

## PCAOB Public Meeting on Auditor's Reporting Model

### Panel 5: Critical Audit Matters Related to the Audits of Large Companies

#### From a Preparer's Perspective

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#### Introduction and general comments

Thank you for hosting the Public Meeting and inviting me to participate on this panel.

This project has been underway for several years now and I commend the PCAOB for the extensive outreach that has taken place during this time. The PCAOB has shown great interest in hearing from all interested parties on this topic. In my role, I work closely with the independent auditors and with our Company's audit committee, but management has a very distinct role, so I will offer my observations on the proposed reporting of critical audit matters (CAMs) from a financial statement preparer perspective. I believe that these observations are shared by many in the preparer community.

On several occasions, the PCAOB has pointed out that the auditor's report has changed very little since the 1940s. As a preparer, I don't see it that way, since the auditor's opinion on internal control over financial reporting was added for large public companies in 2004. This regulatory requirement was a massive undertaking by management, auditors and audit committees; and it fundamentally expanded and changed a Company's financial reporting process and the audit process. To put the effort in perspective, at many companies, audit fees doubled or tripled. In my view, this change to the auditor's report in 2004 was huge, a major overhaul. My hope is that the Board will consider some of the implementation problems that occurred with the implementation of AS2 as they deliberate on the best approach for this auditor's reporting model proposal.

Another point I would make is that from a preparer perspective, receiving a clean opinion is a major accomplishment, each and every year. Internally, the efforts throughout the year are substantial and costly, from more routine and material components, to highly subjective, judgmental and complex areas. The efforts by the auditors are also substantial and costly, and they ask lots of questions and require lots of support, and come back with more questions and requests for more support and so on. A clean opinion comes at the end of a comprehensive and robust audit process that occurs on an ongoing basis throughout the year, and only once all the work is fully completed. So I believe a clean opinion should mean a lot to investors.

On an overall basis, I have concerns about the proposal on CAMs as currently drafted. The examples are more troubling to me than some of the concepts. For this reason, I believe it is imperative that the Board lead a comprehensive field test to assess whether the proposal will produce the information investors are seeking at an acceptable cost.

#### Critical Audit Matter Proposal

Although the proposal does not include an AD&A, which was of great concern to the preparer community, the proposed CAM's have elements that raise similar concerns as follows.

1. My primary concern relates to preserving and not confusing the distinct roles of management, auditors and audit committees. Management is responsible for the preparation of the financial statements and notes, and in ensuring full disclosure of important qualitative and quantitative financial information, including the MD&A. Open communication between auditors, management and the audit committee is vital to this process. The proposal, in certain cases, could require auditors to report CAMs that will result in the auditors being the original source of new information. The audit report should not be used as a vehicle to communicate new information about the Company – this will serve to inhibit a healthy and well-functioning financial reporting process. In other cases, CAMs may include additional commentary on items already disclosed in the financial statements or report on what I would consider to be unnecessary details. If there are perceived shortcomings in the current financial reporting model, the FASB or the SEC should work to address these concerns and management should handle any additional disclosure requirements.
2. Further, written auditor communications are the beginning part of a dialogue between auditors and audit committees. These written reports have limited value without the important discussion that takes place between auditors and audit committees, as well as management. Ideally, all important matters are discussed in detail, context is provided and there is an opportunity for a robust dialogue and follow up on specific questions or concerns, as necessary. But with CAMs included in an auditor's report, there would be no effective mechanism for any dialogue with investors. In certain cases, this could result in questions from the investment community about an auditor's report, and issuers will be put in the difficult position of trying to explain what they believe an auditor meant related to a CAM. In my view, it isn't appropriate or feasible to include in the auditor's report complex matters that are best communicated and understood through extensive dialogue.

3. As I mentioned earlier, the CAM examples in the proposal are of significant concern - they include the following:

- Disclosure by the auditor of a significant deficiency. This disclosure is not currently required, thus the example is in direct conflict with existing rules.
- Discussion of an immaterial corrected error. This detail does not seem appropriate for discussion as a “critical audit matter”.

Since management isn't required to disclose these matters, I don't believe it's appropriate for the audit report to provide details on these items. As noted above, if there are shortcomings in management reporting, the auditor's report is not the appropriate vehicle for new information and the FASB or the SEC should make changes for management to report.

4. I'm concerned that auditors will err on the side of including too many CAMs and auditors will spend significant time documenting why certain matters should not be included as CAMs. Given the volume and complexity of the current disclosure framework, and investor concerns about disclosure overload, investors may be challenged in evaluating new information, alongside the other information provided by management.
5. Much of the work on CAMs is expected to be completed near the end of the audit, which may be a significant distraction for the auditors and management during a critical phase of the audit; this could impair the quality of a company's financial reporting as well as audit quality.
6. The proposal is unclear but through the examples, seems to imply that a discussion of audit procedures with respect to critical audit matters is preferred. In my view, auditor discussion about audit procedures is more appropriate than auditor discussion about the Company's financial statements.
7. The cost/benefit analysis should include increased legal exposure for auditors, the Company, the Company's board and management that may be the result of the proposed reporting. The unique U.S. litigation environment needs to be considered carefully in the analysis. Costs should also include incremental audit efforts. As a preparer, I'm skeptical that the audit fee increases will be justified.
8. Lastly, there is no substitute for actually reading the financial statements and the notes to the financial statements. There is risk that an expanded auditor's report that included CAMs could be perceived or interpreted as a shortcut, a “cheat sheet” that investors would rely on to dummy down the extensive and important information an investor gains from actually reading the entire 10-K.

In my view, although not required by the current proposal, in practice, there will be a presumption that at least one or more items should be reported as a CAM in the auditor's report given the open-ended nature of the proposal. As previously discussed, this will result in duplication of information and at times, it will also give undue prominence to items of lesser importance, among other things. I believe a better alternative to reporting CAMs is through the use of required and expanded emphasis paragraphs – this was discussed in the original concept release. Auditors currently report certain significant matters in the auditor's report through explanatory paragraphs and this could be expanded to require reporting of certain other clearly defined material matters, such as critical accounting policies and estimates, changes to financial statements that affect comparability and significant transactions. I believe this would be a better model to ensure certain specific and significant items are included in the auditor's report, while filtering out unnecessary information or information that is more appropriately the responsibility of management to address. I believe it would also allow for a far more efficient and objective process for auditors to evaluate which items, if any, should be reported. Alternatively, I believe auditor association with the Company's critical accounting policies and estimates would be better than the CAM approach.

If the Board decides to retain the CAM reporting requirement, however, I believe the requirements should be tightened to avoid unintended consequences and to make the process more efficient, as follows:

1. I believe the auditor's report should include objective information, rather than subjective opinions on specific areas, and auditors should not be the original source of new information. The examples in the proposal include new information which could imply that the auditor has responsibility for the preparation of financial statements and footnotes. Providing such information would further increase the so-called "expectation gap" by blurring the line between the role of management and auditor.
2. In practice, the only source of information that auditor's should need to consider for CAM reporting is audit committee communications. It's difficult to imagine a situation in which an item considered to be a "critical audit matter" wasn't previously reported to the audit committee.
3. CAMs should be material to the audit of the financial statements, and should not be a source for highly sensitive or prejudicial information (for example, litigation).
4. The auditors should not be required to document why audit matters aren't included as CAMs.

That concludes my opening remarks and I look forward to discussing these matters further.