CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets
Affiliated with the American Institute of CPAs

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Presentation of CAQ Executive Director Cindy Fornelli
to NASBA's 4th Annual International Forum
"The Future of International Regulation"

Westin Bayshore
Vancouver, British Columbia, Canada
July 25, 2011
9:45 to 10:15 a.m.

"U.S. Developments on the Role of the Auditor"
[30 minutes, including Q&A]

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Notes: You will be preceded by a 45-minute discussion of Legal Liability for Auditors with Gaylen Hanson (NASBA's Vice Chair for 2011-2012) and Rick Murray. Dan Goelzer follows you with a PCAOB Update.

You emailed the following questions to Linda on July 14 for NASBA members' consideration and to help them see the relevance and challenges of some of the possible regulatory changes coming in the U.S. and globally:

- In the US and elsewhere around the globe, there are talks and proposals to expand the role of the auditor. What are the challenges of expanding the role into qualitative disclosures?

- How will some of the proposed changes to the auditors reporting model help investors?

- What are regulators' roles and responsibilities with respect to educating investors on the importance of public company auditing?

We are providing 100 copies of the *In-Depth Guide to Public Company Auditing*.

ICAEW's Audit Quality Forum "International Consistency" paper will be included in Cindy's packet.

Title Slide

Thank you for the invitation to join you. It's a pleasure to be here in Vancouver, a city *The New York Times* has described as "Manhattan with mountains."

Now in our 5th year of operation, the Center for Audit Quality remains dedicated to enhancing investor confidence and public trust in the global capital markets through efforts that foster high quality performance by public company auditors.

Our goal is to encourage continuous improvements in audit quality and to speak for public company auditors on important policy issues that affect public company audits, financial reporting and investor protection.

Today, I'd like to focus most of my comments on developments in the United States with respect to the role of the auditor. And I'll also update you on a number of CAQ activities.

The CAQ has spent much of 2011 contemplating the role of the auditor in today's marketplace.

Slide: The Role of the Auditor

In the wake of the global financial crisis, there have been extensive examinations by panels and commissions to identify the root causes. While none of them found that auditing was a root cause of the financial crisis, auditors – like all participants in the capital markets – have a responsibility to examine their role in light of lessons learned from the crisis.

Since our inception, the CAQ has made it a priority to convene the full range of capital market stakeholders to discuss policy issues pertinent to the public company auditing profession. This year, we have done so through a series of "Role of the Auditor" roundtable discussions.

To date, we have hosted sessions in Dallas, New York City, San Francisco and Chicago. And we are exploring opportunities to hold additional discussions in other cities in the United States and abroad later this year.

An important focus is what information investors need that they do not already receive and who in the financial reporting chain is best suited to provide that information.

On June 21 the PCAOB issued a concept release for changing the auditor's reporting model, which outlines a number of approaches that expand both the auditor's reporting requirements – and scope of work.

Knowing that Dan Goelzer will be along shortly with the Board's perspective, I'll do my best to avoid stealing his thunder.

The concept release indicated an intent to retain the current pass/fail opinion of the auditor's report. It seeks comment on several alternatives, such as:

- An auditor's discussion and analysis, that might address, among other things, the areas of risk in the entity's financial reporting and the auditor's response to those risks;

- Required and expanded use of emphasis paragraphs, to draw attention to important matters about the financial statements and disclosures;

- Auditor assurance on other information outside the financial statements; and

- Clarification of language in the standard auditor's report.

The CAQ welcomes the PCAOB's concept release and applauds the Board's willingness to listen to views of all stakeholders in crafting alternative approaches. On June 28, we submitted an initial comment letter that identified the following overarching principles to guide consideration of revisions to the auditor's reporting model that are equally applicable to U.S. and non-U.S. auditor regulators:

- First, Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard

- Second, any changes to the reporting model need to enhance, or at least maintain, audit quality

- Third, any changes to the reporting model should narrow, or at least not expand, the expectations gap

- Fourth, any changes to the reporting model should add value and not create investor confusion. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors; and

- Fifth; auditor reporting should focus on the objective rather than the subjective.

In addition, the CAQ identified several significant modifications to the auditor's reporting model that are responsive to investors and could be implemented over the short term.

One would be the use of an emphasis of matter-like approach in which the audit report would identify specific topics or events, unusual transactions or other matters that were viewed to be areas of audit emphasis by the auditor. These descriptions would have to be objective, fact-based and make specific reference to where such items appear in the financial statements.

Another would be to prepare a new report on the examination of the issuer's Critical Accounting Estimates disclosure in its MD&A. Although the SEC would need to amend Regulation S-X to require this new report, auditor attestation here would serve to continue to improve disclosures by management in this important area and would provide more emphasis on the important judgment calls made in preparing the financial statements.

In addition, we supported amending the audit report to contain clarifying information suggested by the PCAOB as well as additional information about the audit. And as a demonstration of the profession's commitment to meaningful change, the CAQ developed model disclosures for each of its recommendations for the PCAOB and other commenters to consider.

We provided the PCAOB with model disclosures that incorporate our suggestions that are available on our website.

However, the prospect of providing information akin to the auditors' communications with the audit committee – such as that proposed to be in an AD&A – is more problematic. The auditor's written report to the audit committee is prepared with the expectation that a dynamic two-way discussion between the auditor and audit committee will occur around the points made by the auditor, particularly those pertaining to accounting and financial reporting matters involving a high degree of subjectivity. Moreover, the audit committee already has considerable insight by virtue of its financial reporting oversight responsibilities that provide context for communications from the auditor that the financial statement user will not have. Providing investors with the same information that is provided to the audit committee, without the context obtained from a two-way dialogue, could generate greater confusion and not enhance the overall understanding of the readers of such a report.

We already are seeing some consensus about potential improvements to the auditor's reporting model. The CAQ's initial comment letter generally aligns with much in the PCAOB's concept release. And it is consistent with the message we are hearing at our roundtables: investors want more qualitative information from management and *where appropriate* want the auditor to weigh in on the adequacy of the process management used to develop that information. Some participants also suggested that auditors might also comment on whether the information is an accurate representation of facts, assumptions, etc.

These are ideas that need to be explored.

We plan to share what we heard at the roundtables with the PCAOB and other policy makers later this year. The roundtables are encouraging hard thinking around the cost-benefit of various proposals, including determining whether modifications to current standards and regulatory frameworks will truly have a positive impact on the capital markets and the public's perception of the role of the auditor as opposed to simply piling on more disclosures.

Let me assure you that public company auditing profession is listening hard to what investors are saying and is prepared to implement change under a framework that will provide for consistency of approach. The need for consistency transcends U.S. markets; our global markets require consistency of reporting and auditing frameworks to the fullest extent possible.

Slide: Auditor Independence and Mitigants to the Company Pay Model

Without question, objectivity, independence, and professional skepticism are foundations of a high quality audit. The idea that these principles might be improved upon by instituting mandatory auditor rotation has been evaluated before and is under discussion has been discussed in the European Union, and most recently by the chairman of the PCAOB.

It is the CAQ's view that changes of this magnitude should be evaluated carefully in order to avoid any potentially significant unintended consequences.

As with every job, one can always improve, and we certainly want to be constructive in working with Chairman Doty, Dan Goelzer and other members of the board to look for ways to ensure an appropriate degree of audit objectivity and skepticism is maintained throughout the audit process and across the profession.

In Europe, meanwhile, the European Union's Internal Market Commissioner, Michel Barnier, used a June 30 speech to suggest that audit firms could be banned from offering consultancy services to audit clients.

It is, of course, a structure already in place in the United States, as a result of the Sarbanes-Oxley Act of 2002, although the PCAOB – which has authority to adopt additional independence rules for public company auditors – plans to explore whether more needs to be done to assure to mitigate the pressures created by the company pay model (including consideration of mandatory firm rotation and perhaps audit-only firms).

With respect to Mr. Barnier's thoughts on banning auditors from offering consulting services, we believe that one unintended consequence of prohibiting audit firms from providing non-audit services to their audit clients is that clients may lose access to the range and depth of skills offered by multi-disciplinary firms. Auditing can require special expertise that is developed through audit, tax, advisory and other non-audit services. If an audit firm does not have sufficient experts on complex issues, it may not be able to provide the quality of audit service expected. Moreover, without the variety of rich work experience offered by a multi-disciplinary environment, firms would not be able to attract and retain the highest caliber professional staff. The competitive environment must allow – and incentivize – firms to maintain resources necessary to address a wide range of complex audit issues, particularly for a large multinational company.

I am especially interested in your views on auditor independence and skepticism – and whether you feel there is a need for more regulation in this area.

Slide: Investor Education

Convening and collaborating with other stakeholders to advance the discussion of critical issues – such as the evolution of the auditor's reporting model – is, and will remain, integral to the CAQ's mission.

So, too, is educating investors about the audit and the role public company auditors play in our system of investor protection.

In June, we responded to the SEC's request for public comment on the effectiveness of existing private and public efforts to educate investors. In our letter, we pointed out that while there are many notable investor education sites, they typically do not focus on the audit process and there is not a lot of "easily digestible" information available to the public on the role independent auditors play in the financial reporting processes of public companies.

We know from our most recent "Main Street Investor Survey" that individual investors largely remain confident in the audited financial statements released by U.S. public companies. However, the CAQ is concerned about the longstanding expectation gap investors have with respect to the role of the public company auditor.

Accordingly, the CAQ has redoubled its efforts to educate investors about the role of the auditor and the audit process.

Central to the effort is an explanation of what auditors do. **Which is why we released an *In-Depth Guide to Public Company Auditing* – copies of which are available here today.**

The new *Guide* describes how a public company audit firm decides to accept a new audit engagement, how it assesses the risk that the financial statements contain material misstatements as part of determining the audit's scope, and then how the auditors perform and report their findings – all in plain English.

I'm pleased to note that the SEC's Investor.gov Web site and FINRA – the Financial Industry Regulatory Authority – have posted links to the publication. And I want to take this opportunity to ask each of you to consider linking to the *Guide* from your websites.

The CAQ also has created a "**For Investors" area of the CAQ Web site** that each week features a new, straightforward "Did You Know" fact about the audit process. The weekly fact is being archived in the "For Investors" section, along with other resources, including links to the investor education activities of government agencies, regulators and financial literacy organizations.

We also are exploring development of additional educational tools on the role and value of the public company auditing profession, such as brief videos that instruct viewers in an entertaining manner.

The CAQ and the public company auditing profession recognize the importance of engaging in a continuing dialogue with stakeholders – and with investors in particular. It helps the profession gain a better understanding of marketplace needs. At the same time, investors will be more confident in our capital markets as a result of heightened awareness of the independent audit process.

Slide: Global Accounting Standards

I would be remiss if I didn't say a few words about global accounting standards.

As you probably know, the CAQ supports adoption of a single set of high-quality global standards and as much consistency in financial reporting as possible. The SEC has been examining adoption of IFRS for several years. Not long ago, the SEC's Office of the Chief Accountant issued a Staff Paper seeking feedback on a possible method of incorporating international financial reporting standards (IFRS) as issued by the International Accounting Standards Board (IASB) into the U.S. financial reporting system.

The deadline for stakeholder comments is fast approaching (July 31).

The framework proposed in the SEC paper would combine the two approaches taken by other countries in incorporating IFRS into their financial reporting systems: converging national standards and IFRS, and incorporating, or endorsing, IFRS into the existing financial reporting system.

The proposed framework will allow an issuer compliant with U.S. GAAP to also represent that it is complaint with IFRS as issued by the IASB. The framework would retain FASB, but would alter FASB's role in developing accounting standards.

In a related development, the SEC hosted a roundtable discussion on the topic on July 7, with panels representing investors, smaller public companies and regulators.

Many of the panelists favored the "condorsement" approach included in the SEC's work plan. But some participants expressed hesitation about the timing and costs of adopting IFRS, even as they said it was necessary to get a "date certain" for the transition.

Slide: The CAQ's Anti-Fraud Initiative

Financial reporting fraud remains a significant challenge – for all of us.

When I met with you in Madrid last September, the CAQ was just days away from the release of our report, *Deterring and Detecting Financial Reporting Fraud – A Platform for Action*.

The report, which was informed by a series of roundtable discussions and in-depth interviews with a broad spectrum of financial reporting stakeholders, takes the position that while company management has primary responsibility when it comes to detecting and deterring fraud, all members of the supply chain – management, boards and audit committees, internal auditors and external auditors – should work together to leverage their complementary and interconnected duties.

The CAQ report discusses how tone at the top, skepticism and strong communication can mitigate conditions leading to fraud.

We have formed a productive partnership with Financial Executives International, The Institute of Internal Auditors and the National Association of Corporate Directors as part of our anti-fraud initiative, and are engaged in a number of projects aimed at improving our collective ability to deter and detect financial reporting fraud.

First, we are in process of completing a series of fraud scenarios – hypothetical instances of fraud that can be used as teaching tools. We will provide a set of facts and circumstances that can be used by each group in the supply chain to help identify areas where they may have missed opportunities to deter or detect a financial statement fraud. They will be customized for five industries or sectors – financial services, manufacturing, retail, telecommunications, and high tech – and will cover different types of frauds. This project is well underway, and we hope

to complete it this Fall to conduct webcasts and possibly training sessions or seminars based on the content.

One thing we noted in the anti-fraud report is that oftentimes frauds might have been uncovered if someone had asked a follow-up question, and dug deeper into an area they didn't fully understand. **So a second project is to develop training to address that very issue – specifically, how to ask tough, penetrating questions** without communicating a lack of trust or the expectation that the person you're dealing with is dishonest.

We are also going to establish a mechanism to bring together multi-disciplinary groups to discuss fraud-related issues. As one example, we are considering hosting a dialogue about the "expectation gaps" financial reporting supply chain members might have about each other. This would identify any gaps and overlaps of responsibilities, and promote more efficient and effective coordination across the group.

And, we are collectively developing a new component of FEI's Financial Literacy Quiz to focus solely on issues related to financial reporting fraud. The Fraud Literacy Exam will ultimately be featured in an article in FEI's *Financial Executive* magazine, with CPE credit provided to participants who successfully review the content and then complete the exam.

Slide: Commitment to Research

The CAQ also seeks to improve audit quality through research related to the public company auditing profession and encouraging collaboration between auditors and the academic community. We accomplish this by commissioning public opinion research, funding independent academic research, and convening conferences and other meetings attended by senior audit partners and the academic community.

Perhaps the best known of our research activities is our yearly survey of individual investors.

The four years in which we have surveyed individual investors coincided with economic turmoil. And yet, we've found that investors remain confident in U.S. public companies and their audited financial statements. In fact, confidence in audited financials was quite strong – at 70 percent – again last year.

We are in the process of conducting our 5th Annual "Main Street Investor Survey," the results of which will be released in October.

Slide: 2011 Academic Research Projects

Another component of the CAQ's "research effort" focuses on the funding of auditing-related scholarly research.

In response to a request for proposals last December, the RAB received 48 proposals that addressed such topics as audit quality, financial statement fraud deterrence and detection, professional judgment and professional skepticism.

The RAB reviewed the proposals and selected five projects for funding **(you'll see them on the PowerPoint slide).**

> ["A Field Investigation of Auditing Fair Values" by Jean Bedard and Nate Cannon, Bentley University
> "Why and How do Mid-Level Accounting/Finance Managers Perpetrate Financial Reporting Fraud?" by Ikseon Suh ***[ICK-SEE-ON SUE]***, Marquette University, Kristina Linke ***[LINK]***, University of Groningen, and Joseph Wall, Carthage College
> "Confidence Matters: The Effect of Expressed Client Confidence on Auditor Judgment" by Sanaz Aghazadeh ***[SAH-NAHZ AGAZADAY]***, University of Oklahoma
> "The Influence of Social Costs and Strategy on Auditor-Auditor Consultations" by Tammie Rech ***[RECK]***, University of South Carolina
> "Professional Skepticism and Auditing Fair Value: Effects of Task Structure, Time Pressure and Procedure Framing" by Mark Nelson and Eldar Maksymov ***[MACK-SEE-MOV]***, Cornell University]

The academic community is an important voice in the ongoing discussion of auditing-related issues. We expect these research projects to inform the profession's efforts to continuously improve audit quality.

I was pleased to see that NASBA has established a similar program of its own, with its first accounting education research grants awarded in May.

Together, our two organizations are advancing scholarly thinking that will be a boon to professors and the profession – and ultimately all those who depend on sound accounting and auditing practices and reliable financial reporting.

Slide: CAQ logo; www.TheCAQ.org; Twitter: @theCAQ

That's a brief look at recent developments related to the role of the public company auditor, as well as the CAQ's investor education and anti-fraud efforts.

In closing, let me underscore the importance of this event. There is tremendous value in bringing together the world's accounting and auditing regulators for a discussion of issues and the exchange of ideas. And I applaud David Costello, Ken Bishop and others on NASBA's leadership team for the vision and wisdom to establish the Forum in 2008.

Thank you again for inviting me. I'd be happy to answer any questions you may have.