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December 11, 2013

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

Dear Ms. Brown:

I write to comment on PCAOB Release No. 2013-005 related to the auditor's report on financial statements when the auditor expresses an unqualified opinion. Although I am a member of the PCAOB's Investor Advisory Group (IAG), and although I will refer to the work of a sub-group of the IAG, I am writing this letter in my individual capacity as a professor of accounting, auditing, and corporate governance, and as a personal investor. I currently serve as the EY and Business Alumni professor of accounting at the University of Tennessee, where I also serve as the Executive Director of UT's Corporate Governance Center.

In evaluating the need for change to the standard audit report, I encourage the Board to evaluate the current audit report against the Board's mission – "... protect the interests of investors and further the public interest in the preparation of *informative, accurate and independent audit reports*" (emphasis added). Based on a number of surveys of investors and other financial statement users by the IAG, the Council of Institutional Investors, and the CFA Institute, among others, investors and other users clearly do not view the audit report as informative beyond simply indicating that in the auditor's opinion the financial statements are fairly presented in accordance with GAAP. Although opining on GAAP compliance is valuable, the PCAOB has a once in a generation opportunity to substantively reform the audit report so that meaningful, substantive communication occurs between the auditor and the auditor's ultimate client, investors and other users.

Before commenting on the strengths and areas needing improvement in the PCAOB's proposed auditor reporting standard, I refer the Board back to the comment letter of a sub-set of the IAG on PCAOB Release No. 2011-003 (letter dated 9-29-11). That letter describes the work of an IAG working group on the auditor's report, including reporting the results of a survey

distributed to a number of institutional investors. As a result of our work, a majority of the IAG indicated that changes to the standard audit report should:

- 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.
- Disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas.
- Discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes).
- Discuss the quality, not just the acceptability, of the issuer’s accounting practices and policies.

My evaluation of the PCAOB’s proposed auditor reporting standard is tied to how closely the proposed standard is responsive to the above four recommendations.

In my view, the auditor’s proposed auditor reporting standard is clearly an improvement over the existing report as originally promulgated in SAS No. 58. However, although the proposed standard represents an improvement, it fails to provide some of the most critical information needed by investors. Therefore, any weakening of the proposed standard in response to organized opposition by entrenched interests would likely result in a final standard that is so milquetoast that it would have been better for the PCAOB to not have pursued this project.

The heart of the PCAOB’s proposed standard would require the communication of critical audit matters (CAM), with the expectation that these CAMs are customized to each audit – i.e., they should differ by company, and by year even for the same company. Avoiding boilerplate in reporting CAMs is imperative – this point simply cannot be overstated.

The proposed standard defines a CAM as a matter: (1) involving the auditor’s most difficult, subjective, or complex judgments; (2) that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and (3) that posed the most difficulty to the auditor in forming an opinion on the financial statements. In my view, these areas almost certainly would involve areas of high financial statement and audit risk and, therefore, the inclusion of a CAM is responsive to the one of the four areas identified by the IAG for inclusion in the audit report. Although more subtle, I believe that the CAM criteria would generally require the audit report to discuss unusual transactions, restatements, and other significant changes to the financial statements. If the Board agrees with my evaluation, the inclusion of a CAM is responsive to a second of the four areas identified by the IAG for inclusion in the audit report.

Unfortunately, it is not clear to me that the proposed auditor reporting standard is responsive to the other two suggested changes made by the IAG. First, and most importantly, the proposed standard does not appear to require the auditor to discuss the estimates and judgments made by management. The auditor’s evaluation of management’s estimates and judgments was the most important piece of information desired by investors. If the Board believes that this information will be included in the audit report as a result of its proposed standard, it would be helpful for the Board to be more specific as to its expectation for the

auditor to discuss management's estimates and judgments. Moreover, simply stating that a judgmental area (e.g., allowance for loan losses, fair value, impairments, etc.) represents a CAM is not what investors are seeking. In most instances, a knowledgeable financial statement reader would already know that these areas are critical to the audit. Investors need to know more about areas involving significant estimates and judgments. For example, investors would benefit from knowing:

- The auditor's evaluation of the process used by management in developing the estimate and, with the benefit of retrospective evaluation, the mapping of prior year estimates into subsequent year realizations.
- The auditor's evaluation of whether management's estimate is conservative, aggressive, or "down the fairway" with respect to its effect on current year income.
- The auditor's evaluation of whether a pattern exists across estimates and judgments – for example, are these estimates and judgments consistently conservative or aggressive (again with respect to current year income).

The Board can modify its proposed standard to provide the needed information relatively easily. The CAM for example #1 (the allowance for sales returns) in the proposed standard (p. A5-68) provides no information that would enable investors to assess the aggressiveness or conservatism of the allowance for sales returns, but the auditor would have a sense of how aggressive or conservative the Company's process is related to sales returns and could communicate such information to investors in the CAM. For example, the auditor could compare the allowance at 10-31 (end of the third quarter) to sales returns during the fourth quarter. Moreover, since the Company's credit terms are 120 days, any returns that relate to sales made before October 31<sup>st</sup> should have occurred before February 28<sup>th</sup> of the next year. Since the year-end date is January 31<sup>st</sup>, the audit report would, in most cases, not have been issued by February 28<sup>th</sup>. This type of information, through the eyes of the auditor, is what investors need, and the type of information that would spur capital formation and economic efficiency.

Finally, although investors are interested in the auditor's evaluation of the quality, and not just the acceptability, of the company's accounting policies and practices, it is not clear to me that the proposed standard would result in the auditor providing this information.

Although of less importance to the issues raised above, my other concerns with the proposed auditor reporting standard are as follows:

- The audit report should indicate, consistent with professional standards, that a reasonable level of assurance represents a high, although not absolute, level of assurance.
- The proposal would permit the auditor to state that there are no CAMs. This does not strike me as possible. It seems unlikely to me that an audit would involve no difficult, subjective, or complex auditor judgments, and that no such issues would be documented in the engagement completion document.
- As discussed by PCAOB member Steve Harris in his public comments at the Board's open meeting on August 13, 2013, the proposal appears to allow the auditor to not report a

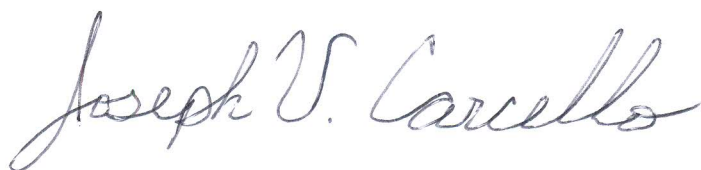
CAM, even if the item meets the definition of a CAM, as long as the rationale for the auditor's decision is documented in the work papers. Although there may be valid reasons for not disclosing a CAM in some very limited situations (i.e., potentially due to litigation concerns or competitive business situations), the Board should more narrowly define the acceptable use of this exception.

- The proposed standard would modify paragraph #10 of AS #7 by indicating that the engagement quality reviewer (EQR) *should* (my emphasis) evaluate whether appropriate CAMs are communicated in the audit report. It seems to me that the EQR *must* or *shall* be required to do so.
- I agree that requiring the audit report to be addressed to investors is a small, but potentially significant, change, as the requirement has the potential to remind auditors who the ultimate beneficiary of the audit is intended to be.
- I agree with the Board that a significant benefit of requiring the disclosure of CAMs is that such a disclosure requirement is likely to both improve management's disclosures with respect to these items and lead to greater audit effort and focus there as well.

I close with the following observation. As of the date of my letter, there have been approximately 47 comment letters posted to the Board's web site. A number of these letters are from issuers or from audit committee members of issuers. Almost without exception, these letters oppose the inclusion of CAMs in the audit report. (As an aside, comment letters from two large institutions, BlackRock and Standard and Poor's largely support the Board's proposal, and the comment letters from individual investors also support the Board's proposal.) It is worth highlighting that issuers use shareholder monies to hire personnel who write comment letters opposing reforms that institutional investors, the majority owners of most of these companies, are seeking. Given that most investors have neither the time nor the resources to match the comment letters that will be forthcoming from the issuer community and its acolytes, I attach Exhibit A which captures the views of many institutional investors as to the need for a significantly revised audit report. Quotes appearing in Exhibit A are derived from the transcript of the PCAOB-sponsored roundtable on the auditor's reporting model held on September 8, 2011.

I compliment the Board and Marty Baumann and his staff for undertaking such a contentious, but vitally important, issue as the audit report. I believe that this topic is the single most important issue on the PCAOB's agenda. Thank you for giving me the opportunity to express my views.

Sincerely,

A handwritten signature in cursive script that reads "Joseph V. Carcello". The signature is written in dark ink and is positioned above the typed name and title.

Joseph V. Carcello  
EY and Business Alumni Professor  
Executive Director – Corporate Governance Center

## **Exhibit A – Comments from Investors on Needed Changes to the Standard Auditor’s Report**

### PCAOB Roundtable – Auditor’s Reporting Model – September 8, 2011

“I believe an AD&A should include, at a minimum, the independent auditor’s assessment of management’s critical accounting judgments and estimates. Such disclosure was supported by 86 percent of the respondents to a 2011 CFA survey and 79 percent of the respondents to the IAG survey.” (Ann Yerger, Executive Director, Council of Institutional Investors, p. 22)

“I strongly believe the additional information should come from the audit firms and not management or audit committees. Audit firms are objective, third-party experts that have unique insights into companies, and it is appropriate and beneficial for the investing public to receive more information directly from these unbiased experts.” (Ann Yerger, Executive Director, Council of Institutional Investors, p. 24)

“When I think about coming back to the unqualified opinion, I think about accounting due diligence reports that I’ve seen where, let’s say, an investor would hire an auditing or accounting firm to render some form of opinion on a company’s financial profile. And those reports are generally rich in information, and they provide a lot of value, whereas the audit for public and private companies opinion does not.” (Mark Newsome, Managing Director, ING Capital LLC, pp. 51, 52).

“We would not object to the identification in AD&A of those areas which were – where there is significant management or auditor judgment or significant uncertainty, given their complexity and, as part of that, the attendant disclosure of some of the key inputs upon which the auditor relied. And again, part of the thesis that we believe, which is based upon the need for management to make original disclosures, we believe that will in part force management to enhance their disclosure and their financial statements, as opposed to having the auditor talk about their key inputs.” (Steven Buller, Managing Director, BlackRock, p. 58).

“And I promise you and the audit firms that are represented here that the additional information you will provide will not confuse me.” (Florida Rivera-Alsing, Chief Audit Executive, Florida State Board of Administration, p. 82).

“It’s probably not a mandate or specific role of the PCAOB, but we think it’s important, and that’s strengthening the hand of the auditors. The mere fact that there’s more to say than pass or fail, we think, would give – and there was broad consensus on this – we think would give the auditors a stronger hand. They would win more arguments, and we think that would be a good thing. And that could be a good thing even if they didn’t say anything at all in the emphasis paragraphs. Simply the ability to say something there as an additional tool.” (Paul Haaga, Jr., Chairman of the Board, Capital Research and Management Co., pp. 86, 87).

“When you were looking at second quarter numbers for several European banks recently, you saw wildly different outcomes for the numbers that were being reported related to losses on

holdings in Greek sovereign paper, just wildly different. Having auditor insight into how those ranges of potential outcome were evaluated and where, to use a golf analogy, a firm was hitting the ball in that fairway of acceptable outcomes and how the conclusion was supported and was okay I think could be just incredibly valuable to investors as they look at the numbers and think about how we want to adjust or how we want to view the numbers differently in our analysis.” (Mark LaMonte, Managing Director, Chief Credit Officer – Financial Institutions Group, Moody’s Investor Service, pp. 101, 102).

“And it’s very important to get a better understanding of some of the judgments and assumptions that are made and how the auditors basically – especially for some of the big issuers, how the auditors got themselves comfortable with that.” (Stephen Kozeracki, Principal, Co-Head of the Corporate Bond Group, The Vanguard Group, pp. 115, 116).

“So we’re talking about who should be giving more information, what the information should be, and where that information should reside. And overwhelmingly, we hear from our investor members that they want to hear it from the auditor, that it needs to be from the independent expert, that, that is important, that they want to have information that’s informative.” (Kurt Schacht, Managing Director, CFA Institute, p. 232).