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## Investor Advisory Group

March 28, 2012

***Discussion Topic:***  
***Role, Relevancy and Value of the Audit***

## Introduction

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- **Task Group** – Joe Carcello, Mike Head, Gus Sauter, Tony Sondhi, and Bob Tarola
- **Approach** – Survey of IAG and their extended network whose primary role is to invest, advise investors, oversee investment funds, or support the interest of investors.
- **Survey** – 21 questions addressing past, present and future of public company audits.
- **Results** – 62 respondents, representing \$8 trillion of invested funds, from institutional investors to analysts to trustees and administrators.

*Not Scientific – But a Good Cross-Section of Investing Interests*

## Role, Relevancy and Value of the Audit - Past

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### 1. The PCAOB has been effective in its oversight of public company auditors.

		Response Percent	Response Count
Strongly Agree		4.8%	3
Agree		46.8%	29
Neutral		41.9%	26
Disagree		6.5%	4
Strongly Disagree		0.0%	0
Additional Comments:			6
answered question			62
skipped question			0

*45% Net Favorable*

## Respondent Comments – Q1

7

- Recent enforcement actions against auditors have been a step forward for the PCAOB.
- Difficult to assess due to lack of disclosure of Part II of inspection reports.
- Difficult to assess given lack of transparency about inspections.
- PCAOB does not have the necessary authority to conduct disciplinary process in public in a timely manner.

## Role, Relevancy and Value of the Audit - Past

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### 2. Audit quality has improved over the past ten years.

		Response Percent	Response Count
Strongly Agree		11.3%	7
Agree		50.0%	31
Neutral		24.2%	15
Disagree		14.5%	9
Strongly Disagree		0.0%	0
Additional Comments:			4
answered question			62
skipped question			0

*46% Net Favorable*

## Respondent Comments – Q2

9

- Madoff.
- Supportive of the PCAOB's role, though with the financial crisis, it does not seem audit quality has improved.
- No marked steps forward.
- 404 has resulted in improved and integrated audits. But audit quality problems seem to persist.

## Role, Relevancy and Value of the Audit - Past

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### 3. The presence, policies and practices of the PCAOB have improved audit quality.

	Response Percent	Response Count
Strongly Agree	11.3%	7
Agree	41.9%	26
Neutral	45.2%	28
Disagree	0.0%	0
Strongly Disagree	1.6%	1
Additional Comments:		5
answered question		62
skipped question		0

*51% Net Favorable*

## Respondent Comments – Q3

11

- Feel strongly that the PCAOB's oversight role is having an influence on audit quality though overall auditors need to do a better job.
- The more robust and public stand that the PCAOB has been taking over the last 18 months or so is welcome and should help to reinforce the importance of audit quality – and the consequences of poor audit quality.
- More transparency on a timely basis would provide more incentive for firms to improve audit quality.

## Role, Relevancy and Value of the Audit - Past

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4. The PCAOB serves an important role in the protection of investors through its oversight and regulation of public company auditors.

		Response Percent	Response Count
Strongly Agree		24.2%	15
Agree		45.2%	28
Neutral		21.0%	13
Disagree		8.1%	5
Strongly Disagree		1.8%	1
Additional Comments:			2
answered question			62
skipped question			0

*59% Net Favorable*

## Respondent Comments Q4

13

- That's the goal. What about accomplishments? All the efforts do not seem to be adequate or worth the time and money spent.
- Potentially yes it does serve a vital role, if it can carry forward that role effectively.

## Role, Relevancy and Value of the Audit - Past

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### 5. Improvements in audit quality over the last decade have outweighed the increases in audit costs.

		Response Percent	Response Count
Strongly Agree		14.5%	9
Agree		29.0%	18
Neutral		37.1%	23
Disagree		17.7%	11
Strongly Disagree		1.8%	1
Additional Comments:			6
answered question			62
skipped question			0

*24% Net Favorable*

## Respondent Comments – Q5

15

- It is obvious that costs have risen steadily – improvements to audit quality are more difficult to discern.
- The current initiatives and considerations at the PCAOB and the IAASB should improve quality, but these are prospective not historic changes.
- Unclear whether quality has improved.....the real question is whether auditors are testing and opining on things investors really care about.

## Role, Relevancy and Value of the Audit - Past

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### 6. The PCAOB has been an important factor in improving corporate governance.

		Response Percent	Response Count
Strongly Agree		6.5%	4
Agree		37.1%	23
Neutral		46.8%	29
Disagree		8.1%	5
Strongly Disagree		1.6%	1
Additional Comments:			5
answered question			62
skipped question			0

*32% Net Favorable*

## Respondent Comments – Q6

17

- We believe the role of the PCAOB has overall improved governance surrounding an audit and the role of the audit committee.
- Auditor – audit committee disclosures have improved.
- The PCAOB has failed in its attempts to agree with the Chinese regulators on the basis for the oversight of Chinese companies listed in the U.S.

## Role, Relevancy and Value of the Audit - *Present*

18

### 7. The auditor's opinion on the financial statements is critical in making investing decisions.

		Response Percent	Response Count
Strongly Agree		23.2%	13
Agree		53.6%	30
Neutral		12.5%	7
Disagree		8.0%	5
Strongly Disagree		1.8%	1
Additional Comments:			8
answered question			56
skipped question			6

*66% Net Favorable*

## Respondent Comments – Q7

19

- It is a boiler-plate letter that people generally don't read.
- It is such boiler-plate wording as to be useless unless a problem is present.
- It is important in the case of adverse or qualified opinions.
- The auditors report should provide additional information which improve an analyst's research.
- It is critical, but more critical is the impact which the auditor, having to give such an opinion, has on the reporting from companies.
- Only of value if it is negative - as a positive opinion does not appear to mean things are really okay.

## Role, Relevancy and Value of the Audit - *Present*

20

8. The auditor's opinion on the effectiveness of Internal Controls over Financial Reporting is critical in making investing decisions.

		Response Percent	Response Count
Strongly Agree		19.6%	11
Agree		42.9%	24
Neutral		21.4%	12
Disagree		10.1%	9
Strongly Disagree		0.0%	0
Additional Comments:			4
answered question			56
skipped question			6

*47% Net Favorable*

## Respondent Comments – Q8

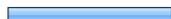
21

- This report has devolved into boiler-plate....that its value is limited.
- Understanding whether there are internal control weaknesses is essential in understanding the governance of the company and the tone at the top.
- The importance of this opinion is grotesquely over-rated and risks raising concerns that need not be there.
- It has been a gravy-train for the profession but only limited value improvement for the investors.

## Role, Relevancy and Value of the Audit - *Present*

22

### 9. The auditor's role is critical to promoting the integrity of the capital markets.

		Response Percent	Response Count
Strongly Agree		39.3%	22
Agree		46.4%	26
Neutral		12.5%	7
Disagree		0.0%	0
Strongly Disagree		1.8%	1
Additional Comments:			5
answered question			56
skipped question			6

*84% Net Favorable*

## Respondent Comments – Q9

23

- But only if investors know what the issues are within companies.
- The role of the auditor needs strengthening and should not be underestimated.
- Confidence of investors in financial statements is critical to a well-functioning market.
- If the auditors' role is carried out well, this is the case - but too often the audit profession does itself a profound disservice by not performing that role well.
- It should be critical to the integrity of the markets but does not seem to add as much value as would be expected.

## Role, Relevancy and Value of the Audit - *Present*

24

### 10. The auditor plays an effective role in mitigating the risk of investing.

		Response Percent	Response Count
Strongly Agree		12.5%	7
Agree		46.4%	26
Neutral		26.8%	15
Disagree		12.5%	7
Strongly Disagree		1.8%	1
Additional Comments:			5
answered question			56
skipped question			6

*44% Net Favorable*

## Respondent Comments – Q10

25

- The auditor provides additional information and confidence in the integrity of reporting.
- The auditor helps minimize confidence risk but does not mitigate the risk of investing.
- The auditor **SHOULD** play an effective role in mitigating the risk of investing, but they do not have a very good track record.
- Only good auditors – mixed performance.
- The auditor can play this role. Whether it is currently genuinely effective we would very much doubt.

## Role, Relevancy and Value of the Audit - *Present*

26

### 11. The auditor plays an effective role in lowering the cost of capital.

		Response Percent	Response Count
Strongly Agree		8.9%	5
Agree		32.1%	18
<b>Neutral</b>		37.5%	21
Disagree		10.0%	11
Strongly Disagree		1.8%	1
Additional Comments:			3
answered question			56
skipped question			6

*20% Net Favorable*

## Respondent Comments – Q11

27

- Difficult to measure this.
- If effective, the auditor can play this role.
- There are studies that show that companies that have better governance, transparency and provide quality disclosures benefit from having a lower cost of capital.
- Auditors bring confidence to the integrity of reporting which should also impact the cost of capital.

## Role, Relevancy and Value of the Audit - *Present*

28

### 12. The auditor plays an effective role in the quality of corporate governance.

		Response Percent	Response Count
Strongly Agree		8.9%	5
Agree		51.8%	29
Neutral		30.4%	17
Disagree		8.9%	5
Strongly Disagree		0.0%	0
Additional Comments:			2
answered question			56
skipped question			6

*52% Net Favorable*

## Respondent Comments – Q12

29

- If effective the auditor can play this role. This is probably the area of greatest doubt about the current degree of effectiveness.
- Discussions with the audit committees I am on tend to add some value...but also some frustration given the complexity of some audit issues and the complexity of required disclosure...40+ pages of notes written in dense paragraphs really does not add a lot of value.

## Role, Relevancy and Value of the Audit - Present

30

13. For the information items below, please indicate the frequency of use when making investment decisions.

	Always	Often	Sometimes	Rarely	Never	Not Sure	Response Count
Audited Financial Statements	<b>62.5%</b> (35)	19.6% (11)	12.5% (7)	3.6% (2)	0.0% (0)	1.8% (1)	56
Management's Discussion and Analysis	<b>50.0%</b> (28)	35.7% (20)	7.1% (4)	3.6% (2)	1.8% (1)	1.8% (1)	56
Auditor's Report on Internal Controls Over Financial Reporting	17.9% (10)	<b>28.6%</b> (16)	26.8% (15)	19.6% (11)	3.6% (2)	3.6% (2)	56
Business Description and Risk Factors Contained in Issuer's Reports	<b>32.1%</b> (18)	<b>32.1%</b> (18)	19.6% (11)	12.5% (7)	1.8% (1)	1.8% (1)	56
Information Contained in Proxy Materials	23.2% (13)	30.4% (17)	<b>32.1%</b> (18)	8.9% (5)	3.6% (2)	1.8% (1)	56
Quarterly Earnings Releases from Issuers	<b>55.4%</b> (31)	28.6% (16)	8.9% (5)	5.4% (3)	0.0% (0)	1.8% (1)	56
Sell-side Analysts Reports	19.6% (11)	<b>30.4%</b> (17)	28.6% (16)	16.1% (9)	3.6% (2)	1.8% (1)	56

## Role, Relevancy and Value of the Audit - Present

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13. For the information items below, please indicate the frequency of use when making investment decisions.

Rating Agency Reports	17.9% (10)	25.0% (14)	<b>37.5%</b> (21)	16.1% (9)	1.8% (1)	1.8% (1)	56
Information Contained in Financial Distribution Networks/Media	19.6% (11)	23.2% (13)	<b>30.4%</b> (17)	17.9% (10)	3.6% (2)	5.4% (3)	56
Investor Day or Other Opportunities to Meet with Management	<b>35.7%</b> (20)	32.1% (18)	19.6% (11)	7.1% (4)	3.6% (2)	1.8% (1)	56
Self-Developed Investment Models that Rely on Audited Financial Statements	<b>37.5%</b> (21)	35.7% (20)	12.5% (7)	5.4% (3)	5.4% (3)	3.6% (2)	56
Self-Developed Investment Models that Do Not Rely on Audited Financial Statements	19.6% (11)	<b>23.2%</b> (13)	19.6% (11)	21.4% (12)	12.5% (7)	3.6% (2)	56
Issuer Information Distributed via XBRL	7.1% (4)	10.7% (6)	<b>23.2%</b> (13)	21.4% (12)	19.6% (11)	17.9% (10)	56

*High Percentage Use Audited Financial Statements in Decision Making*

## Respondent Comments – Q13

32

- Auditor reporting should include additional information that will assist investors in their capital allocation decision.
- Each investment decision has its own characteristics and drivers.
- Brokers' advice.

## Role, Relevancy and Value of the Audit - *Future*

33

### 14. The auditor should provide an opinion on the earnings release.

	Response Percent	Response Count
Strongly Agree 	12.7%	7
Agree 	23.8%	13
Neutral 	21.8%	12
Disagree 	30.9%	17
Strongly Disagree 	10.9%	6
Additional Comments:		3
answered question		55
skipped question		7

*6% Net Unfavorable*

## Respondent Comments – Q14

34

- Focuses industry on short-term quarterly information only relevant to progress and management understanding of operating environment.
- Since such opinion would unlikely involve an in-depth audit, the value of such an opinion would be questionable.
- No opinion is necessary, but an auditor sign-off before the release can be issued is of assistance.

## Role, Relevancy and Value of the Audit - *Future*

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### 15. The auditor should provide an opinion on Management's Discussion & Analysis.

		Response Percent	Response Count
Strongly Agree		7.3%	4
Agree		36.4%	20
Neutral		21.8%	12
Disagree		27.3%	15
Strongly Disagree		7.3%	4
Additional Comments:			2
answered question			55
skipped question			7

*10% Net Favorable*

## Respondent Comments – Q15

36

- The requirement to read and raise concern...is of much greater value (and would involve much less audit expense).
- Auditors do not really understand the business details and issues and the financial numbers are already reviewed and compared with the financial statement.

## Role, Relevancy and Value of the Audit - *Future*

37

### 16. The auditor should provide an opinion on quarterly reports under SEC Form 10-Q.

		Response Percent	Response Count
Strongly Agree		12.7%	7
Agree		43.6%	24
Neutral		20.0%	11
Disagree		16.4%	9
Strongly Disagree		7.3%	4
Additional Comments:			2
answered question			55
skipped question			7

*32% Net Favorable*

## Respondent Comments – Q16

38

- Probably similar to earnings releases – no opinion necessary but a sign-off before issue would assist.
- The value of such opinion would be questionable.

## Role, Relevancy and Value of the Audit - *Future*

39

### 17. The auditor should specifically report on the quality of estimates used in the financial statements.

	Response Percent	Response Count
Strongly Agree	27.3%	15
Agree	41.8%	23
Neutral	20.0%	11
Disagree	7.3%	4
Strongly Disagree	3.6%	2
Additional Comments:		3
<b>answered question</b>		<b>55</b>
<b>skipped question</b>		<b>7</b>

*58% Net Favorable*

## Respondent Comments – Q17

40

- This would be ideal, but tough to implement.
- Agree if auditors report on estimates which are most relevant to the business.
- We would suggest that the auditor make a specific report on the neutrality of the statements overall, rather than a more general view on estimates employed.

## Role, Relevancy and Value of the Audit - *Future*

41

### 18. The auditor should specifically report on the quality of disclosures.

	Response Percent	Response Count
Strongly Agree 	20.0%	11
Agree 	47.3%	26
Neutral 	27.3%	15
Disagree 	3.6%	2
Strongly Disagree 	1.8%	1
Additional Comments:		4
answered question		55
skipped question		7

*61% Net Favorable*

## Respondent Comments – Q18

42

- Would be very hard to find a balance.
- While quality disclosures are of crucial importance, too often the actions of the auditor seem to lead to an increase in disclosures on a safety-first basis...making it harder for investors to see relevant information through the slew of data. We would therefore only support a more direct role of the auditor on disclosures if it was clear that this is genuinely about quality, and would not simply generate further excessive quantity.
- In the financial statements only.

## Role, Relevancy and Value of the Audit - *Future*

43

**19. The auditor should report on the fairness of the presentation of the financial condition of the issuer.**

		Response Percent	Response Count
Strongly Agree		32.7%	18
Agree		45.5%	25
Neutral		14.5%	8
Disagree		5.5%	3
Strongly Disagree		1.8%	1
Additional Comments:			2
answered question			55
skipped question			7

*70% Net Favorable*

## Respondent Comments – Q19

44

- Window-dressing has been at the heart of many corporate collapses.
- This reflects our view that there should be a neutrality report.

## Role, Relevancy and Value of the Audit - *Future*

45

### 20. The auditor should report on non-GAAP financial information.

		Response Percent	Response Count
Strongly Agree		12.7%	7
Agree		41.8%	23
Neutral		20.0%	11
Disagree		20.0%	11
Strongly Disagree		5.5%	3
Additional Comments:			1
answered question			55
skipped question			7

*30% Net Favorable*

## Respondent Comments – Q20

46

- A requirement to read this other information and comment if there is any discrepancy between it and what has been discovered through the audit should be sufficient.

## Role, Relevancy and Value of the Audit - *Future*

47

**21. The auditor should report on all independently verifiable information contained in issuer reports (e.g.: sustainability data, compensation data, operational data, etc.)**

		Response Percent	Response Count
Strongly Agree		9.1%	5
Agree		27.3%	15
Neutral		40.0%	22
Disagree		18.2%	10
Strongly Disagree		5.5%	3
Additional Comments:			2
answered question			55
skipped question			7

*12% Net Favorable*

## Respondent Comments – Q21

48

- Would be hard to decide where to draw the line.
- A requirement to read this other information and comment...should be sufficient.

## Role, Relevancy and Value of the Audit

49

22. Please indicate which category best describes your current investing role.

	Response Percent	Response Count
Institutional Investor	57.1%	28
Individual Investor	6.1%	3
Buy-side Analyst	22.4%	11
Sell-side Analyst	0.0%	0
Venture Fund	2.0%	1
Broker/Dealer	0.0%	0
Investor Advisor	6.1%	3
Trustee/Administrator of Investment Funds	10.2%	5
Other (Describe)	4.1%	2
None (Investor Representative)	6.1%	3
Additional Comments:		1
answered question		49
skipped question		13

## Summary Observations

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- Generally - investors showed strong support for PCAOB.
- Generally - investors voiced strong support for the role of the auditor.
- Generally - investors are encouraging actions to improve audit quality, and want a more informative audit report.
- Generally - investors are most interested in expanded auditor involvement into areas of; 1) financial condition, 2) estimates, and 3) quality of disclosures.