financial executives international

COMMITTEE ON CORPORATE REPORTING

September 30, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Board:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Release No. 2011-003, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" ("the Release"). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

High quality financial statements accompanied by high quality audits are essential to investor confidence and we appreciate the Board's efforts in undertaking a standard-setting initiative to consider improvements to the current auditor's reporting model. We also want to thank the staff for their extensive outreach efforts leading up to the publication of the Release.

We agree with the Board that some improvements to the auditor's reporting model may enhance investors' and users' understanding of the audit process, its benefits and limitations. We are concerned, however, that the Board is considering possible changes, as illustrated in some of the alternatives, without clearly identifying the underlying problem.

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Overall, we believe the following principles should be integral to the Board's decision around possible changes to the current auditors reporting model:

- Any standard-setting initiative should not change the fundamental responsibilities of management, the audit committee or the auditors. That is, management owns and is responsible for preparing the financial statements, for adopting sound accounting policies and for establishing and maintaining internal controls that will report transactions, events and conditions consistent with management's assertions embodied in the financial statements as a company's transactions, assets, liabilities and equity are within the direct knowledge and control of management; the audit committee has the responsibility to oversee management's financial reporting process; and the auditor has the responsibility to express an opinion on whether the financial statements and disclosures taken as a whole are presented in conformity with GAAP in all material respects. While an auditor may make suggestions around the form or content of the financial statements, their responsibility remains confined to the expression of an opinion on them.

- Given those responsibilities, we believe that the audit report should provide objective information, rather than subjective opinions on specific items which lack the context or balance that is achieved when forming an opinion on the overall financial statements. The outreach performed by the Board indicates that there is a significant gap between what the auditor's responsibility actually is and what the investor perceives that responsibility to be and therefore, the presentation of subjective opinions would increase the audit "expectation gap" by blurring the line between management and the auditor's responsibility. In particular, we observe that the Release contemplates the auditor possibly providing their views on contentious issues, close calls, and matters in which management is in technical compliance with GAAP but in the auditor's view, the disclosure of such matters could be enhanced. This subjectivity or second-guessing of management's decisions would suggest, if implemented, that the auditor has the responsibility to prepare financial statements and disclosures in compliance with GAAP. The current audit opinion already requires an explanation if the disclosures are materially deficient.

- The financial reporting process, as overseen by the audit committee, not the audit report, should be used to resolve any differences between management and the auditor. The audit report should not be an avenue, or a "lever," in which resolved issues are redistributed for public consumption without the depth of understanding necessary to develop an informed opinion about the meaningfulness of the issue and the associated views. We believe that such reporting would inhibit open communication between auditors, management and audit committees. Rather than using the audit report as a means to address users concerns, we recommend that the Board work with the FASB or the SEC to develop or enhance financial reporting disclosures, if necessary, to address specific concerns about perceived shortcomings in the current financial reporting model.

- Finally, any possible standard-setting changes must be accompanied by a comprehensive cost-benefit analysis. Costs should include increased legal exposure for auditors, management, the company's board members and the company that may be the result of the proposed reporting. While we understand that certain of the Board's alternatives utilize models from other countries, the unique U.S. litigation environment needs to be considered carefully in this analysis. Costs should also include an analysis of incremental audit efforts and whether these efforts will require filing deadlines to be extended. Changes to the auditor's reporting model will require additional audit time to prepare and conduct necessary reviews, as well as discuss with management and audit committees. The accelerated filing timelines, coupled with other reporting requirements, such as SOX, XBRL as well as increased reporting requirements included in the Board's Proposed Auditing Standard on Communications with Audit Committees, may create additional difficulties for some companies to maintain timely reporting. The audit reporting model initiative also comes at a time of significant pending changes in accounting standards as a result of the FASB and IASB's convergence projects, and the SEC's evaluation of the use of IFRS as the reporting framework in the United States. This should also be considered in the Board's analysis.

We believe the current pass/fail opinion is well understood by investors and users of financial statements. An unqualified opinion means that all material matters have been resolved and that the auditors are in agreement with management that the financial statements do not contain any material misstatements. We are in support of the Board's alternative to include clarifying language in the existing standard auditor's report and believe it will enhance investors' and users' understanding of the audit process. We are also of the opinion that the required and expanded use of emphasis paragraphs in certain limited instances may be of some value to certain investors and users. We do not support the auditor's discussion and analysis alternative and we do not believe that auditor assurance on other information outside the financial statements is appropriate. We believe these alternatives would result in more confusion and have unintended adverse effects on the auditor-client relationship, auditor independence and audit costs, and give certain information undue prominence.

Auditor's Discussion and Analysis

We are not in support of the Auditor's Discussion and Analysis (AD&A) alternative presented in the Release. The AD&A alternative would significantly expand the auditor's role beyond their current attestation responsibility and may impair the auditor's independence. Management owns and is responsible for the preparation of the financial statements and disclosures in compliance with GAAP, not the auditor. Further, it is the audit committee's responsibility to provide oversight of the financial reporting process on behalf of investors. Management, coupled with the oversight of the audit committee, is in the best position to provide understandable, accurate and insightful information regarding the company's historical results of operations and current financial position, and objectives and challenges for the future. An AD&A would confuse investors and users as to who is actually responsible for the company's financial reporting and damage the existing financial reporting system. We believe specific concerns about shortcomings in the current financial reporting model should be addressed to the FASB or the SEC to develop or enhance financial reporting disclosures, if necessary.

An AD&A requirement would create a barrier to productive and candid communications between management, auditors and the audit committee. Also, we believe that the AD&A could evolve into boilerplate disclosure. Consistent with an appropriate auditor-client relationship, management diligently works through highly subjective and judgmental issues to arrive at the appropriate GAAP accounting and disclosure, and the open and transparent discussion with auditors naturally results in the auditor's report to the audit committee summarizing matters upon which management and the auditor are in agreement. That is, the "contentious issues" that are contemplated for reporting in the AD&A are generally resolved by management and the auditor. In fact, items that investors and users might label as "contentious" are not generally disagreements or arguments, but are issues requiring discussion due to their highly complex nature. Such information in the AD&A may inappropriately highlight items that would raise unwarranted concerns and evolve into boilerplate disclosure.

We are also concerned that the AD&A would give undue prominence to items that are of lesser importance or immaterial. The intention of the AD&A is not to provide separate assurance on individual balances, disclosures, or transactions; however, we have difficulty reconciling that intention with our expectation that such granularity may result in order for the auditor to fully report on audit procedures and results, the auditor's views regarding management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." Such AD&A disclosures would naturally be associated with balances, disclosures or transactions, while the auditor’s knowledge would be limited to that acquired during the audit.

Finally, an AD&A would result in significant reporting delays and an increase in audit fees. A substantial amount of time would be required for the auditor to prepare the report, conduct national office consultations, and obtain the necessary reviews and agreement with management. We do not believe the reporting delays and additional cost will result in any beneficial information to the investor. Instead, as stated above, we recommend that the Board work with the FASB or the SEC to develop or enhance financial reporting disclosures, if necessary, to address specific concerns about shortcomings in the current financial reporting model.

Required and Expanded Use of Emphasis Paragraphs

We are of the opinion that the required and expanded use of emphasis paragraphs in certain limited instances may be of some value to certain investors and users. We are, however, concerned that this may over time evolve into a standard boilerplate section of the auditor’s report that will eventually diminish the importance of the matters that we believe should be included in such paragraphs. In most cases, we do not believe the addition of emphasis paragraphs to the auditor’s report will be particularly valuable to investors and users. We remain convinced that an educated investor and user of financial statements should be able to identify all the critically important matters by thoroughly reviewing the Management Discussion and Analysis (“MD&A”) and the financial statements and related footnotes.

The auditor’s report should only include emphasis paragraphs if there are matters that the auditor determines are of critical importance to the financial statements and there is the risk that a well informed investor and user will not reach the appropriate conclusion from their review of the financial statements. The auditor should highlight such matters and refer to management’s disclosure regarding the matters as management is responsible for the financial statements and for maintaining effective internal control over financial reporting. Matters of critical importance not currently required by auditing standards may include critical accounting policies, areas of critical accounting estimates, changes to the financial statements that impact comparability to prior years, and significant transactions. It is important that the Board provides adequate guidelines to assist auditors in their determination of the matters that should be included in emphasis paragraphs, if any (e.g., material mergers or dispositions with materiality determined consistent with Form 8-K disclosure requirements).

We do not believe emphasis paragraphs should be required on an extensive basis. This would result in auditors developing lengthy checklists to determine which items should be included in emphasis paragraphs to ensure consistent application across all offices, and expect that the disclosures would become boilerplate over time. We are also concerned that auditors may include items that are not necessarily of critical importance, diminishing any potential benefit emphasis paragraphs may provide to the investor.

Further, if audit reports for companies in the same industry include different items in emphasis paragraphs, we are concerned that investors may misinterpret the inclusion or exclusion of a matter in a particular company's auditor's report and potentially draw erroneous conclusions.

We do not support the disclosure of the nature and/or extent of audit procedures in emphasis paragraphs for any matter, including matters of critical importance. The nature and extent of audit procedures appropriately vary significantly from company to company based on risk assessments and the control environment. Further, the complexity of audit procedures varies significantly from one area to the next. It would require extensive discussion to put the audit procedures for an item referred to in an emphasis paragraph in the proper context for an investor and user.

Auditor Assurance on Other Information Outside the Financial Statements

We do not believe it is appropriate for an auditor to provide assurance on any information outside the financial statements for the following reasons:

- The information contained outside the financial statements is of a more subjective nature, in particular with regards to the MD&A. Information presented in the financial statements is based on detailed and largely prescriptive GAAP rules, which dictate the accounting treatment and disclosure requirements. The auditors currently focus on auditing the accuracy of the information presented in the financial statements and the adequacy of disclosures in compliance with GAAP. However, the rules governing the MD&A disclosures are less prescriptive and encourage management to provide their views on the historical and future business performance "through the eyes of management." The MD&A information is intended to be more qualitative and forward-looking than those contained in the financial statements and requires significant judgment and understanding of the registrant's business. Much of the information provided represents management's analysis and insights based on their detailed current knowledge of their businesses. We believe it would be extremely difficult for the auditors to audit this information effectively to enable them to provide meaningful value to investors and users. We are also concerned that this may affect the independence of the auditors.

- We are concerned that the requirement to audit MD&A could lead to less transparent, boilerplate content. As noted above, the MD&A is intended to provide an analysis of performance (both past and forward-looking) through the eyes of management. By necessity, this involves the inclusion of items that may not be objectively verifiable. To the extent certain items are not auditable, we are concerned that there may be a tendency to exclude the related discussion rather than deal with the consequences of potential scope limitations in the auditor's report on the MD&A. This would reduce the overall value of the MD&A to shareholders.

- We expect that the cost to provide additional assurance would be high compared to the benefit investors and users may derive from such assurance. We are not aware of strong support from any relevant stakeholder groups for this alternative based on our interaction with such groups. It is likely that the auditors performing these types of engagements would generally be more experienced resulting in costs exceeding the existing average audit rates. The subjective nature of the information and lack of prescriptive guidelines would likely result in extensive additional discussions between senior management and auditors, as well as documentation supporting management's thought process and conclusions. The combination of higher rates and extensive hours would likely mean a significant increase in audit fees, which we believe would be completely disproportionate to any benefits received.

- The requirement to provide assurance on information outside of the financial statements would require significant additional time, and would almost certainly lead to a later release of Form 10-K filings, in most cases by at least several days. For some companies, SEC filing deadlines would become unachievable.

- To the extent that information in the MD&A is derived from financial statements or is subject to internal control over financial reporting, auditors are already performing procedures to ensure the information is materially consistent with the information presented in the audited financial statements and footnotes.

With respect to critical accounting policies and estimates, we do not believe separate assurance is appropriate for the reasons outlined above; however, as discussed earlier, we support an emphasis paragraph highlighting these. Further, we believe that clarification of the auditor's responsibilities with respect to MD&A in the standard auditor's report is desirable.

Clarification of the Standard Auditor's Report

We are in support of the Board's alternative to include clarifying language in the existing standard auditor's report and believe it will enhance investors' and users' understanding of the audit process.

We believe the clarifying language around the auditor's responsibility for information outside the financial statements should be limited to the items included in the annual report on Form 10-K as required by the SEC.

Other Questions and Considerations

In the attached appendix, we have included additional information on our views with respect to certain questions in the Release.

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We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have questions, please contact Lorraine Malonza at (973) 765-1047 or lmalonza@financialexecutives.org.

Sincerely,

Loretta Cangialosi

Loretta V. Cangialosi
Chair, Committee on Corporate Reporting
Financial Executives International

cc: Martin F. Baumann, Chief Auditor and Director of Professional Standards

Form of the Auditor's Report

Question 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.

Management is in the best position to provide additional information regarding the company's financial statements. Management is closest to the daily operations and has direct knowledge and control of assets, liabilities, equity and activities of the company and has the responsibility to prepare financial statements and disclosures in compliance with GAAP. Management is responsible for making the necessary judgments and estimates, and has a far better understanding than the auditor of the industry, business strategy and results of operations.

We are concerned that if the auditor was responsible for providing additional information, they could be seen as acting in the capacity of management, thus impairing their independence.

B. Required and Expanded Use of Emphasis Paragraphs

Question 18:

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

We are of the opinion that the required and expanded use of emphasis paragraphs in certain limited instances may be of some value to certain investors and users. However, we do not believe that the required emphasis "could potentially increase the quality of management's disclosures in the financial statements because of specific reference to such disclosures in the auditor's report." Management has the responsibility to provide high quality disclosures, and it is the auditor's responsibility to opine as to whether those disclosures are prepared in accordance with GAAP. Making reference to those disclosures in the auditor's report would only tend to highlight specific disclosures that are made in the financial statements, but we do not believe that this reference should change the content of those disclosures.

D. Clarification of the Standard Auditor's Report

Question 22:

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

We believe this alternative has some benefits without altering the scope of the audit or impacting the auditor's responsibilities. Further, the cost associated with this alternative would be minimal. It will enable investors and users to obtain a better understanding of the scope of the audit and the role of the auditor.

Question 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?

We believe the AD&A (alternative 1) and emphasis paragraph (alternative 2) may confuse the users of financial statements, who may possibly perceive the opinion to be qualified.

Alternative 1: We believe that it would be very difficult to develop an appropriate framework for an AD&A, and once developed, it would be very difficult for a framework to be consistently followed by auditors when disclosing information of such a highly subjective nature. Requiring auditors to present information of this nature could result in misleading reports, make it difficult to have comparability among financial statements, and cause confusion about the auditor's pass/fail opinion. An unqualified opinion means that all material matters have been resolved and that the auditors are in agreement with management that the financial statements do not contain any material misstatements. Highlighting additional information (e.g., close calls, contentious issues, etc.) would likely suggest a higher level of importance to the issue(s) than is warranted since users would not be privy to the dialogue that occurs between the auditor, management and the audit committee in which additional context and perspectives are communicated.

Alternative 2: Requiring auditors to emphasize certain areas could result in misleading reports, make it difficult to have comparability among financial statements, and cause confusion about the auditor's pass/fail opinion. For this reason, we believe it is vital that required emphasis paragraphs are limited to only include matters of critical importance.

We believe auditor assurance on other information outside the financial statements (alternative 3) could lead to the opinion being perceived as piecemeal, if this assurance is combined in one report with the audit pass/fail opinion.

We do not believe the clarification of the standard auditor's report (alternative 4) will result in the opinion being perceived as qualified or piecemeal. We believe it will enhance investors' and users' understanding of the audit process

Question 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?

We believe the clarification of the standard auditor's report alternative is the most appropriate way to improve the auditor's reporting model. Providing clarifying language for the items outlined in the Release would serve to enhance the auditor's report and help users better understand the responsibilities of the auditor and what an audit represents. Providing clarifying language for each of these items will be beneficial as discussed below.

- Reasonable assurance – This will reinforce the concept that an audit provides a "high level of assurance, but not absolute assurance."

- Auditor's responsibility for fraud – We believe that the auditor's responsibility for the detection of fraud should be addressed within the standard auditor's report. We are supportive of expanding the current language within the report to include "…Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, <u>whether caused by error or fraud</u>" as is consistent with the current auditing standard.
- Auditor's responsibility for financial statement disclosures – This will bring the standard auditor's report more in line with the actual responsibilities of auditors as set out in current auditing standards. This will provide assurance to users that the auditors have a responsibility to plan and perform their audit to obtain reasonable assurance that misstatements of items that are material to the financial statements are detected and that the financial statements cover both the basic statements and related footnotes.
- Management's responsibility for the financial statements – This language should reiterate that management has responsibility for preparing the financial statements and management has the responsibility for adopting sound accounting policies and for establishing and maintaining internal controls that will report transactions, events and conditions consistent with management's assertions embodied in the financial statements as a company's transactions, assets, liabilities and equity are within the direct knowledge and control of management. This will enhance the view that an auditor is an independent party responsible for evaluating the accuracy of management's presentations.
- Auditor's responsibility for information outside the financial statements – We believe that providing the users with an understanding of the auditor's current responsibilities under AU 550 would be beneficial and help users to better understand the procedures being performed on other information outside the financial statements. We believe the clarification should be limited to sections of the Form 10-K.
- Auditor independence –We believe this could provide users with a better understanding of the auditor's role and provide more confidence in their judgments and the audit process.

Question 29:

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

We believe alternative 1 and 3 could have a serious negative effect on audit quality due to the additional time and resources these alternatives would require in today's accelerated filing timelines, which already includes an opinion on internal control over financial reporting. These alternatives would divert audit resources and the audit partner's attention away from required work needed to support a conclusion on the financial statements.

We also believe that requiring disclosure of audit procedures performed in connection with items discussed in the emphasis paragraphs could have a similar impact on audit quality for the reasons stated above.

IV. Considerations Related to Changing the Auditor's Report

Question 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 ones and why?

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?

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

All of these considerations are significant and could individually justify a conservative approach to the decisions to be made with respect to the alternatives before the Board. Some of the alternatives present significant consequences for the cost of the audit, particularly the AD&A and attestation to the MD&A. Some of the alternatives could raise very significant concerns about liability and confidentiality, especially the AD&A.

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 AD&A and assurance on information outside the financial statements alternatives would likely result in significant audit cost increases. We also believe that these alternatives, especially the AD&A, would significantly increase legal exposure for auditors, companies, management and Boards of Directors. Further, we believe that these alternatives would result in significant unforeseen consequences and costs that would far outweigh the intended benefits.