CAQ
CENTER FOR
AUDIT QUALITY

The Role of Auditors in Company-Prepared Information: Present and Future

December 2019

About the Center for Audit Quality

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

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About This Publication

The pace of change in business is accelerating, and the volume of information available to investors and other stakeholders in the US financial reporting ecosystem continues to grow. Investors and others are using both audited financial statements and—increasingly—unaudited company-prepared information to make decisions.

This publication provides a foundational understanding of the current role of auditors in various types of company-prepared and publicly disclosed information. It also serves to assist audit committees and investors in understanding how auditors are positioned to help fill existing gaps in enhancing the reliability of decision-useful information by providing an independent assurance of data, processes, and controls related to some of the common types of public-facing company-prepared information beyond audited financial statements.

"Investors and other consumers of the financial statements are increasingly relying on information not subject to the audit."

J. Brown,
Board Member,
Public Company Accounting Oversight Board (PCAOB)
"Preventing Audit Extinction"
October 2019

The Landscape of Company-Prepared Information

Like our economy and capital markets, the nature and type of company-prepared information presented to the public is dynamic and has evolved over time. Investors and other stakeholders are looking for more and different information because traditional book value can be an incomplete measure of corporate value in today's economy. Today's companies create and measure value in ways that extend far beyond their property, plant, and equipment. This has led many companies to generate public-facing information beyond the traditional financial statements that are prepared in accordance with generally accepted accounting principles (GAAP) to position themselves to compete for capital.

As they compete for capital in the marketplace, more and more companies are eager to tell their value-creation story to investors and other stakeholders with information communicated outside of audited financial statements.

This growing amount of information can be overwhelming to participants in and observers of capital markets.

This publication explores the current landscape of company-prepared information, ways to evaluate information's usefulness, and the current role of auditors in building trust and confidence in information. The auditor's role, while critical, is focused primarily on historical financial statements. That role is well positioned to expand. The auditing profession has the capabilities to bring its expertise—building trust and confidence in information—into new areas to enhance the reliability of information in the capital markets.

While not an exhaustive list, some of the common types of public-facing, company-prepared information—and auditors' role in connection with that information—are summarized in the accompanying table on pages 4-5.

<table>
<tr><th>TYPES OF COMPANY-PREPARED INFORMATION</th><th>AUDITOR ROLE</th></tr>
<tr><td>Financial statements—The starting point for the financial information reported by companies

Internal control over financial reporting (ICFR)—Controls specifically designed to address risks related to financial reporting</td><td>As described in the section, Where Auditors Now Play a Strong Role in Capital Markets, the auditor's role is extensive in these areas.</td></tr>
<tr><td>Non-GAAP financial measures—Numerical measures of a company's historical or future financial performance, financial position, or cash flows that adjust GAAP amounts in some fashion. Common non-GAAP financial measures include, among others, earnings before interest, taxes, depreciation, and amortization (EBITDA); adjusted EBITDA; and adjusted earnings per share.</td><td rowspan="2">Professional standards require auditors to read the other information in documents containing the audited financial statements and consider whether such information or the manner of its presentation is materially inconsistent with information appearing in the audited financial statements or contains a material misstatement of fact.[1] Note, however, that even if the non-GAAP financial measures or KPIs are included in the same document as the financial statements, reading and considering information involves substantially less work than an audit. Further, these metrics are typically included in documents that do not contain audited financial statements, such as company earnings releases or analyst presentations. In those instances, the auditor has no responsibility for the information.</td></tr>
<tr><td>Key performance indicators (KPIs)—Financial and nonfinancial performance measures that do not meet the definition set by the Securities and Exchange Commission (SEC) for a non-GAAP financial measure. KPIs can be data points such as number of stores, number of customers, or measures calculated using a GAAP amount and a data point (e.g., sales per square foot).</td></tr>
<tr><td>Sustainability reporting and environmental, social, and governance (ESG) information—Provides stakeholders with information about the impact of the company's activities on ESG matters and how the company is addressing that impact</td><td>Auditor involvement is not required in this area. Sustainability reports and ESG metrics are often included in areas of a company's reporting that do not contain the audited financial statements. In those instances, the auditor has no responsibility for the information. While a small percentage of companies engage auditors to provide assurance on certain metrics, there is an opportunity for the role of auditors to evolve to provide additional trust and confidence to investors and other users.

The American Institute of CPAs (AICPA) published a guide, Attestation Engagements on Sustainability Information, to assist auditors engaged to perform an examination or review engagement of a company's sustainability information.[2]</td></tr>
</table>

1 See PCAOB Auditing Standard 2710: *Other Information in Documents Containing Audited Financial Statements*.

2 For more information, see the AICPA's Sustainability Resources page.

TYPES OF COMPANY-PREPARED INFORMATION	AUDITOR ROLE
Cybersecurity reporting outside of the audited financial statements or documents containing the audited financial statements[3]—*Provides stakeholders with information about a company's cybersecurity risk management program*	*Auditor involvement is* ***not required*** *in this area but could evolve to provide additional trust and confidence to investors and other users.* *The AICPA has developed a cybersecurity risk management reporting framework,* SOC for Cybersecurity.[4] *Organizations can use the framework to communicate pertinent information regarding their cybersecurity risk management efforts and educate stakeholders about the systems, processes, and controls they have in place to detect, prevent, and respond to breaches. The reporting framework also enables an auditor to examine and report on management-prepared cybersecurity information.*
Other communications about value creation outside of audited financial statements or documents containing audited financial statements—*Provides stakeholders with information about how the company is creating and measuring value.*	*Auditor involvement is* ***not required*** *in these other communications. Similar to the other types of company-prepared information discussed in this section, the auditors' role could evolve to provide additional trust and confidence to investors and other users.*

3 See the *CPA's Role in Addressing Cybersecurity Risk* for more information on the financial statement auditor's responsibility for cybersecurity as it relates to the audit of the financial statements.

4 See *SOC for Cybersecurity: A Backgrounder*.

Characteristics of Decision-Useful Information

Companies prepare and present information about their business so that investors and other stakeholders can make well-informed decisions about their financial health and prospects. While the bedrock of the capital market system is high-quality, reliable financial statements, investors and other stakeholders also may look to different types of company-prepared information, in addition to financial statements, to help inform their decisions. As such, companies see the benefit of providing information about performance and value creation from different perspectives to meet the needs of different stakeholders.

Moreover, technology and data have given rise to entirely new business models and company structures, with much of the value of companies being driven by information outside of audited financial statements. Stakeholders, including certain institutional investors, increasingly are interested in—and rely on—unaudited information when assessing a company's value.

While the type of information investors and other stakeholders rely on or desire may vary depending on the stakeholder and context, there is nonetheless a strong demand for information outside of audited financial statements that is useful for capital allocation and governance decisions.

The following characteristics all contribute to making information decision-useful:

+ **Reliability:** Trust and confidence in the information companies disclose is essential to a healthy economy. An independent assessment of that information can contribute to its reliability. Auditors specialize in independently assessing the fair presentation of company-prepared financial statements in accordance with GAAP. As an example, in the early 2000s, visibility to investors and the markets related to the effectiveness of a company's ICFR was limited. To provide more transparency, Congress passed the Sarbanes-Oxley Act, which requires company management to provide an assertion about the effectiveness of the company's ICFR. The Sarbanes-Oxley Act also requires the company's independent auditor to attest to and report on management's assertion regarding the effectiveness of ICFR. Studies have shown that the focus on ICFR—by both management and auditors—has had a positive impact on both financial reporting and audit quality.[5] As noted, however, not all information disclosed by companies is supported by such external assurance.

+ **Comparability:** When companies present information in accordance with a common framework, investors' ability to make comparisons between companies is enhanced. For example, financial statements prepared in accordance with US GAAP are comparable because they are prepared using the same accounting framework. Another way to enhance comparability is for companies to be transparent about how they measure the value they are creating for their stakeholders. While financial statements are one way to communicate value, companies may tailor information beyond the financial statements to make it more relevant to their facts and circumstances. When companies provide clarity on how they are creating value by disclosing what is being measured, how it is being measured, how it is going to be used, and whether there is independent assurance over the information, this transparency allows for comparisons among companies with similar discipline. Understanding whether and how information is comparable to another company's information is important in evaluating how it can be used to inform investment decisions. Investors can make their own adjustments to make information more comparable when companies include transparent disclosure.

+ **Relevance:** Comparability and consistency in the presentation of information can contribute to the relevance of that information. Timeliness also plays an important part in making information relevant to decision making. Earnings releases typically occur before audited or reviewed financial statements are released, and investor decision making often occurs soon after earnings releases are published. For example, 84 percent of respondents to a recent CFA Institute survey stated that investors heavily rely on earnings releases because they are generally released before quarterly reports.[6] Moreover, more than half the respondents to the same survey noted that they consider ESG disclosures when making investment decisions.

When using information to make decisions, it is important to consider reliability, comparability, and relevance in evaluating insights drawn from that information.

5 See the CAQ's and Professor Susan Scholz's *Financial Restatement Trends in the United States 2003-2012*.

6 See CFA Institute's *The Case for Quarterly and Environmental, Social, and Governance Reporting*.

Auditors' Role: Building Trust and Confidence in Information

Auditors build trust and confidence in information through the assurance services they provide.

Assurance may mean different things to different people. Many companies informally use the terms *assurance*, *comfort*, *certification*, *verification*, *opinion*, *compliance*, and even *audit* interchangeably—but they do not mean the same thing. Assurance by CPAs involves the testing of processes, systems, and data, as appropriate, and then assessing the findings in order to support an assurance opinion based on an examination (e.g., "In our opinion, A is presented in accordance with [or based on B, in all material respects.") or an assurance conclusion based on a review (e.g., "We are not aware of any material modifications that should be made to A in order for it to be in accordance with [or based on] B.").

In short, an audit report in this context is designed to enhance the reliability of that information for the intended users of that assurance report by providing an objective and impartial assessment of the assertions, data, and other disclosures by management.

The auditing profession has steadily developed, systemized, and strengthened this trust and confidence-building role for over a century. It has done so in large part thanks to the following:

+ **Powerful principles:** Independence, objectivity, and skepticism are core CPA principles. These fundamental principles, an overarching commitment to continuous quality improvement, and an obligation to protect the public interest all guide the judgment and performance of auditors.
+ **Technical expertise:** Auditors must meet stringent professional requirements, including continuous technical training to perform an audit or attestation engagement.
+ **Professional standards:** Personnel working on an audit or attestation engagement must also abide by any relevant professional standards in the planning and performance of the engagement and the preparation of the report.
+ **Robust regulatory oversight:** Accounting firms operate under a sturdy framework of regulations

and standards, and the profession engages constructively with its regulators, notably the SEC and the PCAOB, as well as standard-setters such as the AICPA.

Building on this foundation, auditors also call on a range of deeply ingrained skills as they help build trust and confidence in information. These skills include:

+ understanding the business, the industry, market forces, and why certain metrics are important financially;

+ identifying and responding to risks; and

+ performing a variety of techniques and procedures to obtain evidence, including incorporating the appropriate specialists.

Where Auditors Now Play a Strong Role in Capital Markets

Investors, lenders, and other users of audited financial statements can more confidently use this information because auditors have provided an independent perspective. This assessment, in other words, builds trust and confidence. Without that trust and confidence, market volatility would likely increase, investors and lenders would likely charge a higher cost of capital for their risk, and fewer funds would be available to fuel business investment and growth. Consistent, reliable, and comparable financial statements underpin robust capital markets.

Traditional public company financial statements consist of the following:

+ Balance sheet
+ Statement of income
+ Statement of comprehensive income
+ Statement of equity
+ Statement of cash flow
+ Accompanying notes

> "The bedrock of this capital market system is high-quality, reliable financial statements. This is indisputable. Without high-quality and reliable financial information, capital markets do not function well."

Joint SEC/PCAOB Statement "The Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally" December 2018

Typically, companies in the United States prepare financial statements in accordance with US GAAP. Auditors conduct an audit to obtain sufficient appropriate evidence to obtain reasonable assurance as to whether management has prepared financial statements that are fairly presented in accordance with US GAAP in all material respects.

Auditors then issue an opinion as to whether the financial statements present fairly—in all material respects—that the financial position, results of operations, and cash flows of the company are in conformity with US GAAP.

Audits have a positive effect on companies by serving as guardrails for management on accounting financial reporting practices. Auditors also provide an independent perspective and resource for audit committees in their role in the financial reporting process. Before an audit opinion is issued, auditors spend countless hours evaluating the design and effectiveness of the company's internal controls and identifying potential issues in financial statements. As a result of this interaction and dialogue, companies improve their financial processes and controls, remedying issues before they become major financial concerns. This behind-the-scenes scrutiny also bolsters a culture of professionalism, discipline, and accountability within public companies.

The US system of financial reporting has a track record of success. Financial restatements have trended down since 2010, as has the magnitude of what gets corrected.[7] Meanwhile, levels of investor confidence have stayed healthy. In fact, nearly three-quarters of retail investors in a 2019 survey expressed confidence in US capital markets,[8] which is consistent with past years. When audit failures occur, they are investigated and addressed, with the lessons learned incorporated into the cycle of continuous improvement.

7 See Audit Analytics' *2018 Financial Restatements Review.*
8 See the CAQ's *Main Street Investor Survey*.

Where Auditors Could Play a Greater Role in Company-Prepared Information

While auditors will continue the essential work of auditing historical financial statements, they could also bring their ability to enhance trust and confidence in other types of data and information issued by companies. Investors and others are increasingly focused on how companies measure the value they are creating for their shareholders and stakeholders. While some of these measurements are contained within financial statements, others exist beyond financial statements in other company-prepared information about value creation. In communications about value creation, it is important that there is clarity regarding what companies are measuring, quality in the preparation of the measurements, and good oversight of the process. Also critical for investors and others to understand is whether the information has the level of trust and confidence that is brought by an independent perspective. Having auditors associated with this information brings discipline to management's process and helps minimize the chances of misunderstanding, mistakes, or challenge. Auditor association signals to stakeholders the importance of the information being reported.

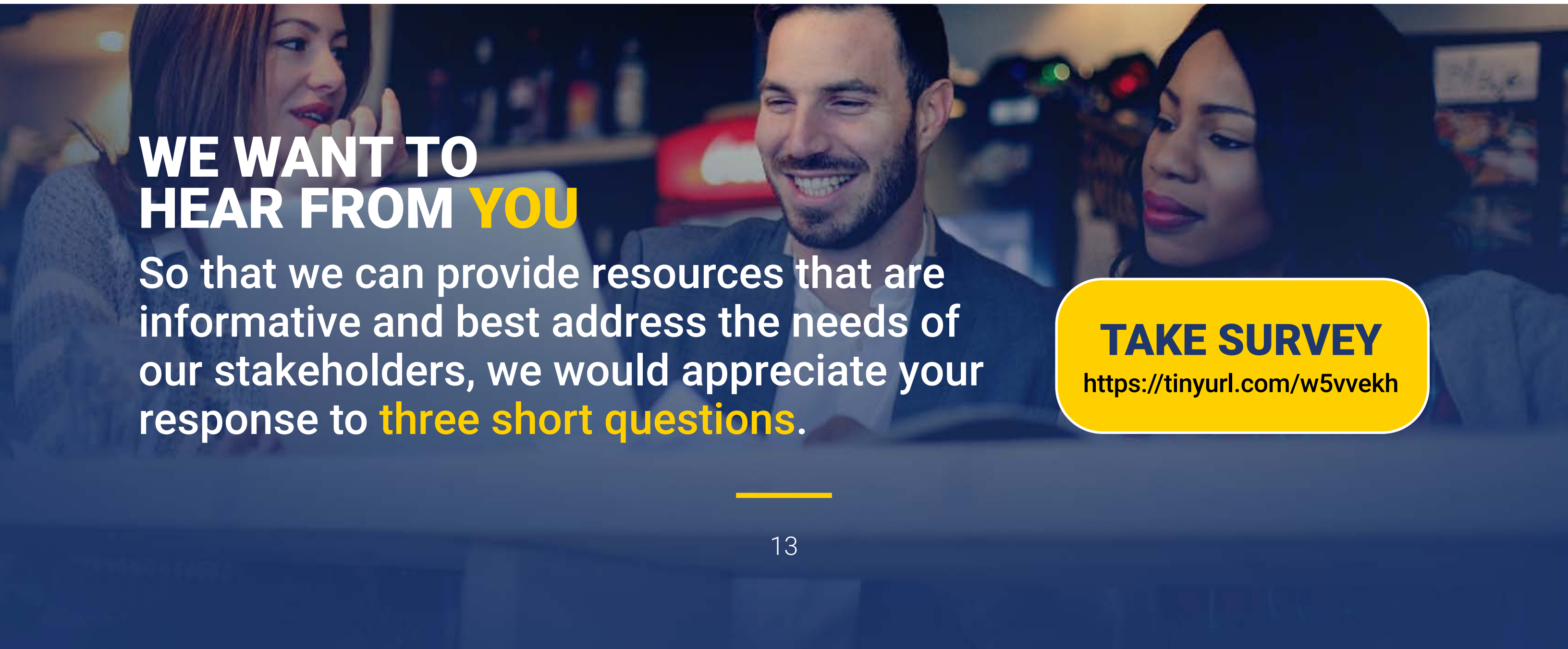
According to EY's global survey of 220 institutional investors in 2018, 97 percent of institutional investors said that they conduct an evaluation of a target company's nonfinancial disclosures and that the evaluation frequently impacts investment decisions.[9]

9 See EY, *Is Your Nonfinancial Performance Revealing the True Value of Your Business to Investors?*

Conclusion

The information prepared and presented by companies, like the capital markets it supports, never ceases to evolve. Auditors have been a part of this evolution and will continue to play an expanding role as they apply their values, experience, and talent to emerging forms of company-prepared information.

While the landscape of company-prepared information and related challenges may shift, the fundamental objective for auditors does not change: building trust and confidence for the benefit of our economy and markets.



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