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September 30, 2011

Via Email
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB No. 2011-003, Rulemaking Docket Matter No. 34

Dear Sir/Madam,

The American Federation of State, County and Municipal Employees ("AFSCME") submits this letter in response to the Concept Release of the Public Company Accounting Oversight Board (the "Board") on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, Release No. 2011-003 (the "Concept Release"). AFSCME is the largest union in the AFL-CIO, representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over \$1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages \$850 million in assets for its participants, who are staff of AFSCME and its affiliates.

At the outset, we wish to emphasize that we view the Concept Release as one part of a larger suite of important reforms under consideration by the Board. In particular, we believe that some of the objectives of the measures proposed in the Concept Release cannot be fully realized in the absence of mandatory auditor rotation. Decades-long relationships between auditors and clients are likely to impair auditor independence. We therefore applaud the Board for issuing the Concept Release on Auditor Independence and Audit Firm Rotation, Release No. 2011-006, to explore this issue. Our support for the reforms proposed in this Concept Release does not indicate that we believe those changes would, by themselves, be sufficient.

American Federation of State, County and Municipal Employees, AFL-CIO

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The Concept Release outlines several possible changes to the standard auditor's report. Before discussing the specifics of potential reforms, it is worth noting the importance of the auditor's report to investors. As the Treasury Department's Advisory Committee on the Auditing Profession stated, "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."¹

In 2008, 2010 and 2011, the CFA Institute, a global, not-for-profit association of investment professionals, surveyed its members regarding the independent auditor's report. Seventy-two percent of respondents to the 2010 survey said that the auditor's report was important or very important to their analysis and use of financial reports in the investment decision making process.² These findings are consistent with the feedback the Board received from investors in the course of its outreach that the audit is a "valuable process" giving the auditor "significant insight into the company."³

The needs of investors and other users of financial statements should be the Board's highest priority as it decides whether to undertake the standard-setting initiative outlined in the Concept Release. The CEOs of the six largest accounting firms concurred with this notion in a 2006 white paper, which stated that "The new (reporting) model should be driven by the wants of *investors and other users of company information . . .*" (emphasis in original)⁴

For several decades, influential voices have criticized the auditor's report. Numerous reports of expert panels have concluded that the auditor's report conveys insufficient information to public company investors. In the 1970s, the Commission on Auditors' Responsibilities (the Cohen Commission) called for the auditor's report to be expanded to report on the entire audit function.⁵ The National Commission on Fraudulent Financial Reporting (the Treadway Commission) recommended in 1987 that the auditor's report provide additional information on the auditor's role, the extent to

¹ U.S. Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report," at VII: 13 (Oct. 6, 2008) (available at <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>) (hereinafter "ACAP Report").

² "Independent Auditor's Report Survey Results," CFA Institute, at 5 (Mar. 2010) (available at http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf) (hereinafter, "2010 Survey").

³ Concept Release, at 7.

⁴ S.A. DiPiazza et al., "Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks" at 17 (2006) (available at <http://www.iasplus.com/resource/0611visionpaper.pdf>).

⁵ Commission on Auditors' Responsibilities, "Report, Conclusions and Recommendations," at 75 (1978).

which users can rely on the audit and limitations on the audit process.⁶ Most recently, the Treasury Advisory Committee on the Auditing Profession recommended in 2008 that the Board undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.⁷

Negative feedback has also come from the investor community. CFA Institute members were dissatisfied with the amount and type of information contained in the auditor's report. Some respondents characterized the auditor's report as "boilerplate."⁸ Sixty percent said that the report should contain more information about the audit process itself and matters related to the audited financial statements.⁹

Key Disclosure Topics

In our view, requiring discussion in the auditor's report on four topics would substantially improve the report's usefulness to investors:

1. The auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment;
2. Areas of high financial statement and audit risk and how the auditor addressed these high-risk areas;
3. Unusual transactions, restatements and other significant changes in the financial statements, including the notes; and
4. The quality, not just the acceptability, of the company's accounting practices and policies.

None of these areas require the auditor to become an "original source of information about the company," a concern raised by the Center for Capital Markets Competitiveness in its comment letter.¹⁰ Instead, they primarily relate to the auditor's professional judgments about the audit and particular aspects of the company's accounting policies and practices. Moreover, they involve communicating to investors material the auditor already obtains and communicates to others.

⁶ National Commission on Fraudulent Financial Reporting, "Report of the National Commission on Fraudulent Financial Reporting" (1987).

⁷ ACAP Report, *supra* note 1, at IV:13.

⁸ 2010 Survey, *supra* note 2, at 5-6.

⁹ *Id.* at 11.

¹⁰ Comment of the Center for Capital Markets Competitiveness, at 9 (available at <http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/PCAOB-Concept-Release-9.14.2011.pdf>).

Estimates and Judgments

We disagree with the assertion of the Center for Capital Markets Competitiveness that investors expect a single “right answer.”¹¹ On the contrary, investors understand the role of estimates and judgments in applying accounting principles. The importance of estimates and judgments supports conveying the auditor’s view on this subject to investors.

Auditors are already communicating with the audit committee of the board about estimates and judgments. AU section 380.08 requires that “The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor’s conclusions regarding the reasonableness of those estimates.”¹² Thus, including a discussion on this topic in the auditor’s report would not require additional information gathering by the auditor.

Discussion regarding accounting estimates and judgments has support within the investor community. In the 2011 survey, 86% of respondents said they believed that it was important or very important that the auditor’s report include information about the auditor’s assessment of management’s critical accounting judgments and estimates.¹³ Respondents to the 2010 CFA Institute survey, which did not ask the specific question posed in the 2011 survey, cited “comments about accounting judgments and control issues” and “significant judgments and estimates made by management and how the auditors audited them” as examples of additional information that would be helpful.¹⁴

Financial Statement and Audit Risk

We believe that the auditor’s report should discuss areas of high financial statement and audit risk and how the auditor addressed these areas. Fundamental to the performance of a GAAS audit is the identification of high-risk areas in the financial statements. Auditing Standard No. 12(4) requires that “The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and

¹¹ *Id.* at 7.

¹² AU section 380.08 (available at <http://pcaobus.org/Standards/Auditing/Pages/AU380.aspx>).

¹³ “Usefulness of the Independent Auditor’s Report,” CFA Institute, at 6 (Mar. 2011) (available at http://www.cfainstitute.org/Survey/usefulness_of_independent_auditors_report_survey_results_mar_ch_2011.pdf) (hereinafter “2011 Survey”).

¹⁴ 2010 Survey, *supra* note 2, at 11-12, 19.

assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures.”¹⁵

An evaluation of audit risk—the risk that the auditor expresses an inappropriate audit opinion—is also part of normal auditing procedures. Audit Standard No. 8(3) provides that “To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.”¹⁶

The audit committee is already receiving much of this information in the course of its oversight of the audit process. Thus, disclosing it to investors would not, we think, impose a significant information collection burden. Respondents to the CFA Institute’s 2010 survey indicated that more information about high-risk areas would be useful to investors.¹⁷ As one respondent noted, “Having been an auditor I know that certain areas of the balance sheet and income statement are much higher risk than others. If we as users know this information we can better understand the risks in using and analyzing the financial statements as presented.”¹⁸

Unusual Transactions, Restatements and Other Significant Changes

In our view, the auditor’s report should communicate information about unusual transactions, restatements and other significant changes. The auditor obtains information about unusual transactions, which have the potential to increase the risk of financial misstatements (see Auditing Standard 12(46)), in the regular course of performing the audit. Auditors are clearly very involved in accounting restatements. Significant changes in the company, including changes in internal control over financial reporting (see Auditing Standard No. 12(8)), plus changes in the company’s accounting principles and related policies and disclosures (see Auditing Standard No. 12(13)), are currently noted by the auditor as part of its risk assessment procedures.

¹⁵ PCAOB Auditing Standard No. 12(4) (available at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_8.aspx).

¹⁶ PCAOB Auditing Standard No. 8(3) (available at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_8.aspx).

¹⁷ 2010 Survey, *supra* note 2, at 12-13

¹⁸ *Id.* at 13.

As well, these matters are already communicated to the audit committee. AU section 380.11 requires the auditor to discuss with the audit committee items that have a significant impact on the representational faithfulness, verifiability and neutrality of the accounting information included in the financial statements; examples of such items are unusual transactions and selection of new or changes to existing accounting policies.

The CFA Institute survey supports including this discussion in the auditor's report. Respondents cited changes in accounting standards and related party transactions as areas on which more information would aid investors.¹⁹

Quality of Accounting Policies and Practices

The auditor's report should discuss the quality, not just the acceptability, of the company's accounting policies and practices. Companies have significant discretion in applying GAAP; however, some alternatives are considered to be higher quality than others. Investor feedback to the Board indicates that information on the auditor's views regarding the quality of the company's financial statements would be useful.²⁰ Similarly, responses to the 2011 CFA Institute survey support such a requirement: 90% of respondents stated that information regarding the quality, not just the acceptability, of management's selection and application of accounting principles is important or very important to have in the auditor's report.²¹ Numerous additional comments by respondents supported the value of such discussion.²²

As with the other areas discussed in this comment, auditors are currently required to communicate this information to the audit committee. AU 380.11 requires the auditor to discuss with the audit committee the auditor's judgments about the quality of the company's accounting principles as applied in its financial reporting.

Additional Items

In our view, clarification in the auditor's report of the auditor's role would be valuable to investors. There has been much discussion of the "expectations gap" between what the audit actually does and what users of financial statements believe it does, especially in the area of fraud detection. The auditor's report should state that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements

¹⁹ *Id.* at 13, 20.

²⁰ Concept Release, at 8.

²¹ 2011 Survey, *supra* note 14, at 6.

²² See *id.* at 6-7.

are materially misstated. Whether caused by error or fraud, and that this represents a high, though not absolute, level of assurance.²³ Responses to the CFA Institute survey indicate that investors are interested in more specific disclosure on this topic.²⁴

Format for Additional Discussion

The Concept Release asks for comment on whether additional discussion by the auditor should appear in a separate supplemental report that has been described as an Auditor's Discussion and Analysis ("AD&A")(akin to the Management Discussion and Analysis section of a 10-K or a Compensation Discussion and Analysis section of a proxy statement). We believe that the AD&A would have the benefit of allowing fulsome discussion of key matters by the auditor, with the opportunity to place that discussion in context.

The format in which additional discussion takes place is less important, however, than the substance of that discussion. Accordingly, we would be open to other mechanisms, such as requiring and expanding the use of emphasis paragraphs in all audit reports.

* * * *

We appreciate the opportunity to share our views with the Board on these important issues. If you have any questions, or need additional information, please do not hesitate to contact Lisa Lindsley at (202) 429-1275.

Sincerely,



GERALD W. McENTEE
INTERNATIONAL PRESIDENT

²³ See AU 230.10 (available at <http://pcaobus.org/Standards/Auditing/Pages/AU230.aspx>).

²⁴ 2010 Survey, *supra* note 2, at 12-13.