Perspectives on Corporate Reporting, the Audit, and Regulatory Environment:

Institutional Investor Research Findings

November 2023

KRC RESEARCH

CAQ

About KRC Research

KRC Research is a global opinion research and insights consultancy that specializes in designing research to support effective public affairs, advocacy, engagement and communications initiatives. For over 30 years, we have helped nonprofits, governments, and corporations execute on their strategic imperatives and meet their organizational goals.

Our team draws from the worlds of global health, consumer and social marketing, journalism and academia, and public policy arenas. Not only are we passionate about the work we do for clients, but we also pride ourselves on being flexible, practical, creative, and knowledgeable, combining sophisticated research tools with real-world intelligence and communications experience.

We understand the needs and challenges of diverse target audiences and complex objectives. This breadth of experience and depth of knowledge positions KRC to deliver the highest quality insights needed to inform your organization's most pressing strategic decisions.

About the Center for Audit Quality

The Center for Audit Quality (CAQ) is a nonpartisan public policy organization serving as the voice of U.S. public company auditors and matters related to the audits of public companies. The CAQ promotes high-quality performance by U.S. public company auditors; convenes capital market stakeholders to advance the discussion of critical issues affecting audit quality, U.S. public company reporting, and investor trust in the capital markets; and using independent research and analyses, champions policies and standards that bolster and support the effectiveness and responsiveness of U.S. public company auditors and audits to dynamic market conditions.

Contents

Introduction

Data underpins our capital markets, providing investors with valuable information to use when making capital allocation decisions. For capital markets to operate effectively, the information driving investor decision-making needs to be accurate, transparent, and reliable.

This research was commissioned to understand how institutional investors perceive the state of corporate reporting and what they are looking for when it comes to existing and emerging types and sources of information.

Objectives & Methodology

OBJECTIVES

In an effort to engage capital market stakeholders and better understand their information expectations, the CAQ commissioned KRC Research to conduct qualitative research with institutional investors whose portfolio consists primarily of equities in North America, working in a range of investment settings from family offices to pensions and large banks. The research was primarily designed to:

+ Understand what information institutional investors seek regarding public company auditing and the audit process, and
+ Explore attitudes toward potential standards and regulations related to additional reporting or audit requirements.

METHODOLOGY

In September and October of 2023, KRC conducted in-depth interviews with 38 institutional investors in two formats:

+ Small group discussions with 3 to 4 institutional investors working at companies with a minimum of $500M in assets under management.
+ Individual interviews (IDIs) with institutional investors working at companies with a minimum of $500M in assets under management. Most worked at firms with over $1 billion in AUM and some with $1 trillion or more.

Investors were screened to ensure they were portfolio managers or investment analysts at buy side firms or research directors and similar job roles at sell side firms. The investors included a mix of buy-side and sell-side investors in both the triads and the IDIs.

Key Findings

- Institutional investors have an overall positive view of corporate reporting in the U.S., believing that the system of checks-and-balances delivers reliable information

- Many institutional investors continue to focus on revenue and risk as top areas of information need, with cybersecurity risks increasing in importance

- Investors seek more information on communication between auditors and audit committees

- In emerging areas of reporting investors desire greater consistency in reporting standards

- Investors support modernized regulations that balance the value of information with the cost of collecting the information

Detailed Findings

Financial Reporting and Other Disclosures

FINANCIAL REPORTING/RISK DISCLOSURES

Unsurprisingly, factors tied to the long-term valuation of a company are seen as most useful by investors. In addition to revenue growth, sources of revenues and expenses, and revenue projections, investors cite general financial risks as a significant focal point in their research.

Top risk factors cited by investors include:

+ Liabilities and debt
+ Competition/market conditions
+ Regulatory compliance and litigation
+ Corporate leadership
+ Geopolitical instability
+ Cybersecurity

While investors rely on 10Ks as a useful source of information, they also note the proliferation of "boilerplate" information that is commonly used and so detailed as to make identifying the most important risk factors difficult. Within the Form 10K, investors indicated that MD&A (Management Discussion and Analysis) can be helpful because it outlines the company's financial condition while also discussing risk factors associated with the company's financial health.

CYBERSECURITY

In the face of the SEC implementing rules requiring disclosure of a public company's cybersecurity risk management, strategy, and governance and material incidents, many investors cite cybersecurity threats as a source of increasing focus in their analysis. All investors identified cybersecurity risk assessment as a very important element in their analysis, particularly for financial institutions, retailers, and other companies that collect personal information from consumers because the financial and reputational damage of a cybersecurity breach can be extremely significant. There are several elements of a company's cyber strategy that investors say they are interested in:

+ Past breaches and the consequence of those breaches
+ Handling of prior breaches and steps taken to protect against future breaches

> "I get a lot of value out of audited financial statements like balance sheets, income statements, and cash flow statements. You can tell a lot about how a company is positioned by looking at the most recently available results and then year-over-year trends.
>
> **Chief Investment Officer, Pension Fund (Buy-Side)**

+ Disaster recovery plan

+ Budget on cybersecurity and risk management

+ Insurance coverage for losses resulting from a breach

COMMUNICATIONS BETWEEN AUDITORS AND THE AUDIT COMMITTEE

Existing rules require the auditor to communicate with the company's audit committee regarding certain matters related to the audit, though investors show an interest in learning more about these communications through disclosures. When considering communications between audit committees and the external auditor, investors prioritized:

+ Discussions of uncorrected and corrected misstatements to gain insights into materiality and how management approaches preventing a recurrence

+ Audit committee awareness of certain matters relevant to the audit, including, but not limited to, material violations or possible violations of laws or regulations

+ Audit strategy overview, including the timing of the audit, and discussion of the significant risks identified during the auditor's risk assessment procedures

ESG

Environmental, social, and governance (ESG), taken as a whole, continues to be a source of concern for investors. Investors noted, among other things, the lack of clearly established methodologies and metrics for evaluating ESG. Many institutional investors in this study view ESG as a problematic metric to rate companies on for several reasons:

+ Breadth of topics covered in "ESG"

+ Lack of established metrics to evaluate

+ Concerns about greenwashing

+ Low confidence in third party ESG ratings

Governance was perceived as the most essential element of ESG as it incorporates many factors beyond the accurate reporting of financial statements including the responsibility to protect shareholder interests, and establishing values and ethical business practices. As a result, governance in some ways incorporates a company's overall approach to other ESG components as well. Further, governance is seen by investors as much easier to measure or evaluate than environmental and social elements.

> "I would say that ESG is still a little immature at this point, and I think the statements are intentionally maybe a little bit vague because once you get a statistic or something, then you go after it and you can do the proof of the finding, right?
>
> **Senior VP, Risk Management, Commercial Bank (Sell-Side)**

Audit Quality

PERSPECTIVES ON AUDIT QUALITY

Investors expressed trust in the audited financial statements, with many taking the audit at face value because of the system of checks-and-balances in corporate reporting as well as the reputation of public accounting firms. To the extent there was interest in additional insights regarding the audit process, investors cited the planning stage where risks or vulnerabilities in financial reporting are identified.

When investors were asked how they evaluate the quality of an audit, almost all pointed to the audit firm conducting the audit. They indicated audit firm name/reputation, years of engagement, and the people/technology resources the firm can bring to the audit process as criteria for audit quality. Many felt that the reputation and economic risks of poor performance are much higher for larger accounting firms, giving them a greater incentive to ensure audit quality. Others trust public accounting firms based on their perception that the audit procedures are clearly defined and regulated, they have established protocols in place, and any irregularities are more likely to become public due to firm visibility/publicity. Some investors indicated that the audit process is standardized and therefore quality is equalized amongst firms regardless of size.

AUDIT QUALITY REPORTS

In discussions with the investors, most were either unfamiliar or unaware of audit quality reports published by public accounting firms. In discussing these reports, investors suggested the most useful information to them includes:

+ **Use of technology.** How public accounting firms use technology, such as AI, is seen as important because of its impact on auditing in the future.

+ **Number of restatements.** The number or restatements associated with an audit firm would signal the overall quality of the firm, its methods, and the quality of its audits.

+ **Audit firm inspections/reviews.** Audit firm inspection results can provide an indication of the quality of the firm and its audits.

“

Unless there's been something broadcast in the news that's going to open my eyes to something, I am going to take [the audit] very much at face value.

SVP Equity Research Analyst, Investment Bank (Sell-Side)

“

Whenever I get an audit report… it's not something that would compel me to either challenge or affirm that I'm dealing with a good audit. Sometimes you need to take these things at face value.

SVP Investment Analyst, Asset Management Firm (Buy-Side)

“

The reputation of the firm matters. If it's somebody I haven't heard of, I'm probably going to [conduct some background research] and that's probably something to be a little more concerned about if it's not one of the more reputable firms.

Portfolio manager and Senior Analyst, Insurance Company (Buy-Side)

AUDIT PERFORMANCE METRICS

While most investors expressed confidence in audit quality, a majority indicated that some metrics related to the expertise and knowledge of the audit team could be useful, such as:

+ Audit lead engagement partner background
+ Audit engagement team tenure
+ Specialist experience level or related information

Engagement level metrics are of greater interest because they are specifically about the audit of a specific company, and these are also metrics that are more objective and measurable according to investors. In particular, audit team experience and years on the engagement are most frequently cited as points of interest because these are associated with the people "on the ground" who are doing the audit.

This area may get more attention as regulators may propose standards related to firm and/or engagement level metrics as additional sources of information for investors and other stakeholders.

PCAOB INSPECTIONS

Most investors had knowledge of the regulatory bodies – particularly the SEC and PCAOB – that have oversight and enforcement authority to corporate reporting matters. However, most investors are not familiar with specific activities and resources available to investors and some expressed skepticism about their value. For instance, most investors were unaware of PCAOB inspection reports and, to the extent they were aware, found the report results to be expected. Only one out of all interviewees cited ever reading a PCAOB inspection report, and most expressed little inclination to do so.

Although investors acknowledged audit deficiencies are an issue to monitor, for a subgroup of investors, the lack of restatements resulting from inspections signaled to them that the deficiencies were not material and thus alleviated concerns. Several investors said they would be surprised if no deficiencies were found given the complexity of the audit and the number of decisions that an audit team must make. Investors raised questions about details of the inspection process, such as firms inspected, datasets reviewed, issuers covered by inspections, and risk factors considered by the PCAOB.

> These firm level [metrics] would be quickly manipulated...it would be interesting, but I would imagine over the medium term it would stop being useful. The engagement level quality metrics, I think, that would be more interesting.
>
> **SVP Equity Research Analyst, Investment Bank (Sell-Side)**

> I don't go and read the audits of the auditors. If there were no restatements, the deficiencies are probably technicalities and not material.
>
> **Director of Investments, Family Office (Buy-Side)**

> [If there were no material restatements], that itself is saying deficiencies [in the audit] were not material or were not significant enough to cause a restatement... It's just that the document gathering was inefficient and it doesn't really matter at that end of it.
>
> **VP Risk Management, Commercial Bank (Sell-Side)**

Standard Setting Environment

GOING CONCERN

Although standard setters are considering going concern standards, when investors were asked what new requirements for going concern assessments would be helpful, if any, there were mixed views. Most investors found the current requirements to be acceptable. However, some investors desired information about auditor concerns related to the business as a going concern, even if management satisfactorily addresses the auditor's concerns. That way, investors can make their own determination on the issue with both the auditor's initial point of view and management's point of view considered.

Other investors felt that if management satisfactorily addresses the auditor's concerns, those concerns should not be revealed because it could be unfairly detrimental to the company, placing trust in the auditor's assessment of management's response.

NOCLAR

The PCAOB received over 100 comment letters in response to its proposed amendments to its standard on a company's noncompliance with laws and regulations (NOCLAR). The NOCLAR proposal garnered the attention of a diverse group of stakeholders and the level of attention was uncommon. In our research, investors support the disclosure of material noncompliance with laws and regulations, but – like inspection deficiencies that do not result in a restatement – question the utility of gathering such large amounts of data if there is no material effect on financial statements.

Of those in favor of the proposal, some investors qualified their response, wanting more information on the practicality and unintentional consequences of implementation such as the burden it would place on companies and auditors, the costs associated with implementation of the standard, and achievability. A few investors noted that the proposal did not provide enough detail on its impact on the audit process and costs to fully evaluate. Some investors voiced opposition to the proposal, raising concerns about the practicability of gathering the data, appropriateness of the role of the auditor in conducting legal analysis, and value of the information if it is not material.

> [On going concern], I think an auditor's negative assessment, even if adequately addressed by management, should be disclosed so investors can make the assessment themselves...
>
> **Portfolio Manager, Hedge Fund (Buy-Side)**

> I'm not sure how practical [the proposed NOCLAR standard] would be. I'm just trying to imagine, if I was an auditor, how would I even do this... knowing that laws are always changing and are dynamic? That sounds like a very tall ask...I don't know in practicality whether I even believe an auditor can achieve this.
>
> **Investment Analyst, Asset Management (Buy-Side)**

> In general, [the proposed NOCLAR standard is] probably a good thing but reading this it's hard to tell because it says under the proposed standard the auditor would be required to identify all laws and regulations with which noncompliance could reasonably have a material effect on financial statements. Is this saying that they're expecting an auditor to identify every law in the world that could impact this company? That just sounds absurd. If there's no reason to think that there's any kind of violation of any specific law, it just sounds like a massive waste of time with no benefit.
>
> **Portfolio Manager, Hedge Fund (Buy-Side)**

KRC RESEARCH

www.krcresearch.com

CAQ

www.thecaq.org

We welcome your feedback!

Please send your comments or questions to info@thecaq.org