



National Association of State Boards of Accountancy

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**STATEMENT OF  
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PCAOB PUBLIC MEETING | AUDITOR'S REPORTING MODEL  
WASHINGTON, D.C. | APRIL 2, 2014**

***BACKGROUND***

My name is Gaylen Hansen, immediate past chair of the National Association of State Boards of Accountancy (NASBA), also an audit partner and director of quality assurance at EKS&H.<sup>1</sup>

I was appointed to the U.S. Treasury's Advisory Committee on the Auditing Profession (ACAP) and am a former chair and member of the Colorado State Board of Accountancy, a former member of the PCAOB's Standing Advisory Group (SAG) and AICPA's Professional Ethics Executive Committee (PEEC). Currently, I serve on the board of directors of NASBA and the Consultative Advisory Group of both the International Auditing and Assurance Standards Board (IAASB) and International Ethics Standards Board for Accountants (IESBA).<sup>2</sup>

NASBA's mission is to enhance the effectiveness of CPA licensing authorities and their firms in the U.S. and its territories. Boards of Accountancy take seriously their responsibilities to protect the public interest. They understand the importance of the public's confidence in reliable capital markets. In that spirit and on behalf of NASBA, I wish to convey my appreciation for the opportunity to share some thoughts on the PCAOB's proposed Auditor's Reporting Model (ARM).<sup>3</sup>

***ADVISORY COMMITTEE ON THE AUDITING PROFESSION (ACAP)***

I've been asked to provide some insight into the ACAP's recommendation leading to the PCAOB's proposed ARM initiative.

Dealing with ACAP's issues in the midst of the 2008 economic meltdown was interesting, to put it mildly. I recall Treasury Secretary Henry Paulson missing most of our meetings due to the urgency of the economic crisis. We met at the Treasury Building next door to the White House. I saw frenzied late-night activity at Treasury and as I walked the hallways, noticed an abundance of loose-leaf binders, curiously labeled "TARP." We would later learn the significance of TARP and the economic Armageddon the country narrowly dodged.

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<sup>1</sup> EKS&H LLLP, based in Denver is the largest accounting firm in the Rocky Mountain Region with over 500 professionals. The firm audits both issuers and non-issuers, including emerging growth companies and broker-dealers; our issuer component approximates ten percent of total firm revenues and includes accelerated and non-accelerated filers.

<sup>2</sup> The views expressed herein are my own and do not necessarily reflect those of any of the organizations mentioned.

<sup>3</sup> *The Auditor's Report on an Audit of Financial Statements, et seq.*, PCAOB Release No. 2013-005, Rulemaking Docket No. 034, August 13, 2013.

ACAP’s proceedings took place five years after the PCAOB’s formation. Among ACAP’s many objectives was the opportunity to reflect on the PCAOB and its source, the *Sarbanes-Oxley Act of 2002*.

Against this backdrop, the handpicked ACAP members, with very diverse backgrounds, hoped to wrestle with meaty issues, find common ground, and in this city of grand bargains, come up with creative solutions designed to ensure the long-term sustainability of the auditing profession. We were dealing with matters that had been kicked around for decades and sorely needed solutions. This was a chance to do something meaningful, even historic.

If we could help resolve a few of these big issues it might provide the public greater comfort about the quality of financial reporting and increase their confidence in the information that drives capital markets, thereby reducing the cost of capital and raising the standard of living; a noble aspiration indeed.

A general sentiment was that more is required of auditors, including more feedback on matters historically kept tightly under wraps. There was also serious concern about firm concentration and overreliance on the remaining handful of firms auditing upwards of 90% of all public companies’ market capital.

At the same time, the firms coveted civil litigation reform. Accordingly, they were willing to consider some compromises to achieve that goal. On the table was greater firm transparency, governance, and improvements in audit quality. The concept of “moral hazard” was debated endlessly. Unfortunately, disagreements about the adequacy and interpretation of the underlying data required to support private litigation reform prevented a grand bargain. In that respect, we failed.

ACAP’s work extended beyond a year with a final report issued on October 6, 2008, three days after President Bush signed into law the *Emergency Economic Stabilization Act* that created the \$700 billion *Troubled Assets Relief Program* or “TARP.” All told, ACAP held eight public meetings, heard 57 witnesses, and considered thousands of pages of evidence. Its bibliography filled volumes. The final result was 31 recommendations.

The recommendations covered a broad range of topics from establishing a national center to combat fraud, greater audit firm transparency, education curricula for entry-level staff, risk of catastrophic loss of firms, firm concentration and competition, to enhancing independence. The *Firm Structure and Finances Committee* that I served on developed seven of the 31 recommendations. Our fifth recommendation led, at least in part, to the subject matter of this meeting. I believe it to be among the most important:

<p><b>Recommendation 5:</b> Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor’s standard reporting model. Further, urge that the PCAOB and the SEC clarify in the auditor’s report the auditor’s role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.</p>
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The Committee wasn’t interested in changing the audit report for change sake, or just because the current model was 70 years old. We were interested in a substantive fix, increased accountability and transparency with real teeth, which is why we are here today.

### *ACAP’S REPORTING RECOMMENDATION IN HINDSIGHT*

In retrospect, ACAP’s recommendation remains as appropriate today as it was in 2008, particularly in light of what we learned about the economic crisis. Investors continue to express dismay over auditor’s reports offering very limited or no value. Specifically, today’s audit reports are silent about:

- Audit strategy and overall approach
- Extent of evidence obtained
- Key audit judgments made

Further, during the crisis there were numerous instances of clean opinions, immediately followed by corporate collapse. Investors witnessed their capital vanishing overnight while those in the know couldn’t or wouldn’t share untapped insight. The public interest is not served when investors have no way to challenge audit conclusions that are foundational to their investment decisions. This defeats an efficient capital market.

The extant audit report doesn’t offer investors much to reasonably assess the underlying quality of audits. This contributes to the so-called “expectations gap” that must be narrowed if auditors and their audits are to remain relevant. Raising the bar on what is required of auditors is the obvious option since it’s unrealistic that investors will expect less. Consequently, I support the PCAOB’s ARM proposal because it raises the bar.

Generally, auditors don’t like change and have objections to the ARM, especially aspects of “critical audit matters.” Some objections are legitimate but others simply because the ARM will take them out of their comfort zone. That is understandable. Management is more resistant and audit committee members even more so. Some convincing needs to take place.

On that matter of “convincing,” here is a portion of the ACAP testimony of Jules Muis on audit reports:

*I have on various occasions in the past thrown out a less revolutionary teaser suggesting that we should ban clean audit opinions as an audit reporting instrument for at least ten years to come. Just to wean the audit profession off its addiction to clean opinions. And to make it recognize a public interest in having the **right** opinion, rather than a **clean** opinion per se. If the profession would better marshal the professional courage it takes to use its whole panoply [sic] of audit opinions, in particular disclaimers when disclaimers are due, the world would be a better place... Remember, we only see the waves caused by dysfunctional audits, not the invisible undercurrents that steer audit clients into changing their minds; to change their financial reporting. This invisible audit hand never shows up on the public screen. And cannot be shared because of client confidentiality.<sup>4</sup> [Bold emphasis is that of Mr. Muis.]*

Jules I am quite sure isn’t really serious about banning clean opinions, but his message about the lack of communication and transparency resonates. Client confidentiality has a long-standing and important place in the accountancy profession. However, it doesn’t serve investors well when it is parlayed to obfuscate the important obligation to call things as they are seen.

The customer of financial reporting is the investor. While cliché, business schools teach the basic idiom that the “customer is king,” meaning the success of a business is ultimately determined by its customers. Business is compelled to sell products and services to customers they want or need, at a price they are

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<sup>4</sup> Jules W. Muis, former vice president and controller of the World Bank, June 3, 2008 ACAP public meeting, <http://www.treasury.gov/about/organizational-structure/offices/Documents/Muis060308.pdf>

willing to pay, otherwise customers will look elsewhere to fill their wants and needs. The informational wants and needs of investor-customers supersede all others in an efficient capital market.

Of the 232 comment letters to the proposed rule, it does not escape notice that only nine percent came from investor-customers.<sup>5</sup> Hopefully, the weight of regulatory reform will come down heavily on the side of the public interest represented by the nine percent.

Back to confidentiality, the apparent enemy of transparent communication, it is noteworthy that while it is protected in the trade association’s code of conduct,<sup>6</sup> it is conspicuously absent from the standards of both the SEC and PCAOB. The reason is obvious – public protection is the regulator’s priority. As a result, it is fair game to question whether confidentiality trumps all other priorities or if it has *any* limits.

### ***REACTIONS TO THE PCAOB’S PROPOSAL***

As noted before, overall, I’m comfortable with the changes proposed in the ARM. To begin, it fixes several glaring shortcomings in the current model. For instance, it scopes in note disclosures and references firms’ PCAOB registrations. The most difficult matter obviously relates to reporting “critical audit matters.” Here are my general reactions to the more important changes:

1. ***Reporting critical audit matters (CAM).*** This represents a significant change in practice but will enhance communications by providing more relevant information to investor-customers, analysts and other users of financial statements. If the CAM focus remains on those few things that “keep the partner awake at night,” I believe the CAM concept can work. If there are more than a few things, there may be something awry. If nothing keeps the partner awake, there may be a different problem!

CAM commentary should of course respect the principle that management is primarily responsible for communicating companies’ original information. Because of this, there is the likelihood of serious disagreement between auditors and managers over what constitutes a CAM, and that is understandable. How to resolve such disagreements needs to be clarified in any final standard.

It may be difficult to avoid boilerplate language and ultimately, substantially increased liability if a firm fails to mention a CAM and then something blows up. Conversely, when CAM language hints at weakness or uncertainty, we may be entering a mine field because auditors may never identify all CAMs or necessarily the right ones – therefore, finding the right balance of general or broad statements is crucial.

While finding the right balance may be difficult, the way to avoid boilerplate-creep is to make the CAM requirement as entity-specific as possible. Also, CAMs should focus on the auditing versus the accounting. Finally, there should be resistance to simply cross-referencing to financial statement disclosures and thinking we have accomplished anything.

2. ***Reference explicit to the auditor’s responsibility to detect material error or fraud.***  
Although current audit performance standards require reasonable assurance that financial

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<sup>5</sup> Source: overview of comment letters prepared by the Center for Audit Quality as of January 8, 2014.

<sup>6</sup> AICPA *Code of Professional Conduct*, ET Section 301, Confidential Client Information,  
[http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/et\\_300.aspx#et\\_301](http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_300.aspx#et_301)

statements are free of material misstatement, whether due to error or fraud, the reporting is oddly silent on the matter. The ARM proposal fixes this omission and infers that the auditor also has a *duty to find* error or fraud. Although I wish the “duty to find” inference was clearer, I support this much needed change.

3. ***Disclosure of audit firm tenure.*** Long-term auditor-client relationships were discussed by ACAP at length but a specific recommendation was not made. There are many who deny tenure impacts independence and/or professional skepticism. I am not among them.<sup>7</sup>

I believe long-term client relationships can damage professional skepticism. Although firm rotation has been removed as a regulatory safeguard, professional skepticism is crucial to the audit process and must be continually nourished. While not a dynamic solution to the concerns, disclosure of tenure will at least let investors know the length of a client relationship and allow the investor-customer to decide for themselves. Therefore, I support disclosure of tenure and further, that it be included in the independence paragraph.

4. ***Assurance on other information accompanying the financial statements.*** For many years auditors have “checked” information such as *Management’s Discussion and Analysis* (MD&A) without clear performance or reporting standards, other than a weak requirement to “consider” the information.<sup>8</sup> It is now proposed that the auditor review, evaluate and report on other information accompanying the financial statements. A level of responsibility attaches to “evaluate” missing in the current “consider” approach.

There is a massive amount of information in SEC filings, much of which is not related to the financial statements. It would be helpful if the proposed ARM were more specific about which other information requires auditor attention. Those areas would seem to be those that have a nexus with the financials, e.g., *MD&A*, *Selected Financial Data*, *Management's Report on Internal Control Over Financial Reporting*, etc. The focus on these other information areas should be to make sure there are no material inconsistencies between it and financial statements.

In addition, with *all* other information, including the financial-related sections, the auditor should be required to report *if anything* comes to their attention that is *misleading*. This “eyes open” approach would also emphasize the importance of narrative statements that can exaggerate or omit material facts and circumstances. This would be more of a substance-over form approach versus a mechanical exercise focused on just ensuring that numerical amounts cross-reference or reconcile with the financials.

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<sup>7</sup> See my statement as a panelist at the PCAOB’s Public Meeting on *Firm Independence and Rotation*, October 18, 2012, Houston, TX, [http://pcaobus.org/Rules/Rulemaking/Docket037/ps\\_Hansen.pdf](http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Hansen.pdf)

<sup>8</sup> See PCAOB AU 550, *Other Information in Documents Containing Audited Financial Statements*.  
<http://pcaobus.org/Standards/Auditing/Pages/AU550.aspx>

5. **Identification of the audit engagement partner.** This was one of the more contentious issues debated by ACAP. A lot has already been said and written about this – everyone seems to have an opinion. I am in favor of partner signatures and believe it would deliver more accountability, but understand and can accept the ARM’s identification approach.
6. **Reference to independence in the body of the proposed report.** The proposed ARM would say the auditor is *required to be* independent. I question why this shouldn’t be taken one step further to affirmatively report that the firm *is actually* independent.

Here are some other thoughts and suggestions:

- A. **Independence (with respect to item No. 6 above).** Independence is an ethical matter, without which an audit is useless. However, independence is not the only ethics principle auditors must comply with. Objectivity and integrity are mandated as well as matters such as resolving conflicts of interest.<sup>9</sup> Competency, due professional care and professional skepticism are assumed. Prior to finalizing a standard, please consider incorporating some language to indicate the auditor has also complied with these “other relevant ethical requirements.”<sup>10</sup>
- B. **Other Information (beyond the scope of No. 4 above).** There is an increasing trend of market participants relying upon preliminary announcements such as forecasts, earnings guidance and releases, and operational data such as unit sales. And of course there are the ever present non-GAAP measures like EBITDA. This information and data drives many investment decisions; some would argue more so than the issuance of financial statements. Auditor responsibilities to public protection in this area, if any, should be considered.
- C. **Alignment of the PCAOB’s ARM with the IAASB’s Proposal.** Many observers are hoping the PCAOB and IAASB projects are converged as much as possible. To the extent this is possible it is probably desirable. However, in some instances there may be an advantage to distinguishing the differences. For example, while CAM is very similar to the IAASB’s key audit matters (KAM), there *are* distinctions. It is important that those distinctions are not overlooked. While a minor point, the use of differing acronyms may be useful in some cases.
- D. **Applicability to Audits of Emerging Growth Companies (EGC).** There is no reason EGCs should not be required to comply with the same ARM as non-EGCs. Due to their very nature, there is even more reason to scope EGCs into the Board’s proposal.

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<sup>9</sup> To remind, on April 16, 2003, the Board adopted interim ethics standards that include not only independence requirements but rulings on integrity and objectivity. See <http://pcaobus.org/Standards/EI/Pages/default.aspx>

<sup>10</sup> The IAASB’s draft model audit report frames the independence and ethics assertion this way: “We are independent under relevant ethical requirements and have fulfilled our *other ethical responsibilities* under those requirements...” [Italics added for emphasis]. See [https://www.ifac.org/sites/default/files/meetings/files/20140317-IAASB-Agenda\\_Item\\_4A-Auditor\\_Reporting-Remaining\\_Suggested\\_Improvements-final.pdf](https://www.ifac.org/sites/default/files/meetings/files/20140317-IAASB-Agenda_Item_4A-Auditor_Reporting-Remaining_Suggested_Improvements-final.pdf)

E. *Applicability to Broker-Dealer Financial Audits.* I support the applicability of the ARM proposal to broker dealer audits, except for the applicability of the CAM component. The benefits of CAM disclosures accrue primarily to investor-customer decisions, which would not be relevant in broker-dealer audits.

**FINAL THOUGHTS**

There is a clarion call from many quarters for greater auditor accountability and transparency. Other major players on the international scene are moving rapidly to require more informative auditor reports – with or without the U.S. in tow. The IAASB anticipates finalizing its reporting project in the second half of 2014. I am sure Professor Arnold Schilder, the IAASB Chairman, will enlighten us on the details later today. Their project incorporates many of the features the PCAOB is considering. The U.K. and the European Union have also moved forward with their reporting projects that will expand on auditor responsibilities.

The auditing profession has a long and storied history of excessive secrecy. At times it can even strain the imagination. My first four years in the profession were with a Big 8 firm in Los Angeles. The firm’s office was a large standalone, two-story, red brick building – *without a single window*. I was told the lack of a view emphasized confidentiality – outsiders would *never* know what was going on within those brick walls! On the other hand, we couldn’t see out. At the time it seemed normal, I knew nothing better. In retrospect it was just plain weird. There is an analogy here.

Today’s auditor’s reporting standard is akin to a windowless building lacking visual functionality. We can do better, and doing it is long overdue.

Respectfully submitted,

A handwritten signature in cursive script that reads "Gaylen R. Hansen". The signature is written in dark ink and is positioned at the bottom left of the page.