Dr. Mark Peecher: Good afternoon and welcome to today’s Deloitte Fireside Chat, broadcast live on www.sechistorical.org. I am Dr. Mark Peecher, Professor of Accountancy at the University of Illinois at Urbana-Champaign, and moderator for today’s program.

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Through its virtual museum and archive at www.sechistorical.org the SEC Historical Society shares, preserves, and advances knowledge of the history of financial regulation. The virtual museum and archive is the premier, trusted, and permanent online resource of financial regulatory history and now welcomes more than 5,000 visitors a day. Both the museum and the Society are independent of and separate from the U.S. Securities and Exchange Commission, and receive no funding from the public sector. The Society is grateful for the generous and sustained support of Deloitte LLP in helping make the Deloitte Fireside Chats possible.

Today’s broadcast is the tenth in the series that began in 2009 to address current issues in financial regulation of interest to the accounting and auditing professions. All past broadcasts, ranging from preventing and detecting financial reporting fraud to the role of professional judgment, are available in the Deloitte Fireside Chat section under Programs in the virtual museum and archive. I actually had the privilege of moderating past chats on the role of the auditor and on the profession’s look at the Sarbanes-Oxley Act. I am happy to share that more than 17,000 visitors to the virtual museum and archive have accessed one or more of these chats during or since broadcast. I am encouraging those joining with us today to check out the Deloitte Fireside Chat section at the conclusion of the broadcast. The series will be well worth your time.

For today’s tenth Deloitte Fireside Chat, we will be looking at financial reporting, examining the past and present models, and looking ahead to the future. I am joined today by J. Michael Cook and Joseph Ucuzoglu.

Mike is former Chairman and CEO of Deloitte LLP, and the former Chairman and President of the Financial Accounting Foundation. He has been active on corporate boards and can share his thoughts on both his practitioner experiences and board experiences.

Joe is National Managing Partner for Government Regulatory and Professional Matters for Deloitte LLP. He is a former Senior Advisor and Professional Accounting Fellow in the SEC
Office of the Chief Accountant. Joe is also a member of the SEC Historical Society’s Board of Advisors.

Let me begin by asking a question, maybe teeing off to Mike, about what do you see the differences between broadly financial reporting and financial reporting as it relates to the filing of statutory financial statement audits with an organization like the SEC?

J. Michael Cook: I will start with the background of the regulatory financial reporting; it’s been with us for a long time. We have had the 10-K for almost eighty years, almost the length of the time that we’ve had the SEC, kind of before my time. We had a 9-K which was a semi-annual filing, and then in about 1970 that was replaced by the 10-Q. We’ve had quarterly reporting for close to 50 years as well. That has been pretty much the norm. The 8-K has been there throughout the period, the timing of filing of 8-K and the content of 8-K has changed over time and now we have a relatively timely, almost immediate filing of certain information when events take place that require 8-K reporting.

The 10-K and 10-Qs, as I said, have been with us for quite a long time. There have been changes and updates, but they have not changed dramatically from a regulatory standpoint during that period. When you step back and think about how much has changed in just 10 years or 20 years, say nothing of 35 or 40 years, the speed of communication, the form of communication has changed very dramatically and some would ask whether the regulatory requirements have kept pace with those changes. People at the SEC are asking those questions of themselves and challenging it. For me and my perspective here as principally an audit committee chairman of large public companies, financial reporting today is based on financial statements, and to some extent based on regulatory filings. But it is much more than that, financial reporting is a continuous process, a continuous flow of information to investors for decision making. Few companies might even today be reporting more frequently than quarterly, but for most companies today the crux of their public financial reporting is driven by the quarterly process.

The earnings release, the communications that they have with analysts, the analyst phone calls, the releases that they put out. Those always take place prior to the regulatory filings, and sometimes quite a bit before the regulatory filing. The driving force in my experience of late at least is that the earnings release process on a quarterly basis is the information that investors are getting and using to make investment decisions. The foundation of all of this is GAAP-based regulatory filings, but I illustrate their role in talking to folks about the financial reporting process by asking them to visualize the financial reporting train. The engine of the train in my experience and I think many others today is the quarterly communication, the timely communication by management to investors. Audit committees are engaged in that part of the process through their oversight role, and auditors are in my experience generally associated with the quarterly information on a timely basis, but not always.

Annual financial statements, the annual audit, perhaps sadly but nonetheless, the annual financial statements and the annual audit in my experience are in the caboose of the financial reporting train, approaching obsolescence as vehicles to communicate with investors. They fulfill a function with respect to compliance, fulfill a function with respect to stewardship, but
people are really not using the annual financial statements which will be issued next February or March to make investment decisions in the marketplace today. They need timely information. There’s a possibility that the annual audit, the annual financial statements will disclose something that has not previously reached the marketplace and therefore might cause the market to move at the time that they are issued, but rarely is that the case. The important information that people are making decisions on are flowing to the marketplace much more on a timely basis. It is the question first of timing, in the financial markets that we have today with the volume of activity, with the decisions that are being made every day, even a quarterly report is challenged in terms of its effectiveness from a timeliness standpoint, but annual is a period of time that just doesn’t make sense for the investing public other than to compartmentalize a few things for annual assessment.

The second issue around this which is evolving and changing and expanding in my experience is content of financial information. GAAP-based annual financial statements are usually not, or often not, adequate to meet the information needs of people to make investment decisions. Hence you have a proliferation of non-GAAP information of various kinds which is necessary for management and companies to communicate to their shareholders the things the shareholders need to know to be able to judge the performance of the company and project from their assessment of that performance future cash flows; the things that financial information is supposed to achieve. You have different kinds of non-GAAP information. You have information which is derived from the GAAP financial statements but is adjusted in numerous ways to try to portray what people call core earnings as opposed to traditional net income and traditional earnings per share. Then many companies will have non-GAAP metrics to measure their performance, things like operating cash flow, or EBITDA, or free cash flow, things of that kind which are more meaningful to investors to understand this company and how this company is performing than traditional net income and earnings per share.

Also, add onto that, and this may be to some people’s mind outside the financial reporting scheme, but it’s part of the overall process, is business performance information. Some is financial, a lot is not financial and it is critical for this information to be communicated for people to understand again how the business is performing, not just the numbers but customer information and market share information and other things of that type which are essential to overall financial reporting.

I’ve got the financial reporting engine, I’ve got the quarterly process up there, with the audit committee hopefully up there with them and the auditors dropping by at least regularly to ride in the engine. The question for the discussion today is where are the regulators? Where are the regulatory processes? I would suggest for the most part they are in the caboose or they’re close to it. So is the PCAOB, not entirely by their choice, because they have a legislative mandate from the Sarbanes-Oxley Act which relates to annual audits of annual financial statements of registrants. They don’t have a mandate that pertains to timely reporting, they don’t have a mandate that pertains to non-GAAP information. The places where they are focusing their attention are part of what I would suggest is becoming increasing less important to the investing community. The SEC pays attention to quarterly results, they pay attention to earning releases and non-GAAP information, but in a very high level broad way through things such as Reg FD and Regulation G and 10(b)-5 and so on, but the principal focus of the SEC in my experience
continues to be on the annual reporting process. They thoroughly review 10-K’s and that may be quite valuable in the overall scheme of things, but where are the review processes that relate to the 10-Q’s? Where are the review processes that relate to earnings releases and non-GAAP information? The things that are more important to investors are not part of that review process or certainly not to the extent of the annual compliance based financial report. FASB is not a regulator per se, but a standard setter, for the most part is focused on the annual financial statements and the annual report. I would probably have them mostly in the caboose with the others, or close to it. But, there are some signs of recent movement perhaps to alter things in the presentation in the income statement that might say there is a sensitivity to GAAP not getting the job done in terms of being able to communicate to investors, but a need to report things differently within the income statement to separate out non-recurring or non-essential items from the core operations. One of the advantages of that, of course would bring it into the entire system where the audit and assurance processes would apply to that as well.

My friends the auditors, and I’ll let Joe speak to this, where are they? I think in reality in my experience, they are very often up in the engine. They are working on a continuous basis with the company, particularly large companies, they are involved in quarterly financial reporting, they are giving assurance to audit committees, not externally but to audit committees, about the reliability of quarterly financial reporting. I think that is where great value is being added. Unfortunately to the investor community, to the public, they’re back in the caboose because nobody ever hears from them except for the one time a year, and I am smiling at Joe when I jokingly say this, is a day close to Groundhog Day where the auditors emerge for one day, express their opinion on the financial statements and return to their former location not to be heard from again for approximately another year.

There’s a lot more going on in the audit process, there’s a lot more value being added than can be expressed in a once a year one day communication focused on an annual period of time. I think there is value opportunity here for everybody but that assurance they provide needs to be timely. We can talk a little bit about the future, I don’t have a very clear view of the future but when I think back I couldn’t have predicted how financial information would flow today, five or ten years ago to say nothing of 25 or 30 years ago, how rapid it is, the forms in which it comes. Maybe we can talk about that a little bit as we get into crystal-ball'ing the future.

**Dr. Mark Peecher:** Absolutely. There are a lot of interesting changes there, changes driven, Joe, in part by timing and content, the proliferation of business metrics and interesting discussion on regulators and how auditors are actually doing a lot of things behind the scenes from prospective investors. I have never heard auditors compared to Groundhog’s Day, that’s really good.

I want to switch over to Joe, what are some of the fundamental underlying reasons for this potential realized drop in the relevance of the annual financial audited financial statements?

**Joseph Ucuzoglu:** It’s a great question Mark, and first let me say what a privilege it is to have Mike here with us, and really a unique opportunity to hear a firsthand perspective from an individual who has had a front row seat to the evolution of the financial reporting system over the last half century. This is a real treat.
I am not sure I would frame it in exactly the same way, the assertion that the financial reporting process through regulatory means somehow is taking on less importance. I think what I’d say is there simply is a shift here, it’s not an either/or but it’s a building upon. The regulatory mandated periodic financial reporting system is still the foundation upon which everything else is built and there is tremendous assurance and comfort that is provided to the investing community by virtue of the fact that those reports have integrity and that the auditor is in there, as Mike indicated, within the financial reporting engine and providing levels of assurance on not just the financial statements, but the system of internal control for larger public companies at periodic intervals.

When you ask well then why isn’t that enough? Why has there been such a shift to a need to supplement that basic financial reporting with a much broader set of reporting including press releases, key performance indicators, dialogue around business metrics with the analyst community? I think that shift really tracks the shift in the value creation model within the broader economy. If you go back to a time where the economy was primarily driven through bricks and mortar means, the basic financial reporting system tracked that value creation chain very nicely. Put up a plant, the financial statements reflect the amortization of that building, the creation of inventory which then was sold through, and you could see the revenue and the cost of sales come through. And then that periodic financial report did a very nice job of measuring up whether the company was a net creator or destroyer of value. As the economy has moved to primarily, in many sectors, being intellectual property based, intangibles taking on a much more prominent role, now you go to the balance sheet and the income statement and they actually do a very poor job in some cases of reflecting that value creation cycle. If you take an early stage company that’s investing a lot of money in R & D, building up a very, very valuable technology, they may patent that and have succeeded beyond their wildest dreams and have the prospects for tremendous future cash flows; yet if I freeze it at a point in time, I may look at the annual income statement and see losses because all of those R & D expenditures went through as expenses. I look at the balance sheet and I see zero, because we have a historical cost based model where I do not reflect the intellectual property that’s come into existence on a fair value basis. And yet investors are clamoring to buy that entity’s securities and rightfully so, and so naturally the marketplace has looked to supplemental measures of value over and above tangible equity and GAAP-based earnings to form a more complete understanding of metrics that might be predictive of future cash flows.

It’s not at all surprising that basic financial reporting, which still comprises the underlying integrity of the system, has to be supplemented with the other mechanisms that I think Mike very articulately laid out.

**Dr. Mark Peecher:** Yes, absolutely. As our society shifts from this industrial era to an information driven economy, one of the things that also comes into mind, and we can stay with you Joe or shift over to Mike, is looking at technology a little bit more carefully. I know a very small part arguably of that is the availability of XBRL but just the idea of being able to get more information to management, to auditors, and to investors through things like big data. Is that going to change, not only the way that stakeholders receive information, and thereby even make statutory financial reporting even more so in the caboose, or will you see something
happen in the standard setting venue that will change the content of quarterly or annual financial statements? One example would be, this is not a financial statement but it is an example of how fast these things could manifest. Floyd Norris had an article in The New York Times explaining that banks starting next summer are going to need to calculate liquidity daily, and presumably report this calculation to stakeholders and this is in part to help overcome the risks of only sporadic financial reporting. This is a technology question; it’s not probably going to just affect banks.

**Joseph Ucuzoglu:** There is no question, Mark. Technology is enabling a revolution in information flow, and the financial reporting process will in no way be immune. I won’t predict a timeline over which this occurs. You can’t underestimate how difficult it is to move the supertanker that is the financial reporting system with all of its longstanding legacies in terms of the role of management, the auditor, the investment community, the regulators. But quite frankly the relic of receiving your mail and seeing a report every three months or every year is clearly going to be replaced with a much more real time and dynamic system. There’s a number of elements to it, it’s not just the timing, it will become much more immediate. It is also the manner of presentation. Right now we use a flat file to communicate a lot of this, we haven’t yet leveraged the ability of technology to enable summarized reporting that then enables different users with different levels of information needs to drill down and obtain successively greater levels of detail in a customized format based on their personal information needs. That is coming. As companies evolve their information systems, it will enable much more timely reporting of key metrics. Ultimately auditors will be required and we at Deloitte are putting significant investment dollars into new forms of technology to harness data analytics and big data, and form insights in ways that are different from the traditional sampling based assurance techniques. And in turn may allow us to provide more real time assurance on the information that management is putting out to the investment community on a much more timely basis. This is all happening very fast, again it won’t all transform overnight but I actually think in the next couple of years you’ll see some pretty significant movement towards a much more customizable real time system of reporting that’s all founded upon the use of big data and technology.

**Dr. Mark Peecher:** Absolutely. It’s fascinating. The content of what is being reported upon not only in financial statements but in these very important press releases, these Q & A sessions during conference calls; a lot of this is really related to complex financial statement estimates. This is a long way away from what you saw in the 1969 Wheat Report where there was a real reluctance, especially within a prospectus to have any hint of a projection because of civil liability issues, or because of the idea that this could be a trap for unsophisticated investors who might be prone to attach more significance to projections than they really deserve. What you see now is that’s gone out the window. You see a lot of information coming out not just in the financial statements that are very estimate based, and there’s no thought about the degree to which investors can handle this. The market is demanding it; it’s quite the reverse.

Having said all of that, one thing that is providing a pause button in the regulatory space is that there is now an effort underway at the SEC, it’s called the disclosure effectiveness project, and it’s going to be one of the first top down looks at the financial statements, in particular the Division of Corporation Finance reviewing the disclosure requirements in Reg SK and SX,
which provides requirements for financial statements, and is considering ways to improve the
disclosure of regime for both the company and investors.

This is an unusual thing in regulatory history, instead of an issue by issue emergence that the
FASB has taken on, this is sort of step back and look, almost from whole cloth. I wondered if
you had any insight, either Mike or Joe, about what direction this may take us?

**Joseph Ucuzoglu:** Sure, let me start. With respect to the SEC’s review of disclosure
effectiveness, clearly they have to be commended for recognizing that there’s a need to
modernize the regime for the benefit of investors. This isn’t about less disclosure, it’s about
more effective disclosure. I think what’s interesting though is when you hear the SEC talk
about this project, part of what they’ve come to conclude is that their current rules aren’t
necessarily the impediment to making progress, there are a lot of enhancements that could be
made by companies if only the marketplace would leverage the opportunity here to disclose
information in a much more meaningful and transparent way. There are some things that
probably need to be tweaked in the rules and some required duplications that could go away,
but the SEC has essentially extended an invite to the corporate community to essentially cease
the practice of layering and simply putting more and more on top of what you already did last
year, and take a fresh look at whether the several hundred pages that have accumulated over
time is really doing its job as an effective means of communication to the investing public. One
of my favorite slogans is that the disclosure process shouldn’t be a means of regulatory
compliance, it ought to be a means of communication. When you view it through that lens,
what do investors need to know, you get a much higher quality product than what do the rules
require me to disclose.

I also want to respond, you articulated some thoughts around the fact that numbers are
becoming much more estimates-based and that’s partly feeding into this need to disclose more
and potentially leverage technology to give investors a better understanding of what’s behind
the numbers. There was a group that had come together about a decade or so ago, put together
by the American Assembly, and they did a study on the current state of financial reporting, and
recognized that so many more of the numbers within the financial statements are estimates-
based. They came up with the term, which I absolutely love because it captures the essence of
the issue, that financial reporting represents the brittle illusion of exactitude, that we report an
earnings per share number of $3.48. That’s the end process, consisting of literally hundreds of
estimates, and one could have come up with a wide range of reasonable estimates that might
have given you different numbers, yet we boil it all down to one amount. In some respects that
can be misleading, and so part of what I hope we take advantage of with respect to the ability to
introduce some more technologically flexible disclosure mechanism, is to provide investors
greater understanding of the assumptions and the ranges so that they can go in and do their own
plug and play and have a sense and a feel for the variability inherent in these numbers, which
then is much more useful in terms of predicting ranges of future cash flows. That is also
coming.

**Dr. Mark Peecher:** That’s fascinating to me. One of the things that a lot of the equity analysts
do now is take the single numbers that are reported, associated various line items in the income
statement balance sheet, statement of cash flows, and then they take qualitative disclosures and
all that they know and convert that to distributional amounts. Like a probability density
function might even be something for academics out there. So do you think at some point in
time, since we’re on this topic, if you look into the future, will there be a point in time where
what you see in the primary financial statements and the general purpose financial statements,
as they are called, instead of these point estimates that you do see something more akin to a
distribution or ranges – is that coming?

J. Michael Cook: It makes sense, as you think about it. They have $3.84 or whatever, we don’t
have any gun that shoots that straight in financial reporting. The implied precision of that is
almost unrealistic. I do agree with the notion of ranges and estimates; we’ve talked about using
different types of information to make different kinds of disclosures or reach different types of
conclusions, maybe historical cost information for some purposes, current value information for
other purposes. We’ve had this for a long time, we have this great debate about one or the other,
but perhaps there is place with the types of information systems we will have and the evolution
of that going into the future for both, with each having their relative place.

I think XBRL is perhaps a starting point for this, but I just can’t from my own standpoint see
what that is doing right now. Maybe it’s being used effectively to make better judgments about
what is being reported in the aggregation process. Where I am familiar with it, we comply with
the requirements, we file the information. I don’t know any of the companies have had any
analysts asking questions based solely on the XBRL disclosures. I just don’t know. Joe, I would
be interested in what you see and hear. I think it’s there, I think it’s being complied with, I think
it could be part of a process that would lead to better more complete financial information but I
am just not familiar with how it’s being used.

Joseph Ucuzoglu: I view XBRL as step one, it is probably at this point a decade old
technology, and it has produced some real benefit in terms of taking the manual manipulation
process out of a consumer’s job because it immediately allows you to download the flat file,
take the numbers and import them into a spreadsheet without having to rekey them. There’s a
real benefit of the efficiency that comes with that as well as eliminating the ability for error in
manually rekeying that data. The ultimate potential of technology is of many multiple
magnitude of simply taking a flat file and converting it into electronic format. We’re just
scratching the surface, we haven’t really leveraged the ability of technology to allow drill down
capability in successive layers of information disclosure that can be accessed by individuals on
a customized basis. XBRL is probably phase one.

J. Michael Cook: Mark, a comment if I could make to the topic that Joe has responded to quite
well, and I’m not familiar with the specifics of the SEC project or initiative on disclosure
effectiveness. I would only relate it back to my earlier broad definition of financial reporting
and ask what is the focus of the review? And if the answer to the focus of review is to look at
the 10-K and see what we can do differently in the 10-K, or let’s look at the 10-Q and see what
we can do differently with the 10-Q, I would argue that’s fine and that’s a good thing to do,
let’s take out things we don’t need and let’s streamline things that we have. I am all in favor of
those things, but let’s look at the big financial reporting picture. Let’s add in the earnings
process on a quarterly basis, let’s add in the earnings releases, let’s add in the business
performance information. If you’re really focused on disclosure effectiveness, effective for
whose purposes? If the answer is effective for the purpose of making investment decisions, and you’re only looking at the regulatory filings, you’re missing a big, big part and a growing part of the picture. Somebody needs to step back and look at the total disclosure process that provides the information that people use to make investment decisions and not just focus on the regulatory end product. All the activity, where the action is, if you will, on a quarterly reporting basis takes place well before regulatory filings are ever made, and when they are made my experience is they are not market moving events, they are confirmation of information that has previously been disseminated. The quarterly earnings release process gets a high level of attention and scrutiny from management, audit committees, and auditors, because it’s very important that it be accurate and that it be effective, and the regulatory process comes along later. The same thing with the 10-K, by the time the 10-K arrives, the process for the year has long before been completed. It does need to confirm what has previously been communicated, but if the 10-K is the source of new information, it’s not the right place for that information to get to the marketplace. It’s not timely to find out next March that there is something I need to be concerned about making investment decisions in the fall of the year or even earlier in the year. It’s a question of if they are really going to tackle disclosure effectiveness, can you only look at the piece of it and perhaps not the most dynamic piece that needs change.

Joseph Ucuzoglu: If you look at it all in the aggregate, and then you layer in the functionality of current technology, some of what you can do is really exciting. Just take for example in the current system, within one disclosure document, the 10-K. If you’re an analyst and you’re interested in revenue and the company’s prospects for generating revenue, there may be some disclosure about revenue in the risk factor section, some disclosure in the business section, some in the MD&A, more yet in the footnotes. And then outside of that 10-K there’s likely some information about revenue within the press release, perhaps a Q & A that touched on revenue prospects on an analyst call. Perhaps some revenue information in an 8-K that was filed in connection with a significant event. Technology has the potential to take and integrate all those discrete pieces and with one click of a button bring them all together in one place for somebody who is interested in learning about the company’s revenue. The SEC’s disclosure database would be the natural housing of all of that information across the set of public companies, that would allow some incredibly powerful analytic tools to be deployed if only we leveraged the ability of technology to tag these pieces and then allow them to be sorted and cut and pasted with the click of a button. I can see that coming.

Dr. Mark Peecher: That’s exciting because I think that’s a huge value proposition to take the enormous growth and unstructured data that is all out there and structure that for decision makers. I want to go back to one of Mike’s earlier points where as I understand it, what’s visible to many stakeholders with respect to the auditor is largely a one off annual report. The activity of the auditors, a lot of the activity is occurring way up in the front of the engine, to use your analogy, with management when key decisions are being made. What you see today is maybe as a result of some frustration about that, is you see some move afoot in various reporting jurisdictions to actually change the content of the auditor’s report. What you see, for example in the UK, there are a number of audit reports, probably near a hundred or more, some that have gotten a lot of popular press have been a report from KPMG regarding Rolls Royce, and a report from Deloitte on Vodafone, those are two examples. What is happening in these
reports is a lot more information content about some of the judgment inputs that the auditors have entertained to help guide their audit. For example, planning and performance materiality, you also see them comment on what’s very similar to what’s being proposed here by the PCAOB, the critical audit matters. You’ll see in some of these reports commentary from the auditor about how management resolved these difficult audit areas, and often you’ll see what additional procedures, if any, the auditor did to address those areas.

I guess is that in part a response to trying to make more of the value that the auditor brings more out into the public arena, and if so how do you see that evolving both maybe in the near term, because it is a hot button issue right now, but over the longer term, the nature of the auditor’s report. That’s really for either of you, Mike?

**J. Michael Cook:** I think change in that direction is positive, but I question the value of it, and I question the value of it for the same basic reason that I question the annual audits and annual financial statements is timeliness. The PCAOB, and again I respect the fact that they have limited jurisdiction, has a limited mandate but nonetheless, we, all who participate in this process, need to find a way to improve all of it without limitations of legislative mandate. On this point I am talking about critical audit matters, they characterize that as we want auditors to communicate about what was keeping them up at night during the course of the audit. I say again to the timing issue, I am very interested in what’s keeping Joe up at night when he’s leading an audit of a major company, but I am not really interested in hearing next March what kept him up at night in March the year before.

I want that information to go where it can be useful on a timely basis. The audit committees are the place for this, they represent the investor community, they represent the shareholders and I said in my response to the PCAOB on the proposal with respect to the auditor’s report, the communication needs to go to the right people at the right time that can do something about it, and it needs to go to the audit committee as part of the audit planning process. And if something is keeping Joe up at night in July after we did the audit plan back in March or April, and something’s really bothering him in July, I want the people who need to know and that’s the audit committee to know about it in July, not next March. My issue, I find the auditor’s report to be reasonably effective for what it seeks to accomplish, people kind of disparage the pass/fail, like there is something wrong with that. I don’t find anything wrong with that at all. I find it more wrong that we’re going to make that harder to discern by putting in seven or eight or who knows how many critical audit matters that will cause people to wonder whether the passing grade really was a passing grade, or whether somebody should have got a failing grade that didn’t get a failing grade. I don’t see that it enhances the investor’s understanding of the audit process to say, we’re giving them a passing grade but here are eight things that kept us up at night before we got there. That just doesn’t work for me, and I do believe that audit committees have the need and responsibility to get this information to deal with, to talk to the auditors. If something is bothering the audit team, hear about it on a timely basis, ask management, get management together with the auditors and work your way through it. Talk to the right people about the right things at the right time. I don’t see that being accomplished by adding a lot more information into the auditor’s report. I think it has all of the downsides that people are concerned about, again diminishing the impact of the pass/fail judgment and
communicating through the auditor’s report things which should be communicated by the management of the company in the first instance.

**Joseph Ucuzoglu:** I actually think this directional move towards expanding the auditor’s role outside of a pure pass/fail on the backwards looking financial statements is at the same time exciting and scary, and if you’re a student you ought to be real excited, and I’ll explain why. Let me first address the scary part, though.

I’ll take the blame on behalf of my profession that historically we have tended to be very resistant to significant change. And the reason we’ve been resistant to significant change, particularly in what we say to the general public or how we say it, is because of liability risk, the risk of litigation within the U.S. environment. And that’s certainly a legitimate concern, but I worry as much from a risk standpoint around the macro trends we’ve been talking about over the last 40 minutes with respect to the relevance to the investing community of the backwards looking financial information and the increasing relevance of some of the information that gets reported through the financial reporting system outside of the basic annual and quarterly statements and that the auditor needs to ensure, in order to remain relevant and a valuable part of the capital market system, that we’re in that financial reporting engine and we’re in it in a way that’s visible to the investing public. The fact that in jurisdictions around the world there is this conversation about how to enhance the amount of work the auditors are doing and what we say to the general public, it ought to give you a level of confidence that this is a vibrant and exciting growth profession where there’s tremendous opportunity for students coming into the firms and coming into the corporate community, and all of that is very, very positive.

Now, how exactly you do it is difficult. We can debate the merits of the particular proposals, but it’s evident to me that there is an expanded role for auditors to be involved with information over and above slapping an opinion one day a year on Groundhog’s Day on last year’s financial information. Whether that’s through these CAMs that you talked about, whether it’s through greater association with financial information in the rest of the 10-K outside of the financial statements, which is also something the PCAOB is thinking about. Whether it’s through some form of auditor attestation on information that’s not within the regulatory filings, but the broader ethos of information that’s being reported today and relied upon, we can all have a very good and productive debate. But the mere fact that we’re having that dialogue and that you’re seeing the auditing firms speaking out in support of an expanded role for the auditor is a net positive for the profession.

**Dr. Mark Peecher:** Okay.

**J. Michael Cook:** Just to add to that thought, I think there is real value to be added, and it is being added, but I’m not sure how wide spread or how far down it goes, the auditors being up there in the engine with the timely financial reporting and financial reporting on a broader base than just financial statements, regulatory based financial statements. If this is the information that matters to the marketplace, if this is what investors make decisions on, there is assurance that can and should be provided there that would have high value. It’s not going to be audited on a quarterly basis in the traditional sense of auditing, but partners are very capable people, they know a great deal about the company. They know a great deal about financial reporting.
They can add assurance and they will be reluctant to do so, as Joe indicates, but everybody, I think in time, will see if that’s the value proposition and that’s where this profession really makes a difference for the investing community in the future, they’ll get there. And they’ll get there in the right way, but auditors can add levels of assurance with respect to the reasonableness of the information that is presented outside the traditional financial reporting system that they opine on. Consistency is very important when you talk about non-GAAP measures and people start giving different kinds of information, one thing that’s very important is that it be consistent from period to period. Not that in the first quarter we pick one way and adjust our reported results and the second quarter that didn’t work out so well so we pick a different way to do it, and year to year it’s not done the same way. If people are going to report business performance information and non-GAAP information, consistency from period to period is very important.

We don’t have a system that provides that consistency across companies at this point because what is a business performance indicator for one company in a particular industry might be different from how that has been defined by other companies. Their disclosure becomes important; it becomes very important that if you choose a term like operating cash flow, which is a commonly used term or EBITDA, which is somewhat the same. If you were going to use a term like that you really do need to disclose completely what it is that you have done to define that and what it consists of, because other companies in the same industry are calling something operating cash flow, and it’s not with the same components because there is no standard across industries for those types of disclosures. Auditors can be very helpful in assessing the adequacy of disclosure, they can’t be responsible for bridging the gap from Company A to Company B if there are no standards and people choose to define a metric differently. But they can be sure that the information is there that enables people to say oh I see, Company A includes X, and Company B doesn’t include X and I have the information, so if I want to compare Company A to Company B I can add it in or take it out. Whatever needs to be done, there is value to the independent assurance that can be brought to that information, and if that’s where the action is that’s where the value is going to be. We need to get out of the caboose and get into the engine on a more continuous basis and I think to Joe’s point, I think also some form of more frequent and continuous communication. I’m not sure having the auditors issuing their review reports on quarterly information is going to add great value. I’d like to hear from them five times a year instead of once a year, just as a matter of course. But those reports could be included today and there does not seem to be a market demand for that. And yet they are issuing those reports orally to audit committees every quarter, and it is very valuable to audit committees to have that assurance.

**Dr. Mark Peecher:** That’s rather fascinating to me, because you have a value proposition for the auditors to become much more visibly involved with information that’s disclosed to the stakeholders, the investors, anyone who is consuming financial reporting in a more public way. What you’re saying Mike reminds me of an academic study where they were showing basically that a variety of mutual funds would pick and choose how they calculated returns year over year over different periods to make returns look better, so that makes a lot of sense.

Let me broaden the topic just a little bit. Do you guys have an opinion about the extent to which financial reporting will be melded with overall business reporting. What I am getting at in part
is what you see today called CSR, CSR being corporate social responsibility reporting, where you see companies say not only here’s what we’re doing in terms of our traditional earnings per share, in terms of operating cash flow, but here’s what we’re doing to make our society better. You can think of a green company, you can think of safety information, environmental performance – is that something that is going to be integrated into financial reporting or are these things more or less fads that will dissipate over the next decade or so?

**J. Michael Cook:** I have a strong view that they are not at all fads, this is a very important area, it matters to society, it matters to consumers, it matters ultimately to investors because how well you do on your social responsibility in the long run can have a considerable effect on the value of your company. I don’t think it’s a fad, I think it’s here to stay and I think it will become even more prominent and more frequent as we go forward. My only question is whether it is enhancing either financial reporting or social responsibility reporting to add them together. We have seen a little bit of this in recent issues with respect to SEC reporting, SEC disclosure requirements with respect to conflict minerals. It’s an important issue and it’s appropriate to have disclosure about it, but is it a part of the disclosure regime for financial reporting or is it for a different purpose and should be put in a different place. I’m all in favor of both of these trains going down the track, I’m just not sure adding them together is going to be an enhancement to the overall process, but I don’t think social reporting is going to gain any less importance. I think quite the opposite, there are a lot of things going on in our country that are very important to us that are socially oriented and will be part of the disclosure system I think, going forward.

**Joseph Ucuzoglu:** I absolutely agree. To some extent we have already seen some level of integration taking place, including through groups like the IIRC, trying to bring together a model of portraying a balanced scorecard of metrics, both financial and non-financial that represent value drivers. I think the most fascinating part of this dialogue though is where the line is drawn. Clearly there’s a much broader set of metrics that actually speak to issues that are directly relevant and material to investors, and when you meet that threshold there is little disagreement as to whether the SEC disclosure regime should be used to capture the totality of that information, whether it’s financial or non-financial, as long as it has a direct material impact to evaluating the company’s prospects through the lens of an investor. Where you start to breakdown in terms of consensus is when there are those who would wish to use the SEC’s disclosure system to accomplish other societal goals that don’t necessarily materially influence the value of the company to an investor. There has been some pushback including some statements coming out of the SEC as to whether that was really the purpose for which the SEC’s disclosure system was created. You’ll continue to see that play out in a number of different contexts. The SEC continues to get requests from constituents to require companies to disclose things like corporate political contributions, there are those on the other side who say interesting but these are small dollars. If somebody believes those should be disclosed, don’t knock on the SEC’s door, knock on the door of those who regulate elections. That’s where the dividing line and the battleground will be.

**Dr. Mark Peecher:** Let me ask a more pointed, maybe in some sense shorter-term question before I’ll end on a little more bigger-picture question. This is another sort of contemporaneous issue, one of the things you see going back to the auditor’s report is the idea that somehow by
naming an engagement partner on the annual audit, statutory compliance or for general purpose financial statements audit, somewhere would be of help. That would help reduce transactions costs, reduce the cost of capital. Mike, what are your thoughts on that, and Joe your thoughts or where you think that might be going?

**J. Michael Cook:** Having been part of a significant auditing firm, and significant auditing engagements over the years, I understand the way an audit of a major company is done and it is hardly done by any single individual. I have said if that requirement were to go in place maybe in addition to getting a lead partner to identify himself and sign up, maybe the CEO of the firm, the head of the audit practice and ten other partners who work on the engagement ought to be identified as well, but I’m not sure even the basic information is necessary. I also have a sense this train may have left the station and it’s going to happen, and then I would ask my broken record question, if you don’t mind, about timeliness. I really don’t know how much informational content there is for me to find out. I’d be delighted to find out if Joe is the lead partner on any engagement that I was associated with. But I’m not sure finding it out next March is going to be all that helpful to me, the audit is over, the work for the year is done, I would say if you’re going to require this information, and I think people seem to be headed in that direction, why not put it in the proxy statement for the current year when the auditors are being either elected or ratified, when it’s important for me to know who the auditor is going to be that’s going to do the work during the coming year, not the past year. I realize there may be complications with timing of appointments and things of that type. Again, for me, if we’re going to require new information let’s be sure it’s coming to people in a time when they can deal with it in the most valuable way.

**Joseph Ucuzoglu:** I agree this train has left the station, and frankly as an organization that’s really in the business of transparency, we’re not going to be out arguing against transparency. If people would like this information, the CEOs and CFOs of companies that produce this information already have their names out there and we’ll certainly produce the name of the lead audit partner based on the most recent public press reports. Over the last week or so it looks like they found a mechanism to accommodate the disclosure of this information within the current regulatory infrastructure. I am looking forward to seeing the proposal that comes out soon.

**Dr. Mark Peecher:** Absolutely. Just a closing question, I am very interested in both of your views on this. We recently have begun this look-back process for the Sarbanes-Oxley Act. One thing that is amazing about that piece of legislation is that it really represented a huge change all at once instead of a little bit of change at a time. If we were to think about whoever is sitting in a place like this 20 years from now, and we think about the nature of the changes that you foresee coming down the road, do you think these changes will need to wait for another punctuated piece of legislation of the type you see in Sarbanes-Oxley, or do you think it will happen more gradually?

**J. Michael Cook:** Mark, I don’t know the answer to the question. If it was a choice, if I could vote for one or the other, I would vote for continuous, progressive change rather than burning platform, crisis driven upheaval. Sarbanes-Oxley, in my judgment, accomplished what it was intended to accomplish, and the incidents of earnings management, fraudulent financial reporting has definitely gone down, and gone down substantially. I just hope we don’t sit and
wait for another major crisis of that kind before we do what needs to be done to keep the system up to date and keep people doing the right things on a continuous basis. We have seen how hard it is to deal with this massive repair type of legislation or regulation, whether it’s Sarbanes-Oxley or Dodd-Frank, it’s tough. Let’s keep getting better incrementally if we can, but is that going to happen? I don’t know. We’re real good at crisis management, we’re not so good at evolutionary change, but I hope it does.

Dr. Mark Peecher: Anything to add, Joe?

Joseph Ucuzoglu: I think you’ll see a steady pace of evolution without necessarily a big bang. Part of the driving force here though will be how does the change come into existence. Is it through what you might call a push model where regulatory requirements come into effect and make everybody do it, or is it through a pull model where essentially investors are demanding this information and companies that are looking to access external capital feel compelled to produce information that these investors demand in order to drive a lower cost of capital. I would like to think that as the benefits of this type of an evolved reporting model become more and more clear that the pull model will be sufficient without the need for the regulatory push. The other thing I’m encouraged by though is as we look at the worldwide regulatory landscape, I do see an overall trajectory towards the top and not a race to the bottom. When Sarbanes-Oxley was published, there was a real concern that there would be a flight of capital out of the U.S. markets, that the costs would be prohibitive, and that this regulatory overreach would lead companies to not want to raise capital. In fact what we’ve seen is a push by other jurisdictions around the world to match these high standards, and in some cases have even implemented their own local standards that go beyond what Sarbanes-Oxley required. That’s encouraging to see the overall trajectory of regimes enacting higher and higher quality disclosure standards versus competing for companies to domicile based on “we’re the ones who let you off easiest.” That’s a positive long term trend.

Dr. Mark Peecher: Very interesting. Time will tell how much punctuated equilibrium or gradual change, and maybe one of the topics we talked about earlier will be a big player in this. One thing that seems to be different this go today as opposed to even 15 - 20 years ago is technology, it’s just so much more pervasive, and maybe that will lead to a greater influence of the pull model that you’re talking about instead of it being a push from the top.

Mike and Joe, I am honored. Thank you for your time today. It was a very informed discussion. Both of you are very thoughtful and have a point of view that not too many people have. I don’t want to embarrass Mike but I want to thank him personally because he contributes so much to the academic scene; the J. Michael Cook Deloitte Doctoral Consortium has been a longstanding highlight of the American Accounting Association and we’re very thankful for that generosity.

Today’s broadcast will be soon available in audio mp3 format in the virtual museum and archive, and edited transcript will be added later.

On behalf of the SEC Historical Society, I would like to thank Deloitte LLP for its generous support and assistance in making this program possible.
Thank you for joining us today, and good afternoon.