

## Addendum to VI. Firm Structure and Finances

### Auditor's Report

#### **Recommendation: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's reporting model.**

The auditor's report is the primary means by which the auditor communicates to the users of financial statements regarding its audit of financial statements. The standard auditor's report, not much altered since the 1930s,<sup>1</sup> identifies the financial statements audited, the scope and nature of the audit, the general responsibilities of the auditor and management, and the auditor's opinion.<sup>2</sup> In addition, for companies subject to the Sarbanes-Oxley Act's internal control requirements, the auditor's report includes an attestation as to internal control over financial reporting.<sup>3</sup> The auditor's opinion on the financial statements states whether these statements present fairly, in all material respects, a company's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.<sup>4</sup>

Many consider the auditor's reporting model a pass/fail model because the auditor opines whether the statements are fairly presented (pass) or not (fail).<sup>5</sup> Some believe this pass/fail model with its standardized wording does not adequately reflect the amount of auditor work and judgment.

Over thirty years ago, the Commission on Auditors' Responsibilities (Cohen Commission) made a simple observation: "For the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor's standard report compresses that considerable expenditure of skilled effort into a relatively few words and paragraphs."<sup>6</sup> The Cohen Commission then called for an expansion of the auditor's report to include a report not merely on the financial statements, but covering the entire audit function.<sup>7</sup> The Cohen Commission reasoned that this new more comprehensive

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<sup>1</sup> For a historical analysis of the evolution of the auditor's report, see George Cochrane, *The Auditor's Report: Its Evolution in the U.S.A.*, in PERSPECTIVES IN AUDITING 16 (D.R. Carmichael and John J. Willingham 2d. ed. 1975).

<sup>2</sup> REPORTS ON AUDITED FINANCIAL STATEMENTS, Interim Auditing Standard AU Section 508.08 (Pub. Company Accounting Oversight Bd. 2002).

<sup>3</sup> AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS, Auditing Standard No. 5, para. 85 (Pub. Company Accounting Oversight Bd. 2007).

<sup>4</sup> REPORTS ON AUDITED FINANCIAL STATEMENTS, Interim Auditing Standard AU Section 508.07-.08 (Pub. Company Accounting Oversight Bd. 2002).

<sup>5</sup> Public Company Accounting Oversight Board, Standing Advisory Group Meeting Briefing Paper: Auditor's Reporting Model 3 (Feb. 16, 2005).

<sup>6</sup> COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 71 (1978).

<sup>7</sup> COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 75 (1978).

information would benefit users, but also clarify the role and, consequently, the legal standing of the auditor in relation to the audit.<sup>8</sup>

In 1987, the National Commission on Fraudulent Financial Reporting (Treadway Commission) recommended that the standard auditor's report more clearly identify the auditor's responsibilities, the degree to which users can rely on the audit, and the limitations on the audit process.<sup>9</sup> The Treadway Commission aimed to reaffirm that management has "primary responsibility for financial statements" and to caution users of financial statements from placing more than "reasonable" assurance on the audit process.

More recently, the American Assembly called for differing attestation standards for different parts of the financial statements, depending on the amount of uncertainty and judgment required in making certain determinations.<sup>10</sup> In addition, a February 2008 CFA Institute survey indicated that 80% of its member respondents believe that the auditor's report should provide specific information about how the auditor reached its opinion.<sup>11</sup> A majority of survey respondents thought it was very important to have the auditors identify key risk areas, significant changes in risk exposures, and amounts either involving a high degree of uncertainty in measurement and significant assumptions or requiring a higher level of professional judgment.<sup>12</sup>

In 2005, the PCAOB's Standing Advisory Group (SAG), which advises the PCAOB on the establishment of auditing and related professional practice standards, considered whether the auditor's report should include more information relating to the auditor's judgments regarding financial reporting quality.<sup>13</sup> The SAG also considered whether required auditor communications to audit committees, such as the auditor's judgments about accounting principles<sup>14</sup> and critical accounting policies and practices,<sup>15</sup> should be incorporated into the auditor's report.<sup>16</sup> The PCAOB has not yet taken up a standard-setting initiative regarding the auditor's report.

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<sup>8</sup> COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 75-76 (1978).

<sup>9</sup> NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORT, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (Oct. 1987).

<sup>10</sup> AMERICAN ASSEMBLY, THE FUTURE OF THE ACCOUNTING PROFESSION 12-13 (Nov. 13-15, 2003); AMERICAN ASSEMBLY, THE FUTURE OF THE ACCOUNTING PROFESSION: AUDITOR CONCENTRATION 21 (May 23, 2005).

<sup>11</sup> CFA INSTITUTE, FEBRUARY 2008 MONTHLY QUESTION RESULTS (Feb. 2008), *available at* <http://www.cfainstitute.org/memresources/monthlyquestion/2008/february.html>.

<sup>12</sup> CFA INSTITUTE, FEBRUARY 2008 MONTHLY QUESTION RESULTS (Feb. 2008), *available at* <http://www.cfainstitute.org/memresources/monthlyquestion/2008/february.html>.

<sup>13</sup> Public Company Accounting Oversight Board, Standing Advisory Group Meeting: Auditor's Reporting Model (Feb. 16, 2005).

<sup>14</sup> For this requirement, see COMMUNICATIONS WITH AUDIT COMMITTEES, Interim Auditing Standard AU Section 380.11 (Public Company Accounting Oversight Bd. 2002).

<sup>15</sup> For this requirement, see Sarbanes-Oxley Act, 15 U.S.C. § 78j-1 (2002).

<sup>16</sup> Public Company Accounting Oversight Board, Standing Advisory Group Meeting: Auditor's Reporting Model 4-5 (Feb. 16, 2005).

Foreign jurisdictions are also currently considering changes to their auditor's reports. For instance, the European Commission under the Eighth Directive is authorized to develop its own "European Audit Report" or adopt the International Federation of Accountants' International Auditing and Assurance Standards Board's recently revised auditor's report standard.<sup>17</sup> In December 2007, the Audit Practices Board, a part of the United Kingdom's Financial Reporting Council, issued a Discussion Paper seeking comment on potentially altering the auditor's report.<sup>18</sup> Currently in Germany, public companies are generally required to issue a long-form auditor's report, discussing matters such as the company's economic position and trend of business operations and the nature and scope of the auditor's procedures. The Committee is cognizant that this debate over such disclosures is unfolding in a litigation environment different from that in the United States.

This Committee has also heard testimony regarding expanding the auditor's report.<sup>19</sup> One witness noted that some institutional investors believe an expanded auditor's report would enhance investor confidence in financial reporting and recommended exploring a more "narrative" report in areas, such as "estimates, judgments, sufficiency of evidence and uncertainties."<sup>20</sup>

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 measurements, and also 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 additional 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, in line with Recommendation 1(b) in Chapter VI of this Report, would clarify the role of the auditor in the financial statement audit.

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<sup>17</sup> Directive 2006/43/EC of the European Parliament and of the Council Art. 28 (May 17, 2006); AUDITING PRACTICES BOARD, DISCUSSION PAPER—THE AUDITOR'S REPORT: A TIME FOR CHANGE? 6 (Dec. 2007).

<sup>18</sup> AUDITING PRACTICES BOARD, DISCUSSION PAPER—THE AUDITOR'S REPORT: A TIME FOR CHANGE? (Dec. 2007).

<sup>19</sup> See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 7), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (supporting the Committee's considering whether to change the auditor's report's content given single financial reporting standards, more cohesive global auditing standards, and trends, like fair value measurement); Record of Proceedings (Dec. 3, 2007) (Oral Remarks of Ashwinpaul C. Sondhi, President, A. C. Sondhi & Associates, LLC, 255-57), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf>; Record of Proceedings (Dec. 3, 2007) (Oral Remarks of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 253-54), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-12-3-07.pdf>.

<sup>20</sup> Record of Proceedings (Feb. 4, 2008) (Written Submission of Richard Fleck, Global Relationship Partner, Herbert Smith LLP, 17, 21), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Fleck02042008.pdf>.

The Committee therefore recommends that the PCAOB address these issues, both long-debated and increasingly important given the use of judgments and estimates, by undertaking a standard-setting initiative to consider improvements to the auditor's reporting model. With regards to this initiative, the PCAOB should consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal, and foreign regulators. In view of the desirability of improving the quality of financial reporting and auditing on a global basis, the PCAOB should also consider the developments in foreign jurisdictions that improve the quality and content of the auditor's report and should consult with international regulatory bodies as appropriate. The PCAOB should also take cognizance of the proposal's potential legal ramifications, if any, to auditors.

### **Engagement Partner Signature**

SEC regulations require that the auditor's report be signed.<sup>21</sup> Under current requirements, the auditor's report signature block shows the auditing firm's name, not the engagement partner's. In 2005, the PCAOB's SAG considered whether the audit partner and a concurring partner should sign the auditor's report in their own names.<sup>22</sup> Advocates believe that such signatures will foster greater accountability of the individuals signing the auditor's report, although they note there is no intention to increase or decrease the liability or responsibilities of the engagement partner. These supporters analogize the signatures to the chief executive officer and chief financial officer certifications under Section 302 of the Sarbanes-Oxley Act and directors' signatures on public company annual reports. The signature will also enhance the status of the engagement partner, putting the partner on the same level as the chief executive officer and chief financial officer. Opponents of such signatures argue that the auditing firm operates as a team and takes responsibility for the audit, but not individual partners.

The Committee notes that engagement partner signatures are required in other jurisdictions. The European Commission's Eighth Directive requires that the engagement partner sign the auditor's report.<sup>23</sup> Even prior to the Eighth Directive, several European countries, including France, Germany, and Luxembourg, required engagement partner signatures for a number of years.<sup>24</sup>

The Committee has heard testimony regarding the benefits of engagement partner signatures<sup>25</sup> and has discussed and debated the merits of the senior engagement partner

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<sup>21</sup> SEC Regulation S-X, Rule 2-02a.

<sup>22</sup> Public Company Accounting Oversight Board, Standing Advisory Group Meeting: Auditor's Reporting Model 7-8 (Feb. 16, 2005).

<sup>23</sup> Directive 2006/43/EC of the European Parliament and of the Council Art. 28 (May 17, 2006).

<sup>24</sup> The Institute of Chartered Accountants in England and Wales, SHAREHOLDER INVOLVEMENT—IDENTIFYING THE AUDIT PARTNER (2005) (noting that Germany, France, and Luxembourg currently require audit partner signatures and European Member states must adopt such a requirement under Article 28 of the Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts).

<sup>25</sup> Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic->

signing the auditor's report.<sup>26</sup> The Committee notes that in Chapter VII of this Report, the Committee is recommending disclosure of the name(s) of the senior audit partner(s) staffed on the engagement in the proxy statement to increase transparency and affirm the accountability of the auditor.

The Committee is considering recommending that the PCAOB revise its auditor's report standard to mandate the engagement partner's signature on the auditor's report. The Committee notes the signing partner should face no additional liability than that under the current liability regime. The Committee is seeking commentary on this potential recommendation, and in jurisdictions where signatures are currently required, their impact on audit quality.

### **Transparency**

The Committee considered testimony and commentary regarding the transparency of auditing firms.<sup>27</sup> The Committee has reviewed and considered a range of transparency reporting options, including the PCAOB's May 2006 proposal, not yet finalized, requiring annual and periodic reporting pursuant to the mandate under Sarbanes-Oxley's Section 102(d).<sup>28</sup> This proposal would require annual reporting by auditing firms on such items as a public company audit client list and the percentage of the firm's total fees attributable to public company audit clients for each of the following categories of services: audit services, other accounting services, tax services, and non-audit services. The PCAOB proposal would also require firms to file a "special" report, triggered by such events as the initiation of certain criminal or civil governmental proceedings against the firm or its personnel; a new relationship with a previously disciplined person or entity; or the firm becoming subject to bankruptcy or similar proceedings.

The Committee has also considered the European Union's Eighth Directive, Article 40 Transparency Report,<sup>29</sup> which requires that public company auditors post on their websites annual reports including the following information: legal and network structure and ownership description; governance description; most recent quality assurance review; public company audit client list; independence practices and confirmation of

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finance/acap/submissions/02042008/Haaga020408.pdf (stating that signatures could improve audit quality and enhance accountability).

<sup>26</sup> See, e.g., Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Donald T. Nicolaisen, Board Member, Morgan Stanley, 228-230) (stating his belief that engagement partner should sign the auditor's report); Record of Proceedings (Mar. 13, 2008) (Oral Remarks of Mary Bush, Board Member, Discover Financial Services, 231) (endorsing the engagement partner signature on the auditor's report).

<sup>27</sup> See e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 10), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf>; Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf>.

<sup>28</sup> See PCAOB, Proposed Rules on Periodic Reporting by Registered Public Accounting Firms, *available at* [http://www.pcaobus.org/rules/docket\\_019/2006-05-23\\_release\\_no.\\_2006-004.pdf](http://www.pcaobus.org/rules/docket_019/2006-05-23_release_no._2006-004.pdf).

<sup>29</sup> Directive 2006/43/EC of the European Parliament and of the Council Art. 40 (May 17, 2006), *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF>.

independence compliance review; continuing education policy; financial information, including audit fees, tax advisory fees, consulting fees; and partner remuneration policies. The Article 40 Transparency Report also requires a description of the auditing firm's quality control system and a statement by firm management on its effectiveness. Auditing firms and investors have expressed support for requiring U.S. auditing firms to publish reports similar to the Article 40 Transparency Report.<sup>30</sup>

The Committee notes that Recommendation 3 in Chapter VII of this Report recommends that, if feasible, the PCAOB develop audit quality indicators and auditing firms publish these indicators. The Committee believes this information could improve audit quality by enhancing the transparency of auditing firms and notes that some foreign affiliates of U.S. auditing firms provide such indicators in public reports issued in other jurisdictions.<sup>31</sup>

Furthermore, for several years auditing firms in the United Kingdom have published annual reports containing audited financial statements pursuant to limited liability partnership disclosure requirements as well as a discussion of those statements, a statement on corporate governance, performance metrics, and other useful information. In the United States, auditing firms typically do not prepare audited financial statements. Some witnesses have called for disclosure of audited financial statements,<sup>32</sup> whereas one auditing firm representative questioned the usefulness of disclosing financial statements of the smaller auditing firms.<sup>33</sup>

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<sup>30</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (recommending auditing firm disclosure of quality control policies and procedures); Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, 6), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (supporting an annual transparency report for U.S. auditing firms); Record of Proceedings (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 10), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (suggesting the PCAOB require auditing firms to publish transparency reports like the European Union's Article 40 Transparency Report).

<sup>31</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Dennis Johnson, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System, 5), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Johnson020408.pdf> (recommending auditing firm disclosure of key performance indicators, such as "percent of training dollars spent on staff compared to the fees received for the audit, average experience of staff, partner time allocated to each audit").

<sup>32</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 2), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (calling for auditing firm disclosure of audited financial statements).

<sup>33</sup> Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Neal Spencer, Managing Partner, BKD LLP, 38-39), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (analogizing the auditing firm to a vendor and noting that the profitability or financial strength of vendors "has little, if any, relevance other than perhaps related to concerns about their ability to financially support their continued existence" and noting that the profitability or financial condition of an auditing firm is not directly related to audit quality; and noting that the "most relevant financial information for users" of

The Committee recommends that the PCAOB require that, beginning in 2010, larger auditing firms (those with 100 or more public company audit clients that the PCAOB inspects annually) produce a public annual report incorporating (a) information required by the Article 40 Transparency Report deemed appropriate by the PCAOB in consultation with investors, other financial statement users, auditing firms, public companies, academics, and other market participants, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VII of this Report. These disclosure requirements should supplement any rules adopted as a result of the PCAOB's 2006 reporting proposal.

The Committee also recommends that the PCAOB determine which of the requirements included above should be imposed on smaller auditing firms (those with less than 100 public company audit clients), taking into account these firms' size and resources.

The Committee is also considering recommending one of the following two approaches to audited financial statements: The PCAOB should require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements prepared in accordance with generally accepted accounting principles or international financial reporting standards and the PCAOB will then either:

Alternative 1: determine, based on broad consultation, whether these audited financial statements should be made public in consideration of their utility to audit committee members and investors in assessing audit quality, impact on firm sustainability, firm comparability, and other considerations relevant to the public interest, or

Alternative 2: make these audited financial statements publicly available.

The Committee is seeking commentary on these potential alternatives.

### **Litigation**

The Committee also has considered liability issues impacting the profession. The Committee received and considered testimony and commentary suggesting certain

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smaller auditing firms is insurance-related information and noting that larger auditing firms with limited commercial insurance coverage may need to disclose different financial information).

measures aimed at liability reform.<sup>34</sup> The Committee also has received testimony and commentary opposing liability reform.<sup>35</sup>

The Committee takes note that the Sarbanes-Oxley Act established a new level of federal regulation over the public company auditing profession. In that context, some believe it would be appropriate to transfer to federal court jurisdiction some categories of claims against auditors, which presently may be brought in state courts. Others are unconvinced by this argument, expressing concerns that this approach might weaken plaintiffs' rights and remedies.

The Committee is considering whether it should recommend that Congress provide federal courts with exclusive jurisdiction over some categories of claims, which presently may be brought in state courts against auditors, when such claims are related to audits of public company financial statements. Should Congress take up this recommendation, it should develop a uniform standard of care with the appropriate and necessary levels of investor protection. While there are various differences among state and federal standards of care, the Committee contemplates a standard fairly and adequately representing investors' interests.

The Committee is seeking commentary on (1) whether it is appropriate to have exclusive federal jurisdiction for some categories of claims and a uniform standard of care; and, if so, (2) what types of claims should be subject to federal jurisdiction; and (3) what should be the uniform standard of care.

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<sup>34</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, 7-8), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Nusbaum020408.pdf> (suggesting general securities litigation reform); Record of Proceedings (Dec. 3, 2007) (Written Submission of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 16), *available at* <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Turley120307.pdf> (suggesting the ability to appeal motions to dismiss in securities class actions).

<sup>35</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Questions for the Record of John P. Coffey, Partner, Bernstein Litowitz Berger & Grossmann LLP, 1-7 (Mar. 31, 2008)), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (weighing against reforming the calculation of damages in securities fraud class actions and auditor liability protections, including a professional judgment framework and safe harbor, but supporting scheme liability); Record of Proceedings (Feb. 4, 2008) (Questions for the Record of Paul G. Haaga, Jr., Vice Chairman, Capital Research and Management Company, 1-3), *available at* <http://www.treas.gov/offices/domestic-finance/acap/agendas/QFRs-2-4-08.pdf> (opposing liability limits and safe harbors for auditing firms and viewing liability exposure as a "very effective incentive for the firms to conduct high quality audits").