Statement of Joan E. Waggoner

Plante & Moran, PLLC

Public Meeting on the Auditor's Reporting Model of the Public Company Accounting Oversight Board

Panel 6: Critical Audit Matters Related to the Audits of Small Companies

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Thank you for inviting me to participate in the public meeting on the Auditor's Reporting Model. I am a partner in the Professional Standards Group of Plante & Moran, PLLC, a regional public accounting firm in the Midwest. My previous firm, Blackman Kallick, a smaller firm in Chicago, merged into Plante Moran almost two years ago.

I have been asked to discuss the Critical Audit Matters (CAMs) aspect of the proposed model from the viewpoint of the smaller auditing firms with respect to the audits of small issuers.

First of all, I would like to thank the Board for all the work it has done to reconsider the auditor's report model. This project is I think one of the most difficult that the Board has undertaken since its inception, given all of the diverging points of view and interests that are involved. And to focus the auditor's voice on only audit matters has been a very interesting concept to contemplate.

Typical CAMs for Smaller Issuers

My partners and I discussed the typical CAMs that we would expect to see in our practice. Valuation allowances or impairment issues on asset accounts would be the most common theme we would expect to come across, although there are certainly others. I have included a list in an exhibit at the end of my statement that is more specific and complete. I have also highlighted those that we feel are especially relevant to Emerging Growth Companies. We recognize that the determination of CAMs is very specific to a particular issuer, and requires significant judgment on the part of the auditor.

Primary Concerns of Smaller Firms

From reviewing the comment letters of the smaller accounting firms, I find there is a reluctance to totally embrace the inclusion of CAMs in the auditor's report. From discussing the issue with my partners, we also have some worries about certain aspects of CAMs, although we are supportive of the Board's objective to make the auditor's report more meaningful to investors.

The concerns emanate from

- the auditor's historical role
- the desire for information to be useful, and
- cost/benefit perceptions for both small issuers and small auditing firms.

Original Information. First, some of the reluctance may come from accounting firms' lack of history in disclosing original information. I believe many CAMs would correlate with other disclosures already present in the 10-K, or that arguably should be in the 10-K; however, we may end up with some instances where we are faced with the potential disclosure of original information.

The disclosure of original information is not natural to auditors, as, since the beginning of recorded time, we have been following the model of **"Management Asserts; We Attest"**. This model has been reinforced over time as the auditor's responsibilities have changed, most recently with the Sarbanes Oxley internal control work where again "management asserts and we attest." The force is strong within us that original information should be authored by management.

Relevance to Investors. However, it is also important that the auditor's report be relevant to investors. And so the big question with many of the small firms is will the inclusion of CAMs in auditor's reports benefit investors? As my partners and I were thinking through the possible CAMs we would expect to see in our practice of smaller issuers, we were not sure how such information would be used or interpreted by the investors who do not fully understand the complete auditing process.

I understand the Center for Audit Quality has initiated a field-test of the proposed auditor's reporting model, and I am very interested in reviewing the results of that testing once it is completed, vetted and available.

Financial Statements Taken as a Whole. I saw a lot of commentary indicating a concern that the CAM paragraphs might be construed to be piecemeal opinions within the financial statements, or otherwise diminish the value of the pass/fail model. At this point, without clear information about how investors would perceive or use the information, it is hard to conclude one way or another as to whether the opinion would be enhanced or diminished by its inclusion. But I believe that it is very important that investors understand that the audit is of the financial statements taken as a whole, and that the CAMs be presented in a manner such that they enhance, rather than diminish, the opinion.

Cost to Small Issuers. Also, I expect that the volume and cost of CAMs will be proportionately greater for smaller issuers, and especially for emerging growth company audits. Many smaller issuers have excellent controls and processes. Some, including some Emerging Growth Companies (EGC), have not yet built the necessary financial infrastructure because of spending priorities. I expect that this lack of financial infrastructure would most often result in a lot of CAMs, or at least some lengthy ones, disproportionate to the larger filers.

Firm Resources. Lastly, many of us have some concerns regarding the availability of firm resources during a very busy time. We expect that significant firm resources in terms of our most senior and experienced personnel will be necessary at the end of the engagement to determine the CAMs and the content of the additional paragraphs in the report. We worry that this additional responsibility at the end of the engagement may strain resources so that attention would be diverted from other value-added audit responsibilities.

I believe these factors are the primary ones that worry smaller auditing firms with respect to CAMs. The big unanswered question though still to come is whether or not investors will find CAMs useful – once that information is available and vetted, then it will be perhaps easier for the Board to evaluate its direction regarding CAMs.

SOME RECOMMENDATIONS REGARDING THE CAMs APPROACH

I do have a couple of suggestions for the Board's consideration to address some of the above concerns:

1. In order to assist investors' understanding of CAMs, I recommend that the Board consider adding **more context to the CAM introductory paragraph**, so that investors can more easily understand CAMs in the context of the complete audit. This context may help to partially mitigate investor confusion through clarifying that the CAMs paragraphs are not intended to be separate opinions on these matters and that the audit is of the financial statements, taken as a whole.
2. I strongly believe that it is the management of issuers that should author original information. I therefore recommend that the **definition of CAMs be further focused to avoid the disclosure of both confidential information and information that is not required to be disclosed by the issuer**.
3. I also recommend that the **source of CAMs be limited to matters discussed with the audit committee**. Practically speaking, I cannot imagine any good coming from an audit committee learning of the inclusion of a CAM in the auditor's report that had not been discussed with them.

4. In order to partially mitigate the work load and discussions at the end of the audit, I recommend that the Board consider amendments to its planning and audit committee communication standards to include CAMs in the planning process and in the earliest communications with the audit committee:

    - **Amending AS 9 "Auditing Planning" to include an initial consideration of potential/recurring CAMs.**
    - **Amending AS16 "Communications with Audit Committees" to include an initial conversation regarding potential/recurring CAMs with the Audit Committee**

    A CAM is a significant addition to the auditor's report and in my view justifies its addition to the planning process. I acknowledge that some CAMs are not recurring, some will pop up at the end, and that all CAMs need to be re-considered and custom tailored each year. Nevertheless, some of the work can certainly be done earlier. Also, given the sensitivity and importance of the CAMs, to communicate with the audit committee early on would only be helpful in the timelier resolution of any disagreements regarding CAMs between the auditors, issuer management and audit committees.

5. Many of the comment letters indicated that CAMs should not include an actual description of audit procedures for various reasons dealing with possible diminution of audit quality, creation of confusion and lack of readability given the resulting longer length of the report. The proposed guidance currently has these descriptions as optional. I recommend that **the examples included in the guidance be clearly indicated as being optional**, so as to avoid any misinterpretation of the requirement.

EXEMPTION OF EMERGING GROWTH COMPANIES FROM CAMs

Lastly, one of the questions in the proposed guidance was whether or not the guidance should be applicable to EGCs. On one hand, as I mentioned previously, I would expect for the typical EGC that there would be CAMs, maybe many CAMs, to be considered for inclusion in the auditor's report. On the other hand, I would expect that the marketplace's primary interest in these companies at this stage of their development is whether or not the issuer has the potential to be successful in its mission or product. And if this is so, then the cost/benefit may not be there for the CAMs.

Again, thank you for your invitation for me to participate on this panel, and I look forward to our discussion.

Exhibit of Possible Critical Audit Matters in Smaller Firm Practices

Valuation allowance/Impairment issues

- Inventories
- Loan loss allowances
- Other than temporarily impaired investment securities
- Long-lived assets*
- Goodwill
- Deferred income tax assets*

Consolidation – VIEs

Revenue recognition*

Related party transactions*

Going concern*

Debt/equity instruments with embedded things*

Classification of internal control deficiencies*

*Expected to be potential sources of CAMs for Emerging Growth Companies