both? What are they?

**Although we believe that an AD&A is the best medium for auditor commentary on the audit and the financial statements, the key issue to investors is that the additional communication between auditors and investors occurs. The mechanism for this additional communication is of secondary import (i.e., the additional communication could be through our preferred AD&A or through required emphasis of matter paragraphs in the standard auditor’s report).**

- 6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

**An AD&A should indicate areas of high financial statement and audit risk and how the auditor addressed these risk areas. The appropriate content and level of detail should reflect, subject to legitimate confidentiality concerns, the current structure of a summary audit memorandum prepared by the engagement partner at the conclusion of the engagement.**

- 7. What types of information should an AD&A include about the auditor’s views on the company’s financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management’s judgments and estimates, accounting policies and practices, and difficult or contentious issues, including “close calls”)?



**We believe that the auditor should communicate the following about the company's financial statements: (1) the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (3) the quality, not just the acceptability, of the issuer's accounting practices and policies. Again, the appropriate content and level of detail should reflect, subject to legitimate confidentiality concerns, the current structure of a summary audit memorandum prepared by the engagement partner at the conclusion of the engagement.**

8. Should a standard format be required for an AD&A? Why or why not?

**We believe that the Board should require certain topics to be addressed in the AD&A (e.g., financial statement and audit risk, estimates and judgments, accounting policies, unusual transactions, etc.), but that it should not tightly define the required language within each section.**

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

**We believe that auditor reporting on risks be limited to those that affect audit and financial statement risk, at least at the current time. Auditor reporting on business, strategic, and operational risk would represent a significant expansion of audit scope, and it is not clear to us whether auditors currently have a comparative advantage in reporting on this type of information or whether investors would attach significant value to the auditor's perspective on these categories of risk.**

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

**In our view, the key challenge to the PCAOB is to prevent an AD&A from devolving into boilerplate disclosure. The best way to prevent boilerplate disclosure is by setting clear expectations for auditor behavior through adopted standards and upholding them through a rigorous inspection and enforcement program.**

**We are less concerned about the consistency of AD&A reports than are certain other parties. All partners and firms could report in a very consistent manner and the end result may be boilerplate disclosure. We believe that the marketplace can process, and would in fact benefit from, some variability in disclosure formats and practices.**

**Investors are well-positioned to analyze these additional disclosures. See paragraph 36 for further detail.**

11. What are the potential benefits and shortcomings of implementing an AD&A?

**The primary benefit is substantial incremental disclosure to investors from an independent and objective source. The primary shortcoming is that there will be a cost to this disclosure, and an AD&A will be more subjective and have a greater variance than existing auditor reports.**

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

**We believe that the threat that the auditor's communication would diverge from that of management would strengthen the auditor's bargaining position and lead to an improvement in the recognition, measurement, and disclosure practices followed by management. See paragraph 40 for further detail.**

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

**Investors might benefit from having the auditor highlight significant related party transactions and accounting matters affecting the comparability of the financial statements in an emphasis-of-matter paragraph. However, since these matters are already disclosed in the financial statements, we expect that any benefit would be modest. However, if the Board decides against requiring an AD&A, we would support requiring emphasis paragraphs to discuss significant estimates and judgments, financial statement and audit risk, unusual transactions and other significant changes, and the quality of the entity's accounting policies and practices.**

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

**Only if the Board decides against requiring an AD&A.**

- a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

**We prefer an AD&A to emphasis paragraphs.**

- b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

**See our response to question #13.**

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

**See our response to question #13.**

16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

**The appropriate content and level of detail should be patterned after the disclosure in the summary audit memorandum prepared by the engagement partner at the conclusion of the engagement.**

17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?

**See our response to question #10.**

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

**See our response to question #13.**

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

**The IAG did not consider this issue in our investor survey related to the auditor's report and, as such, we do not take a group position on this issue at this time. We therefore do not respond to questions 19a-19g and 20.**

- a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.
- b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.
- c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?
- d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?
- e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

- f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?
  - g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.
20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?
21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:
- Reasonable assurance
  - Auditor's responsibility for fraud
  - Auditor's responsibility for financial statement disclosures
  - Management's responsibility for the preparation of the financial statements
  - Auditor's responsibility for information outside the financial Statements
  - Auditor independence
- a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

**We believe that the audit report should indicate the auditor's responsibility for detecting material fraud. The standard audit report should clearly explain that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should indicate that reasonable assurance represents a high, although not absolute, level of assurance.**

**We further believe that the auditor should describe its responsibility for auditing the financial statement disclosures (notes) as well as the primary financial statements. Additionally, the auditor's report should indicate that the auditor is independent of the company and that the auditor has observed the independence requirements of the SEC and PCAOB. We are not opposed to amending the audit report to indicate that management has the primary responsibility for the fairness of the financial statements, nor to clarifying**

**the auditor's responsibility with respect to other information in documents containing audited financial statements. See paragraphs 31 and 32 for further details.**

- b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

**Yes. These clarifications would better explain to financial statement users the auditor's responsibility for detecting material misstatements due to fraud, would provide an acknowledgement that the auditor is responsible for auditing the financial statement notes, and would indicate that reasonable assurance is a high level of assurance (although not absolute assurance).**

- c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

**The audit report should disclose the nature and extent of work performed by other audit firms, including affiliate firms of the primary auditor (see paragraph 30). Also, the engagement partner should be required to sign the audit report (see paragraph 33).**

- d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

**We believe that the foregoing clarifications would not change the auditor's responsibilities, as they would simply clarify for the reader of the audit report the auditor's responsibilities under existing professional standards.**

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

**The benefit is that financial statement readers will have a better understanding of the auditor's current responsibilities. We are not aware of any major downside from requiring these clarifications.**

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

**We prefer an AD&A for the reasons previously articulated.**

24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?

**We prefer adding clarifying language to the standard audit report (see our response to #21a), and to requiring an AD&A to communicate new information to financial statement users.**

25. What alternatives not mentioned in this concept release should the Board consider?

**We believe that the changes in auditor reporting advocated in this comment letter would serve investors well at the current time.**

26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

**We believe that the Board should write rules in a way that will encourage, or require, narrative commentary that is specific to the audit rather than formalized, non-specific recitations that fail to provide meaningful information.**

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

**The perception of a qualified or piecemeal opinion should not exist if the standard audit report is maintained (with modifications) and is supplemented with an AD&A. Moreover, the auditor would not be expressing an opinion in the AD&A.**

28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

**The clarifying language we suggest would better convey the auditor's role in the performance of an audit. The problem isn't the auditor's role in the performance of the audit. The problem is that the auditor doesn't communicate enough about what he or she did and found. An AD&A addresses this problem.**

29. What effect would the various alternatives have on audit quality? What is the basis for your view?

**We believe that an AD&A would improve audit quality as its preparation would strengthen the auditor's position in negotiations with management relating to appropriate accounting treatments and disclosures. See our response to question #12.**

30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain

entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.

**We believe that the changes we advocate should be applied to all SEC registrants, unless a compelling case can be made for an exclusion. However, given that an AD&A would be a new requirement and there will almost certainly be a learning curve, implementing the requirement on a staggered basis depending on the issuer's size would be reasonable.**

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which one and why?

**We are most concerned about the impact of any change on audit quality, and audit effort and audit quality are positively correlated. However, as previously articulated, we believe that the changes we advocate will improve audit quality.**

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

**We believe that the benefits of an AD&A, assuming the AD&A includes the type of information we advocate and assuming boilerplate can be avoided, will exceed any reasonable level of incremental costs. See paragraphs 38 and 39 for additional detail.**

c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

**None that we want to raise at this time.**

d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?

**Not applicable given our response to question # 31c.**

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

**As stated previously, we believe that providing additional information, either in an AD&A or in emphasis-of-matter paragraphs will strengthen the auditor's position in negotiations with management. We also believe that since audit committees oversee the financial**

**reporting process, that requiring the auditor to communicate additional information to investors will encourage the audit committee to become more actively engaged in overseeing the financial reporting process.**



Appendix 2 – Most Recent Audit Reports for S&P 500 Companies Containing an  
Emphasis-of-Matter Paragraph

"Other Emphasis  
of Matter"

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of American International Group, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of American International Group, Inc. and its subsidiaries (AIG) at December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, AIG maintained, in all material respects, effective 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 (COSO). AIG's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A in the 2010 Form 10-K. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on AIG's internal control over financial reporting based on our integrated 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As described in Note 2 to the consolidated financial statements, AIG changed the manner in which it accounts for other-than-temporary impairments of fixed maturity securities as of April 1, 2009, as well as the classification of non-controlling interests in partially owned consolidated subsidiaries as of January 1, 2009. Also, as of January 1, 2008, AIG adopted a new framework for measuring fair value and elected an option to report selected financial assets and liabilities at fair value.

As described in Note 1 to the consolidated financial statements, AIG completed a series of integrated transactions to recapitalize AIG with the Department of Treasury, the Federal Reserve Bank of New York and the AIG Credit Facility Trust on January 14, 2011.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. As described in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A in the 2010 Form 10-K, management has excluded Fuji Fire & Marine Insurance Company, from its assessment of internal control over financial reporting as of December 31, 2010 because AIG acquired a controlling interest in Fuji Fire & Marine Insurance Company in 2010. We have also excluded Fuji Fire & Marine Insurance Company from our audit of internal control over financial reporting. The total asset and total revenues of Fuji Fire & Marine Insurance Company constitute approximately 2 percent and less than 2 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2010.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

New York, New York February 24, 2011

"Other Emphases  
of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Morgan Stanley:

We have audited the accompanying consolidated statements of financial condition of Morgan Stanley and subsidiaries (the "Company") as of December 31, 2010 and 2009 and the consolidated statements of income, comprehensive income, cash flows, and changes in total equity for the calendar years ended December 31, 2010 and 2009, the one month ended December 31, 2008, and the fiscal year ended November 30, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the calendar years ended December 31, 2010 and 2009, the one month ended December 31, 2008, and the fiscal year ended November 30, 2008, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company changed its fiscal year end from November 30 to December 31.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 28, 2011 expresses an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP New York, New York February 28, 2011

*"Other Emphasis of Matter"*

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

Scripps Networks Interactive, Inc.

We have audited the accompanying consolidated balance sheets of Scripps Networks Interactive, Inc. and subsidiaries (the "Company") as of December 31, 2010 and 2009, and the related consolidated and combined statements of operations, accumulated other comprehensive income (loss) and shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2010. Our audits also included the financial statement schedule at Page S-2. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule 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, such consolidated and combined financial statements present fairly, in all material respects, the financial position of Scripps Networks Interactive, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated and combined financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated and combined financial statements, prior to its separation from The E.W. Scripps Company ("E.W. Scripps"), the Company reflects the combined financial position, results of operations and cash flows of the Scripps Networks and Interactive Media businesses of E.W. Scripps. The combined financial statements also include allocations of certain general corporate overhead expenses from E.W. Scripps. These costs may not be reflective of the actual level of costs which would have been incurred had the Company operated as a separate, stand-alone public company apart from E.W. Scripps.

As disclosed in Note 3 to the consolidated and combined financial statements, the consolidated and combined financial statements have been adjusted for the retrospective application of Accounting Standards Codification (ASC) 810, Consolidation (formerly Statement of Financial Accounting Standards (SFAS) No. 160, Noncontrolling Interests in Consolidated Financial Statements), which became effective January 1, 2009.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2011 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Cincinnati, Ohio

March 1, 2011

"Other Emphases  
of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Dr Pepper Snapple Group, Inc.

We have audited the accompanying consolidated balance sheets of Dr Pepper Snapple Group, Inc. and subsidiaries (the "Company") as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity and other comprehensive income (loss), and cash flows 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, such consolidated financial statements present fairly, in all material respects, the financial position of Dr Pepper Snapple Group, Inc. and subsidiaries at December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

As discussed in the notes, the consolidated financial statements of the Company include allocation of certain general corporate overhead costs through May 7, 2008, from Cadbury Schweppes plc. These costs may not be reflective of the actual level of costs which would have been incurred had the Company operated as a separate entity apart from Cadbury Schweppes plc.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 22, 2011 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP Dallas, Texas February 22, 2011

"Other Emphases  
of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of Marshall & Ilsley Corporation

We have audited the accompanying consolidated balance sheets of Marshall & Ilsley Corporation and subsidiaries (the "Corporation") as of December 31, 2010 and 2009, and the related consolidated statements of income, equity, and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Corporation'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, such consolidated financial statements present fairly, in all material respects, the financial position of Marshall & Ilsley Corporation and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 26 to the consolidated financial statements, on December 17, 2010, the Corporation and Bank of Montreal announced that they had entered into a definitive agreement under which Bank of Montreal will acquire all outstanding shares of common stock of the Corporation in a stock-for-stock transaction.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2011 expressed an unqualified opinion on the Corporation's internal control over financial reporting.

/s/ Deloitte & Touche LLP Milwaukee, Wisconsin March 1, 2011