point of **view**

May 2012

PCAOB Proposed Auditor Reporting Model Changes

Evaluating auditor's discussion and analysis

Highlights

- **Investors value the current auditor's report but want more insight from auditors.**
- **The time is right to consider changes that will enhance the relevancy and transparency of audits to investors.**
- **Some investors want auditors to discuss their views on management's judgments and estimates, accounting policies and practices, and difficult or contentious issues - essentially to prepare an auditor's discussion and analysis.**
- **We do not support an auditor's discussion and analysis. We believe that instituting it would lead to unintended consequences that would be detrimental to audit and financial reporting quality.**

An auditor's discussion and analysis will result in unintended consequences

- The recent financial crisis has motivated regulators, policy makers, investors, and others to consider what improvements could be made to the financial reporting system. This has resulted in suggestions to change the auditor reporting model.
- The Public Company Accounting Oversight Board (the Board) issued a concept release to explore possible changes to the auditor reporting model. They include: (1) required use of emphasis paragraphs to highlight the most significant matters in a company's financial statements and key audit procedures related to those matters, (2) additional auditor assurance on information outside the financial statements, and (3) an auditors' discussion and analysis, which would be a supplemental narrative to the audit report.
- Some investors want auditors to provide their views on the quality of the company's financial statements. Those investors believe that having more information about the company as seen through the eyes of its auditor would better enable them to evaluate a company's future prospects.
- We agree that the auditor reporting model should be enhanced. However, the enhancements must improve audit and financial reporting quality. We believe that the unintended consequences of changing the auditor's role from objectively validating management provided information to subjectively reporting the auditor's views would be detrimental to audit and financial reporting quality.

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Background

The time is right to consider changes

Principles are needed to guide the evaluation of the benefits and drawbacks of possible changes.

To be effective, changes must enhance the relevance and quality of audits and the quality of financial reporting.

Turmoil stimulates change

There is no denying it - the turmoil in the financial markets over the last five years has created challenges for market participants. This market turmoil is serving as a catalyst for change. It is prompting reflection about what improvements could be made to the financial reporting system and has resulted in recent calls for change from investors and other stakeholders. The proposed changes include enhancing the current auditor reporting model. For example, some investors have requested:

- Auditors to provide information about management judgments that have significant impact on a company's financial reporting and how the auditor evaluated those judgments.
- Increased visibility of the auditor's view of the most significant company risks and how they impact the audit.
- Further auditor assurance on information presented outside of the audited financial statements.

The time is right to carefully consider these and other changes that will increase investor confidence in reported financial information by enhancing the relevance and quality of audits and the quality of financial reporting.

The Board's response

The Board issued a concept release asking for input on the feasibility and implications of several possible modifications to the auditor's reporting model.

The potential alternatives include:

- Introducing an auditor-prepared discussion and analysis. This would include the auditor's view about significant financial reporting matters, significant estimates made by management in preparing the financial statements, and additional information about the audit.
- Expanding required use of "emphasis paragraphs" in the auditor's report to identify the most significant matters in the financial statements and the corresponding key audit procedures.
- Expanding auditor assurance to cover information outside the audited financial statements. This could include management's discussion and analysis, earnings releases, and non-GAAP information.

Principles to guide changes

We believe that any changes should enhance the solid foundations that underlie today's financial reporting and auditor assurance models. To that end, we recommend that the benefits and drawbacks of each change be assessed using the following principles. The change should:

- Maintain or improve audit quality and increase the quality of financial information for investors, while being cost beneficial.
- Maintain or enhance the roles of, and effectiveness of interactions between, audit committees, management, and auditors.
- Promote audit reports that will be comparable between companies.
- Maintain management or the audit committee as the original source of information about a company. This avoids blurring the responsibilities of management, audit committees, and auditors. Auditors should not be the original source of factual information.

Our thoughts about each of the Board's three potential alternatives are the subject of three separate "Point of View" publications. This "Point of View" addresses possible changes that would require auditors to provide a discussion and analysis containing their views on management's judgments, the company's accounting policies and practices, and difficult or contentious issues.

Auditor's Discussion & Analysis - a pathway leading to unintended consequences

Although we agree with other ways to achieve the objective of the concept release, we don't agree with instituting an auditor's discussion and analysis.

Maintaining auditor objectivity

We support auditors providing additional information that will meet investors' needs. However, the cornerstone of the auditor's role is to evaluate, rather than generate, information that the company provides to investors. To remain objective, both in fact and appearance, the auditor's role in financial reporting should be confined to rendering a conclusion on information provided by the company. Requiring auditors to express other views and analysis will blur the responsibilities of auditors, audit committees, and management.

The fundamental debate

Proponents of an auditor's discussion and analysis believe it will enhance the transparency of the company's financial statements. Auditors would communicate their views about management's judgments and estimates and provide insight into significant audit issues and audit judgments. Proponents believe this will give investors greater insight into the relative strengths and weaknesses of a company's financial reporting practices.

We disagree. Expanded commentary originated by the auditor will chill communications between audit committees, management, and auditors. In recent years, that communication has become increasingly robust. This free-flowing communication is critical to maintaining quality audits and financial reporting. Requiring auditors to publicly share their analysis and views on subjective areas may make audit committees and management reluctant to engage in dialogues with their auditors. This may inadvertently reduce the auditor's insights and, therefore, the quality of the financial reporting process and the audit.

Further, any such reporting by the auditor will be susceptible to misinterpretation. This is because the public is not privy to the robust dialogue that occurs when information is discussed with management and audit committees. Publishing an auditor's discussion and analysis without a robust two-way communication will, in our view, not enhance an investor's overall understanding of the financial statements. Rather, it could create confusion and misunderstanding.

Our vision for responsive change

While we don't agree with an auditor's discussion and analysis, we fully support the dialogue aimed at improving the relevance and transparency of auditor reporting. One alternative is to expand sections of the standard auditor's report and require greater use of emphasis paragraphs to enhance investors' understanding of the financial statements. We also support expanding the auditor's attestation to cover other elements of corporate reporting, but only if investors find this valuable.

We believe these two possible changes are consistent with the independent auditor's role and could improve the reliability and quality of information for investors. These changes are discussed in separate Point of View publications.

Enhancing an audit committee's role

Some who disagree with an auditor's discussion and analysis say that empowering audit committees, rather than auditors, to communicate more with investors would generate greater long-term benefits. They believe that audit committees are uniquely qualified to provide this reporting. This is because, through exercising their responsibilities for monitoring the financial reporting process, an audit committee develops a deep understanding of a company's financial reporting and its business. It is also because they evaluate management's and the auditor's performance. We agree this approach is preferable.

In conclusion

We understand the desire for auditors to provide more information about the audit and financial statements. However, we believe more meaningful benefits can be achieved through other changes proposed in the concept release and changes to the overall corporate governance model. The strength of the audit is that it provides independent third party attestation. We believe that the disadvantages of issuing an auditor's discussion and analysis would far outweigh the benefits.

Questions and answers

Q: What is the likelihood that an auditor's discussion and analysis will present information that is inconsistent with management's views?

A: Financial reporting is inherently subjective and differences in views are inevitable. However, it is doubtful that management or the audit committee would want the information presented to be inconsistent. Further, for auditors to issue an unqualified opinion that the financial statements are presented fairly (which is required for publicly listed companies), audit committees, management, and the auditor must agree on the conclusions. These dynamics would likely lead to the auditor's and management's discussion and analyses presenting similar matters with similar conclusions.

Q: What are some better changes to consider than an auditor's discussion and analysis?

A: We believe a similar objective can be achieved by increased use of emphasis of matter paragraphs in auditor reports or, if desired by investors, expanding auditor assurance services to include all or elements of management's discussion and analysis. These changes would avoid potentially blurring the auditor's role in the financial reporting process. Moreover, these approaches continue to position the auditor as the attestor of information rather than as a provider of information.

Q: How are the perceived benefits of an auditor's discussion and analysis outweighed by the costs?

A: Certain investors want more insight into the audit by knowing "what auditors are thinking." Though understandable, this type of auditor reporting is likely to come at a high cost. The current auditor report makes a clear and unambiguous statement about a company's financial statements. More subjective commentary by auditors would create the real possibility for investor misinterpretation. Comparisons between companies will likely be difficult, even for similar businesses, due to the nature of the disclosures. Initial differences in points of view that were ultimately resolved may be magnified, overshadowing an otherwise strong financial reporting and control environment. We believe the cornerstone of the audit is reporting on the validity of company information presented in the financial statements. We support this fundamental principle.

Contact Information

To have a deeper discussion about this PwC US point of view on Evaluating the Auditor's Discussion and Analysis, please contact:

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