

Remarks of Jeffrey P. Mahoney
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Chairman Clayton, SEC Commissioners, Investor Advisory Committee (IAC) Chair Sheehan, and members of the IAC, thank you for the opportunity to participate on today's panel.

I represent the Council of Institutional Investors (CII), whose core membership includes asset owners with assets under management of approximately \$4 trillion. Our associate members include non-U.S. asset owners with about \$4 trillion in assets, and a range of asset managers with more than \$35 trillion in assets under management. Our associate members also include the five largest accounting firms and the Center for Audit Quality.¹

Our members believe that accurate and reliable audited financial reports are critical to making informed investment decisions, and vital to the overall well-being of our capital markets.² Our members also believe that investors are the key customer of audited financial reports and, therefore, the primary role of those reports should be to satisfy investors' information needs.³

Advisory Committee on the Auditing Profession

Back in 2007, CII's then Executive Director Ann Yerger was appointed by U.S. Treasury Secretary Henry M. Paulson, Jr., to an Advisory Committee whose goal was to examine

¹ For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at <http://www.cii.org>.

² CII, *Policies on Other Issues, Independence of Accounting and Auditing Standard Setters* (updated Mar. 1, 2017), https://www.cii.org/policies_other_issues#indep_acct_audit_standards ("Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures.").

³ *Id.* ("Attributes that underpin an effective accounting or auditing standard setter include: . . . A clear recognition that investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs").

comprehensively the condition and future of the auditing profession.⁴ The Advisory Committee, which included a philosophically diverse group of investor, business, academic, and institutional leaders, was co-chaired by former SEC Chairman Arthur J. Levitt, and former SEC Chief Accountant Donald T. Nicolaisen.⁵ The Advisory's Committee's work resulted in one of the most significant studies of the auditing profession in U.S. history.

On October 8, 2008, the Advisory Committee issued a final report that included 31 recommendations.⁶ Those included recommendations to the Public Company Accounting Oversight Board (PCAOB) urging the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.⁷ The basis for that recommendation included the view that improving the content of the auditor's report beyond its traditional pass/fail model would better reflect the amount of work and judgment involved in a financial statement audit,⁸ and would likely lead to more relevant information for users of financial statements.⁹

Critical Audit Matters

Fast forward to June 1, 2017, after more than six years of public due process, including three rounds of solicitation of public comment, the PCAOB adopted Auditing Standard 3101.¹⁰ That standard is responsive to the Advisory Committee recommendation by requiring that an auditor of a public company communicate critical audit matters or so-called "CAMs" in any audit opinion relating to its audit of the company's current period financial statements.¹¹

A CAM is defined as a matter arising from the audit of a company's financial statements that (1) was communicated, or required to be communicated, to the audit committee, (2) relates to

⁴ See The Dep't of the Treasury, *Advisory Comm. on the Auditing Profession I:2* (final report Oct. 6, 2008), <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> ("The Advisory Committee on the Auditing Profession, appointed by the U.S. Treasury Secretary Henry M. Paulson, Jr., was asked to examine comprehensively the condition and future of the auditing profession, with emphasis on the sustainability of a strong and vibrant profession.").

⁵ *Id.* II:2, III:1-III:4.

⁶ *Id.* at II:3 ("The Report of the Committee offers thirty-one recommendations derived from the deliberations of three Subcommittees each focused on one of three key areas—human capital, firm structure and finances, and concentration and competition").

⁷ *Id.* at VII:13 ("Recommendation 5: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model").

⁸ *Id.* at VII: 14 ("Some believe this pass/fail model with its standardized wording does not adequately reflect the amount of auditor work and judgment.").

⁹ *Id.* at VII: 17 ("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 would clarify the role of the auditor in the financial statement audit.").

¹⁰ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017), <https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf>.

¹¹ *Id.*

accounts or disclosures that are material to the company's financial statements, and (3) involved especially challenging, subjective or complex auditor judgment.¹²

The standard went into effect for audits of large accelerated filers for fiscal years ending after June 30, 2019.¹³ CAMs will be required for audits of most other public companies this year.¹⁴

Last December, I authored a report on behalf of the CII Research and Education Fund (CII-REF Report) entitled "Critical Audit Matters: A First Look."¹⁵ The following are a few general observations from the CII-REF Report.

Improved Internal Controls and Disclosures

As Mr. Higgins indicated in his written remarks, to-date the implementation of CAMs has gone "pretty smoothly," in part because of so-called "dry run" discussions among auditors, management and audit committees.¹⁶ As expected, the early evidence indicates that implementation of CAMs has resulted in at least two significant benefits to investors and other market participants: (1) improved internal controls; and (2) improved disclosures.

For example, a report analyzing data from a survey of corporate officials who participated in dry run discussions on implementation of CAMs found that: (1) 62% of audit committees have identified and are adding internal controls over financial reporting or are considering such changes;¹⁷ and (2) 52% of large accelerated filers and 61% of all other companies are considering enhancing their financial statement disclosures in light of communicated CAMs.¹⁸

Robust and Useful Disclosures with One Exception

The standard requires that for each CAM, the auditor must (1) identify the CAM, (2) describe the principal considerations that led the auditor to make the CAM determination, (3) describe how the CAM was addressed in the audit, and (4) refer to the relevant financial statement accounts or

¹² See *id.* at 14 (diagraming the requirements of the standard).

¹³ *Id.* at 4 ("Provisions related to critical audit matters will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply").

¹⁴ *Id.*

¹⁵ Jeff Mahoney, *Critical Audit Matters Reporting: A First Look* (Dec. 19, 2019), https://7677c7b7-7992-453f-8d12-74ccbdbee23c.filesusr.com/ugd/72d47f_31e4591ec8954801a6c3d9a717d66310.pdf.

¹⁶ See Keith F. Higgins, Ropes & Gray LLP, Boston, Presentation to the SEC's IAC, *What's on the Audit Committee's Agenda?* 3 (Feb. 27, 2020) (on file with CII) ("For the Audit Committees with which I interacted, this inaugural event went pretty smoothly."); Marc Butler et al., *Critical Audit Matters: Public Company Adaption to Enhanced Auditor Reporting*, Intelligize 12 (Sept. 10, 2019), <https://www.intelligize.com/critical-audit-matters-public-company-adaptation-to-enhanced-auditor-reporting-form/> (registration required & on file with CII) (indicating that 54% of "Large accelerated filers" and 51% percent of companies "will report CAM on or after 12/15/20").

¹⁷ See Marc Butler et al., *Critical Audit Matters: Public Company Adaption to Enhanced Auditor Reporting*, Intelligize at 4 ("43% of audit committees identified additional controls that required implementation, while an additional 19% are still considering such changes").

¹⁸ *Id.* at 3 ("52% of large accelerated filers and 61% of other companies facing CAMs are considering updates to financial statement disclosure").

disclosures to which each CAM relates.¹⁹ These can be very important disclosures for investors including in connection with analyzing and pricing risks and in making proxy voting decisions.²⁰ These disclosures also deliver on the PCAOB's mission, as set forth in the Sarbanes-Oxley Act of 2002, to "protect the interests of investors and further the public interest in the preparation of *informative*, accurate, and independent audit reports."²¹

In the CII-REF Report review of 330 CAMs contained in 191 audit reports, I found that many of the reports provided a robust and useful description in response to three of the four CAM requirements.²² The one common failure in the reports was in response to the requirement to describe how the CAM was addressed in the audit.

CAMs are not intended to imply that the auditor is providing a separate opinion on the CAM or on the accounts or disclosures to which they relate.²³ Nevertheless, the PCAOB's standard provides that:

In describing how the critical audit matter was addressed in the audit, the auditor may describe: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of the audit procedures performed; (3) an indication of the outcome of the audit procedures; and (4) key observations with respect to the matter, or some combination of these elements.²⁴

I believe more can and should be done to encourage auditors to provide more information about the outcome of audit procedures and key observations in ways that make clear how those outcomes and observations contributed to the auditor's opinion and do not imply separate assurance on those matters.

For example, the audit report for CDK Global, Inc., which identified revenue recognition for the company's customer contracts as a CAM,²⁵ described the audit procedures for those contracts, including the testing, evaluation, and confirmation of a sample of the contracts.²⁶

However, the CDK Global, Inc. auditor's report, like the other reports reviewed, stopped short of explaining the outcome or key observations from conducting the audit procedures described.

¹⁹ PCAOB Release No. 2017-001 at A1 – 8-9.

²⁰ See Jeff Mahoney, *Critical Audit Matters Reporting: A First Look* at 3-5 (describing some of the ways "in which investors can use the information provided by critical audit matters").

²¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Section 101(a), 116 Stat. 745 (July 30, 2002) (emphasis added), <https://www.govinfo.gov/content/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf>.

²² See Jeff Mahoney, *Critical Audit Matters Reporting: A First Look* at 4 ("Drawing on a review of the CAMs of more than 190 companies, this report provides some general observations about the utility of the CAMs that have been issued as of December 5, 2019.").

²³ See PCAOB Release No. 2017-001 at 95 ("the communication of critical audit matters in an auditor's report should not be interpreted as altering the level of assurance on any aspect of the audit report, including the identified critical audit matters.").

²⁴ *Id.* at A1 – 9 (para. 14(c) Note).

²⁵ See Jeff Mahoney, *Critical Audit Matters Reporting: A First Look* at 13,14.

²⁶ *Id.* at 15.

And those explanations were the types of disclosures requested by investors during the development of the standard.²⁷

For all the reasons described in the CII-REF Report, CII continues to strongly support the CAM requirements and encourages the PCAOB and auditors to continue to consider how CAM disclosures can be presented in a manner that enhances investor protection through informative audit reports.

I am happy to respond to questions and comments, and I appreciate the IAC considering accounting and auditing issues which are essential to good corporate governance. Thank you for your time.

²⁷ See PCAOB Release No. 2017-001 at 30 (“Several investors suggested that the auditor should be required or encouraged to provide informative, company-specific findings when describing how the critical audit matter was addressed”); *id.* at 31 (indicating that a working group of the PCAOB’s own Investor Advisory Group “stressed the importance to investors of auditor findings, which they described as ‘the one item that [they] believe would provide the greatest value to investors.’”).