

Remarks of Kevin Reilly
Ernst & Young LLP
PCAOB Public Meeting on the Auditor's Reporting Model
Panel 5: Critical Audit Matters Related to the Audits of Large Companies
April 2, 2014

1. Good afternoon Chairman Doty and other members of the Public Company Accounting Oversight Board (PCAOB). My name is Kevin Reilly and I am the Americas Vice Chair of Professional Practice at Ernst & Young LLP. I am glad to be here today on behalf of my many partners and the thousands of professional staff members in our US audit practice working hard every day to execute quality audits.

2. I appreciate the opportunity to meet with you and share some perspectives on the PCAOB's Auditor Reporting Project, specifically as it relates to the topic of Critical Audit Matters (CAMs), and address the questions you may have in this important area.

3. My firm, and the profession more broadly through the work of the Center for Audit Quality (CAQ), has been supportive of exploring ways to improve the informational value of the auditor's report and we commend the Board (and the staff) for the many efforts on this front. We are also supportive of the concept of CAM disclosure in the audit report and believe this concept, if properly developed, could help investors and other financial statement users focus on aspects of the company's financial statements that were important or challenging in the audit. We are also supportive of the efforts of the International Auditing and Assurance Standards Board (IAASB) as it works through a similar project.

4. That being said, we do have a number of concerns with the CAM approach outlined in the PCAOB Proposing Release, in particular with how that approach has been applied/interpreted in developing the various CAM disclosure examples included in the proposal. My firm, and other CAQ member firms, have spent a great deal of time working through the Proposing Release, considering how certain aspects can be improved, while at the same time being mindful of the Board's overall objectives on this project. For example, relative to the issue of CAM identification, we have outlined a variety of suggestions that we believe will make this process better and more operational, most notably by adding another important filter into the CAM determination process-- that being those matters that were the subject of the most

interaction with the audit committee. In practice, CAMs typically tend to be those matters involving a greater level of audit committee discussion and interaction, and we believe this important filter should be added to the CAM identification process in any final standard. This filter would have the added value of responding to requests from some for further insights into auditor/audit committee communications. Our thoughts on this topic and suggestions for improvements in the CAM and other Proposing Release areas are outlined in comment letters from my firm, the CAQ and others in the profession, and we hope you have found these letters constructive.

5. Overall, we believe the biggest ticket concern on the CAM front revolves around the question "What should an auditor say about the CAM in the audit report?" The Proposing Release notes that the description of the CAM should identify the CAM, describe the considerations that led the auditor to conclude the matter is a CAM, and note where the matter is covered in the company's financial statements. We understand these objectives and think the general approach makes sense. However, we have significant concerns with how this framework has been applied in crafting the examples in the Proposing Release. While we fully appreciate that the Board wanted to stir the debate and purposefully intended these examples to be "provocative", I believe it is these examples that have led to the significant push back on the CAM proposal, for many good reasons, and have caused some to suggest we may want to "throw the baby out with the bath water".

6. The Board has heard the many concerns on this front: the auditor will be disclosing original information about the company, the CAM discussions will result in redundant, lengthy and unnecessarily repetitive disclosures, it's possible such disclosure could result in "dueling information" that might be confusing to investors, that such disclosures will increase litigation risks for both auditors and issuers, that a discussion of audit procedures in the CAM disclosure could lead to confusion over an auditor delivering a "piecemeal opinion" on a specific audit matter, and that the suggested language focused on difficulties and challenges faced by the auditor in a particular area could serve to undermine the company's accounting or reporting for that matter. Moreover, in our view, the example CAMs also take on, in certain respects,

some of the "free form" writing concerns that have been raised relative to the Auditor's Discussion & Analysis concept, which is an approach we have not supported.

7. While we share these concerns, we believe they can be addressed and the proposed approach improved. This will however require significant revision to, and clarification of, the manner in which the CAM disclosure concept is expected to be applied in practice. In this regard, we note the Proposing Release's example CAM disclosure on the deferred tax valuation allowance matter contains four paragraphs, runs for a page and a half, and uses the term "difficult" or "difficulty" a half dozen times. The example also highlights a number of very specific matters we thought would be a company disclosure area (such as the occurrence of an unexpected cost increase in an important component part that is expected to unfavorably impact future profitability) and also makes reference to various audit steps or actions (such as a consultation with others outside the engagement team) that we view as largely extraneous. In our view, this example (and the others included in the Proposing Release) illustrates well the reasons for the many concerns noted above.

8. We think the overall objective--to inform financial statement users of those matters that were truly important or challenging in the audit--can be met with a more pragmatic approach that (i) presents a very crisp, fact based outline of the issue that does not compete with the company's disclosures or reflect original information about the entity, (ii) outlines the *principal reason* (and not a checklist of any and all possible influences) why the auditor believes the matter is a CAM, and (iii) references where the matter is covered in the company's financial disclosures. For example, the CAM discussion on the deferred tax asset valuation matter could be streamlined to read, in three sentences, as follows:

Our assessment of the company's evaluation of the realizability of deferred tax assets, and the related determination of the valuation allowance required for such assets, was a critical audit matter in the audit of the company's financial statements. Deferred tax assets are material to the financial statements, the company's realizability assessment involves many complex and subjective judgments, including those used to prepare forecasts of future taxable income, and this was a challenging audit area. The company's

accounting policy for deferred taxes and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12.

We believe our proposed variation, while shorter and more “to the point”, would nonetheless be helpful to financial statement users, will meet the Board's objective of informing users of the matters viewed by the auditor to be most important or challenging to the audit, and will help address certain of the concerns raised by many relative to the examples reflected in the Proposing Release. To date, our efforts to field test the proposal have told us that audit teams tend to look to the examples to guide them on to how to apply the proposed standard. The many problems inherent in the existing examples have led to many concerns with the output from our field testing. If not addressed, we believe similar problems will exist in this area when a final standard is ultimately applied in practice.

9. I suspect one of the issues that will be kicked around over today and tomorrow's discussions is the term "boilerplate", and worries of some that prospective CAM disclosures could take on a standardized language format. We do not share this concern. We fully appreciate that some are calling for this project to drive audit report disclosure of special insights, views or impressions on a company's financial reporting. We think attempts to meet such objectives could lead to harmful consequences. In a more "free form" writing world, two different auditors could have different views or perspectives on similar fact patterns. The resulting diversity in what might be said, and how matters might be characterized in the two instances, could lead to misinterpretations by financial statement users. Expanded disclosures, such as those reflected in the Proposing Release's examples, will also very likely give rise to follow-on questions, which cannot be addressed without the existence of a two-way dialogue, and could require users to speculate on what the auditor might have meant in the disclosure. We believe this would be unhealthy. In contrast, we believe that a concise auditor articulation that is “to the point”, *even if such description is somewhat standardized*, will be helpful. In addition, we believe CAM identification in the audit report will help drive improved financial reporting in the identified area to the benefit of investors and other financial statement users.

10. I hope the Board understands our support for the CAM concept, the concerns raised in this important area and will take to heart the suggestions discussed above and the many others reflected in letters from my firm and others in the profession. We need to recognize and accept that no approach will be perfect, but the approach ultimately selected must be workable in practice. We support the CAM concept and would like to see it come to fruition. We believe the above suggestions, if embraced, will help make that happen. Thank you again for the opportunity to join today's panel and I look forward to questions you may have on this important topic.