

STATEMENT OF RICHARD H. MURRAY
TO THE PCAOB PUBLIC MEETING ON THE AUDITORS REPORTING MODEL

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Chairman Doty, Members of the Board, Director Baumann and Staff:

The Advisory Committee on the Audit Profession (ACAP) presented our report to the Secretary of the Treasury on October 6, 2008, just as the economy was staring at potential free fall. It is hardly surprising that the Report drew less attention than expected, and that our recommendations are only slowly gathering traction. I am, therefore pleased that the PCAOB, to whom many of our 31 recommendations were directed, is addressing the very complex issues of the auditors reporting model. I am honored to have this opportunity to return to the subject.

Auditing is a vital component of the US economy and society. To effectively serve those interests, auditing needs to be understood as both artistic impression and scientific precision. I do not share the view that subjectivity in the formation and expression of audit judgments is a weakness to be eschewed. Auditors must apply intelligence and objectivity to impose order on a multitude of intersecting and overlapping estimates and approximations. Because auditing is in critical part subjective, it is incumbent on anyone recommending how audit should be conducted to disclose his or her experience and perspective to assist others in evaluating the merit of the comments.

My life in and around auditing began with appointment as General Counsel of one of the original Big eight firms. I inherited the responsibility of implementing the first SEC mandated firm-on-firm Peer Review under the very intense and very fair scrutiny of The (now) Honorable Judge Stanley Sporkin. For Judge Sporkin, being scrupulously fair was as important as being heard. I have tried to emulate that standard.

For the next 40 years I shuttled between positions in the profession and positions of responsibility in that portion of the global insurance community that provided audit liability insurance. Both the inside and outside roles provided opportunities to observe the strengths and the flaws of national and global audit practice. I have been privileged to participate in all national assessments of audit, from The Trueblood Commission of 1973 through ACAP. I currently have the honor of membership on the Standing Advisory Group of the PCAOB and continuing involvement with the insurance industry. From these intimate observations I have learned that auditing is the most difficult of the learned professions, and have grown confident that auditors perform at a level which meets or exceeds that of other professions and callings.

CRITICAL AUDIT MATTERS

PCAOB Release No.2013-005 proposes to require auditors of US public companies to include in the standard form audit report a statement of the "critical audit matters" (CAMs) encountered in the course of the audit. The proposal contains detailed directives for determining what conditions

qualify as CAMs, for the audit procedures required with respect to each and for the form of presentation in the report. The CAM proposal is the most significant and transformational aspect of the Release, seeking as it does to provide users of financial statements with a form of insight into the auditors perceptions about the company beyond the current pass-fail form of report.

There can be no doubt that the current model report offers less information at greater expense than is normally found in business communications, matched only in the cost per word by some forms of legal opinions that similarly function as die cut keys for client access to the capital markets under our securities laws.

During our deliberations, ACAP recognized that audit reports could provide considerably more value if the views and impressions of the auditor could in some way be added without undermining the essential value of the pass-fail declaration. ACAP endorsed a search for ways that audit reports could become more valuable to users by facilitating "...a more narrative report..." containing elements such as the auditor's views of "...estimates, judgments, sufficiency of evidence and uncertainties..." (Report VII:17) The ACAP deliberations also included concern over the possibility that such additional disclosures might adversely affect the utility of pass-fail reporting. Extensive discussion focused on the potential liability consequences in the highly litigious US commercial culture.

In the time available for its study, ACAP was not able to determine the best way forward. However:

"The Committee notes that the increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value contributing to greater complexity in financial reporting. The Committee believes this complexity supports 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. While there is not yet agreement as to precisely what information is sought by and would be useful to investors and other users of financial statements, the Committee concludes that an improved auditor's report would likely lead to more relevant information for users of financial statements and would clarify the role of the auditor..." (Report VII:17)

Based on these observations, ACAP recommended "...that the PCAOB address these issues...by undertaking a standard setting initiative to consider improvements to the auditor's reporting model."

ACAP went on to say "The PACOB should also take cognizance of the proposal's potential legal ramifications, if any, to auditors." (Report VII:18)

I am pleased that the PCAOB has taken up the cause, and commend the Board for the thoughtful attention behind this proposal as the way to implement the ACAP recommendation. The questions to be considered at this stage of outreach are:

- Is the CAM proposal the best way to achieve an effective narrative?
- Is the proposal for how CAM information should be delivered the optimal choice?
- Does the proposal raise concerns of increased litigation risk that warrants evaluation?

I accept that the CAM proposal is an appropriate option for providing auditor narrative. However, I would prefer a choice that is less prescriptive and more encouraging of flexible narrative. That is a preference that is broadly applicable to audit regulation globally in the 21st century, and derives from confidence in the overall competence and integrity of the audit profession, relative to other communities of responsibility in an imperfect world.

I have greater concern about the proposal for delivery of all aspects CAM reporting (identification, analysis and description) directly to users of financial statements through the audit report. That process would be a regression to past reporting eras, prior to Sarbanes-Oxley and the initiatives of the PCAOB. The reporting environment of the past 12 years has consistently shifted to the establishment of audit committees as the nerve centers of corporate governance and financial reporting. The auditor's pass-fail determination is the only phase of those activities that continue to flow directly from auditor to financial statement user. That is appropriate because it is the exclusive judgment of the auditor. By contrast, CAM commentaries would be observations that intersect with the company's treatment of those issues. Direct disclosure in the audit report would make this the only interactive component of the governance and reporting function that would not be linked to the audit committee, a curious inconsistency with recent actions such as the rules for auditor communications with the audit committee.

The delivery conundrum could be rectified by requiring the auditor's CAM reports to be submitted to the audit committee. If the committee believes the auditor's text to be appropriate, it would be obliged to include the material in its report to shareholders. If the committee had reservations about the material it would be free to add its observations along with those of the auditor.

What would this indirect process accomplish? It would at a minimum avoid having the auditor publish original information about the company, a condition deemed undesirable by many commentators. It would also reduce the risk of accidental confusion in the many instances where apparent differences of opinion will be found to be differences of articulation. The reporting process is likely to be more orderly in some instances, perhaps in many. Perhaps the resulting interaction of management, the audit committee and the auditor would on occasion lead to improvement of the condition addressed in the CAM, rather than limiting the value to the auditor's sole narrative.

I also have concerns about the CAM proposal as the likely cause of a new wave of litigation against both issuers and auditors. I anticipate that the community of attorneys specializing in the representation of shareholders seeking class action targets would be thrilled to see this proposal adopted. The once great feast of class actions against company and auditor has been curtailed by judicial and legislative restraints of recent years. My apprehensions take several forms.

The legal and regulatory restraints of the past 20 years have provided companies and auditors with the protection of appropriately high hurdles that enable the chaff of claims to be separated from the wheat by early dismissal. The literature of those standards has been developed around the audit report as pass-fail judgment. It is unlikely that auditor narrative would receive the same protection. Strike suits arising in a CAMs reporting environment will assert that:

- If the cause of corporate setback or failure comes within shouting distance of a reported CAM, the auditor is liable for failing to act appropriately on its concern and the company will be similarly exposed.
- If the difficulty is unrelated to any previously reported CAMs, the claim will be that many concerns were expressed by the auditor but not the right one, leaving the auditor and the company to defend a multitude of judgments that have none of the established decision criteria that exists for the single pass-fail judgment.

It is inevitable that that a new wave of litigation by hindsight will be attempted, and likely that decisions with a component of strict liability will emerge.

Litigation exposure and liability risk have wider policy implications than the welfare of auditors and issuers. ACAP wrestled with the critical issue of whether audit liability constituted a threat to audit quality and to the viability of a sufficient number of audit firms of global scale to sustain the independent audit function. E were unable to reach a consensus on those vitally important issues. But there was a sufficient consensus of concern to cause the committee to recommend a resolution methodology for liability crippled firms and for co-Chairs Levitt and Nicholaisen to propose their own alternative business model for audit as protection for the potential failure of the current one.

I believe the potential for impairment of audit quality by the triggering of a new chapter of litigation exposure needs careful study by multiple constituencies prior to a decision on the CAM proposal. I accept that a similar reporting process is underway in the UK with no litigation consequences apparent at this time. But it is early days in the UK, which is in any event a significantly more benign legal culture.

AUDITOR'S STATEMENTS REGARDING INDEPENDENCE

The Release includes proposals intended to enhance the reader's understanding of what is required for an auditor to be independent and to remind auditor's to comply with those requirements.

I consider those proposals to be premature. The ACAP Report reflects our strong view that enhanced clarity about the requirements of independence is vital, as the necessary first step toward both understanding and compliance. We noted that independence is an ephemeral concept, never captured in a direct declaration of required conditions, and further complicated by the many conflicting authoritative declarations regarding its meaning. We attempted to capture its essence as "a mindset of skepticism." (Report VIII:18) We recommended that the following preparatory steps take place before standard setting initiatives are proposed:

- "Compile the SEC and PCAOB independence requirements into a single document and make this document website accessible." (Id.) We noted the variants of definition and application of independence in the literature of the AICPA and other respected bodies as further reason for a comprehensive compilation.

- “Develop training materials to help foster and maintain the application of healthy professional skepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms through the PCAOB inspection process {for the purpose of} independence training of partners and mid—career professionals.” (Id.)

Neither of these steps has taken place. In my view they remain necessary pre-conditions to regulatory action. I hold this view more strongly now than in 2008 because dialogues about auditor independence in recent years have indicated a further confusion that should be addressed before standard setting is considered. Protagonists use the term at times as a noun (the state of being independent), at times as a verb (the form of action) and at times as an adverb (the quality of thought behind the action). The distinction seems never to be recognized, especially in ardent disputes about audit issues and conditions.

This is more than a verbal quibble. If there is no shared understanding of the manner in which the term is being used in the context of audit, it seems unlikely that enlightened agreement on what the term requires will erupt on its own. For decades, from Trueblood through Cohen and Treadway, to O'Malley, independence has been the lightning rod of debate rather than a beacon of understanding. I urge that the ACAP recommendations be implemented as the essential next step.

AUDITOR'S RESPONSIBILITY FOR OTHER INFORMATION

The Release proposes to mandate additional auditor attention to “Other Information” (OI) associated with a company's Annual Report but not incorporated in its financial statements. No such expansion of auditor responsibility was recommended by ACAP and to the best of my knowledge none was contemplated during Committee deliberations.

I do not favor this proposal. The intended distinction between the current requirement that auditors “read and consider” OI and the proposed obligation to “read and evaluate” it is discussed in the Release, but the intent has not been consistently understood by members of SAG. With so many issues encompassed by the Release, I do not see the benefit of adding this matter for which there has been little apparent demand and which seems likely to contribute more interpretive controversy than benefit.

I am also concerned at the potentially adverse consequences if the change were to be adopted. While the external boundaries of what constitutes OI may be uncertain, the proposal would clearly require more attention by auditors to MD&A and to non-financial note disclosures. The scope and character of those components of the Annual Report are coming under intense pressure in 2014 to include “Integrated Reporting” features consisting of non-financial information deemed of crucial significance by the International Integrated Reporting Council (IIRC) as measured in numerical form according to formulas now being promulgated by the Sustainability Accounting Standards Board (SASB).

The IIRC and SASB are recently active non-governmental organizations that promote the concept of expanding corporate governance responsibility and financial reporting to include non-financial interests of stakeholders in what is broadly known as “sustainability” issues. Acting in

collaboration through the SASB they currently seek SEC support for declaring the multitude of identified sustainability issues to be material matters under US Securities laws. Alternatively, it is argued that because of their interest to stakeholders who are not also shareholders, sustainability disclosures are intrinsically material and require disclosure beyond the reach of current financial reporting requirements. If that is not forthcoming, US public companies will continue to be pressed for extensive voluntary disclosure in their Annual Reports of a wide range of additional information beyond and often in conflict with required financial disclosure.

My concern is not with the objectives of the IR movement, which are laudable as addressed to the discretion of corporate governance and investor interests. Rather, I am concerned at the movement's insistence that its agenda should be deemed to be material under current standards, and the effect of those demands if auditors are required to read and evaluate the treatments of sustainability disclosures in the MD&A or notes. There is potential here for disorder squared. With detailed regulation from authorized sources regarding financial reporting amalgamated in the Annual Report with admittedly hard to measure disclosures by an NGO seeking to appear authoritative, confusion will trump transparency of investor information.

I do not view my concern as a digression from the matters before us today, but rather an anticipation of controversies that will evolve during 2014 and beyond. I urge withdrawal of the OI proposal. The audit report should deal with information that is material to shareholders under current US law and regulation, just as the financial statements audited are so limited. Auditors should not become embroiled in efforts to influence corporate purposes and corporate governance beyond those boundaries.

DISCLOSURE OF THE AUDITOR'S RESPONSIBILITY FOR DETECTION OF FRAUD

This topic has been on every audit study agenda since the Penn central collapse of the 1960s, and perhaps as early as McKesson and Robbins in the 1930s. Despite much good faith effort, the expectation gap continues. It impairs all dialogue that seeks to reconcile assumptions about the responsibilities of audit to the reality of the profession's actual capabilities in conducting a sampling based examination without tools to compel third party discovery. The effects of the unbridged gap include the escalation of investor distrust of financial reporting and the inflation of audit and issuer liability. The expectation gap is a problem that begs to be ameliorated.

ACAP wrestled with the challenge, concluding that meaningful progress toward understanding and good order depended on the active intervention of the PCAOB and the conduct of studies not previously attempted.

- We saw the transformation from professional self-regulation to oversight by the PCAOB as an opportunity not previously available to examine the fraud detection dilemma as a collaboration between the profession and its regulator.
- We noted that for a problem as old and vexing as this, it was notable that "No formal forum currently exists where auditors and other market participants regularly share their views

and experiences relating to fraud prevention and detection in the context of fraudulent financial reporting.” (Report VII:2)

Consequently, ACAP recommended “...the creation by the PCAOB of a national center both to facilitate auditing firm’s sharing of fraud prevention and detection experiences {which may not be possible currently}, practices, and data and innovation in fraud prevention and detection methodologies and to commission research and other fact finding regarding fraud prevention and detection.” (Report VII: 3)

The SAG has been advised that an initiative broadly congruent with this recommendation is underway. I commend that effort and urge that the matter of responsibility for fraud be deferred until there are core proposals arise from collaboration between the Board and the profession. Interim action at the fringe of the issue, especially an initiative that invites differential implementation by each firm as they see fit , will be counter productive.

DISCLOSURE OF AUDITOR TENURE OF APPOINTMENT DISCLOSURE OF AND REQUIRED SIGNATURE OF THE REPORT BY THE LEAD PARTNER

ACAP recommended audit partner signature but did not address auditor tenure.

I view both aspects of the Release to be issues rooted in independence concerns. Consistent with my earlier comments on that subject, I recommend that action on these topics be deferred until the ACAP recommendations to the PCAOB are addressed.

Chairman Doty, Director Baumann, I am grateful to have had the opportunity to appear before the PCAOB today to address these issues of vital importance.

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