



Agenda Item 2

The Auditor's Involvement with Municipal Securities Offering Documents

Objective of Agenda Item

To discuss issues related to a proposed standard on the auditor's involvement with municipal securities offering documents.

Task Force members are:

- Chris Smith – BDO (Chair)
- Martha Garner – PwC
- Jeffrey Markert – KPMG
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Background

The growth of debt securities issued by state and local governments (municipal securities) over the last 30 years has been substantial and the size of today's market is significant. In July 2012, the Securities and Exchange Commission (SEC) issued a comprehensive study of the municipal securities market.¹ According to the SEC's research, in 2011 there were over one million different municipal bonds outstanding compared to fewer than 50,000 different corporate bonds. These municipal bonds totaled \$3.7 trillion in principal, while corporate (and foreign) bonds and corporate equities outstanding totaled \$11.5 trillion and \$22.5 trillion, respectively. The municipal securities market is also an extremely diverse market, with close to 44,000 state and local issuers. The market includes not-for-profit entities and private sector companies that issue municipal securities through government agencies that act as conduits. Individuals, or "retail" investors, directly or indirectly hold more than 75% of the outstanding principal amount of municipal securities.

¹ July 31, 2012, U.S. Securities and Exchange Commission, Report on the Municipal Securities Market, <http://www.sec.gov/news/studies/2012/munireport073112.pdf>

The Role of the SEC and Current SEC Requirements

Municipal securities are exempt from all provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 except for the antifraud provisions of those acts, which prohibit any person from misrepresenting or omitting material facts in an offering or sale of securities. A government, not-for-profit entity or private company (referred to herein as “municipal issuers”) that sells securities typically prepares an official statement that offers the securities for sale and provides appropriate financial and other information about the offering. Official statements are widely available to the investing public.

Because the SEC cannot directly regulate municipal issuers, an “indirect” system of regulation is used in which the SEC imposes certain regulatory requirements on the underwriters of municipal securities offerings related to the issuer’s disclosure at the time of issuance as well as post-issuance.² Consequently, almost all municipal securities offerings are subject to primary market disclosures at the time of sale which are made by issuing an official statement (as described above). The underwriter must also obtain a covenant from the issuer that post-issuance the issuer will provide disclosures to the market (referred to as “continuing disclosures” or “secondary market disclosures”) throughout the life of the securities. These include annual financial information (including audited financial statements) and material events notices. Official statements and continuing disclosure documents are filed electronically with the Electronic Municipal Market Access (EMMA) system maintained by the Municipal Securities Rulemaking Board (MSRB). Through EMMA, the investing public can obtain information virtually real-time, free of charge (similar EDGAR for SEC-registered securities).

The SEC’s July 2012 report, referred to above, could provide a basis for an SEC request to Congress for extended regulatory authority over the municipal securities market. The U.S. Government Accountability Office (GAO) also issued a report to Congress in July 2012 which, among other matters, compared and contrasted the quality of disclosures provided to investors in the municipal securities market to the quality of disclosure provided in ‘33 Act offerings to identify any deficiencies.³

Auditor’s Involvement and Responsibilities

There is no requirement by the SEC for auditor involvement with municipal issuers’ official statements thus, an auditor generally is not required to participate in, or undertake any procedures with respect to, a municipal issuer’s official statements. Further, municipal issuers may include an auditor’s report (accompanying audited financial statements) in official

² SEC Rule 15c2-12 and associated SEC Releases

³ July 19, 2012, U.S. Government Accountability Office, Options for Improving Continuing Disclosure (GAO-12-698) <http://gao.gov/products/GAO-12-698>

statements without obtaining the auditor's permission as there are no laws or rules that prohibit such an inclusion.

The AICPA (beginning in the mid-1980s) has provided guidance regarding an auditor's professional responsibilities when his or her audit report is included in a municipal security offering document. This industry-specific auditing guidance appears in the AICPA Audit and Accounting Guide, *State and Local Governments* (SLG Guide). The guidance identifies seven situations in which the use of an auditor's report in an offering document would trigger responsibilities on the part of the auditor. In recent years, this guidance has also been incorporated into the AICPA Audit and Accounting Guide: *Health Care Entities* (HC Guide). The Guides also note that some firms require involvement with municipal securities offerings as a matter of practice risk management. They accomplish this by including a provision in the engagement letter requiring the client to obtain the auditor's permission before using the auditor's report in the disclosure documents.

Prior to the Clarity project, the guidance on auditor involvement in the SLG and HC Guides was phrased using "should" and thus, was interpreted as industry-specific requirements. During the conforming change process to incorporate the Clarity standards, the "shoulds" were eliminated as the clarified standards do not address what actions constitute "involvement" or define auditor requirements when an auditor elects to perform procedures related to a municipal security offering document. The relevant excerpt from the 2014 SLG Guide is included in Item 2A.

It is the Task Force's experience that when involved, most firms read the official statement following the guidance in AU-C 720, *Other Information in Documents Containing Audited Financial Statements*. The Task Force understands that some firms also voluntarily follow the subsequent event requirements in AU-C 925, *Filings Under Federal Securities Statutes*, even though that standard is not applicable to exempt municipal issuances (although it does include several very narrow interpretations that relate to exempt filings). However, other firms may not be doing so in practice because there is no stated requirement.

Issues for Discussion with the ASB Regarding the Development of a Standard to Address Auditor Involvement with Municipal Securities Offerings

The Task Force recommends the ASB develop a standard similar to AU-C 925 that applies specifically to municipal securities offerings. The need for the ASB to more formally address the auditor's responsibilities with respect to municipal securities offerings is amplified by the size of the market, the added complexities and risk in the market since the original SLG guidance was developed, and the fact that the guidance currently included in the SLG and HC Guides post-Clarity has been softened to "best practices" rather than requirements.

Additionally, the Task Force believes it would be prudent to develop standards-level guidance in this area in light of the increased interest by the SEC. Despite the SEC's limited authority in this area, over the past decade it has promoted best practices and may seek additional authority over this market in the future. In public speeches, individual Commissioners have encouraged municipal issuers to obtain an auditor's permission before including the auditor's report in

offering documents and have implied an expectation that doing so would result in a subsequent event analysis and review of unaudited information in the offering document.⁴ This is due to SEC concerns that investors erroneously assume that when an auditor's report appears in an offering document that the auditor has performed procedures similar to those required in the public equity market and derive comfort inappropriately from that belief.⁵

Issue for ASB Discussion

1. Does the ASB agree a standard is needed to address auditor involvement with municipal securities?

Scope: When to Require Involvement

The longstanding guidance in the SLG Guide suggests an auditor be involved when any of the following seven situations occurs in which the auditor is made aware that his or her report is being included in an official statement.⁶

1. Assisting in preparing the financial information included in the official statement
2. Reviewing a draft of the official statement at the entity's request
3. Signing (either manually or electronically) the independent auditor's report for inclusion in a specific official statement
4. Providing written agreement (for example, through a letter or signed authorization form) for the use of the independent auditor's report in a specific official statement
5. Providing a revised independent auditor's report for inclusion in a specific official statement
6. Issuing a comfort letter, the letter described in paragraph .12 of AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, Professional Standards), or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement
7. Issuing a report on an attestation engagement relating to the debt offering.

⁴ October 19, 2012, Speech by SEC Commissioner: Enhancing Disclosure in the Municipal Securities Market: What Now? Commissioner Elisse B. Walter <http://www.sec.gov/News/Speech/Detail/Speech/1365171491532>

⁵ See Item 2A, "Excerpt from Chapter 16, Auditor Involvement with Municipal Securities Filings, of the AICPA Audit and Accounting Guide, *State and Local Governments*" paragraph 16.12 which provides an illustrative disclosure to clearly indicate when the auditor is not involved in an official statement.

⁶ See Item 2A, paragraph 16.07 and related footnotes for further description of the seven situations listed.

The Task Force recommends requiring auditor involvement in these seven situations. In addition, the Task Force suggests an eighth situation to require involvement: Participating in discussions with underwriters on due diligence issues related to a specific bond offering in which the auditor's report will be included. In 2013, the SEC and MSRB undertook regulatory activities associated with improving documentation of underwriter compliance with their due diligence requirements in municipal securities offerings. As a result, auditors began to experience an increase in the number of requests to participate in due diligence meetings with underwriters handling their clients' bond offerings. The Task Force expects this trend to continue. Based on this recent development and the nature of the auditor's participation, the Task Force believes that participation in due diligence discussions should be an additional situation that constitutes involvement.

These are the only situations in which the Task Force recommends that auditor involvement be mandated. It is important to note that the decision of a firm on whether to be involved voluntarily is a risk management matter. The Task Force believes that in the absence of the eight triggers above, when the auditor's report is included in the offering statement, the decision as to whether to be involved with the offering should be up to individual firms.

Issue for ASB Discussion

2. Does the ASB agree with the eight proposed criteria to establish auditor involvement with municipal securities?

Nature of Procedures When Involved

The Task Force recommends that when involved with a municipal securities offering, the auditor follow procedures required in AU-C 925 which includes Other Information procedures described in AU-C 720 and Subsequent Event procedures as described in AU-C 560, *Subsequent Events and Subsequently Discovered Facts* to determine whether any disclosures or events could call the auditor's report into question.

Other Information. As currently written, the scope of AU-C 720 does not encompass municipal securities offerings. An official statement is not similar to an annual report, as contemplated in the scope section of AU-C 720. An annual report is typically planned at the time of the audit engagement and serves as a periodic vehicle that communicates stewardship or accountability demonstrated by the financial statements incorporated within them. Official statements have a narrower purpose and are not issued in regular intervals. It should be noted that the International Auditing and Assurance Standards Board Exposure Draft on the Proposed International Standard on Auditing (ISA) 720 indicated that it did not apply to securities offering documents. As discussed in the previous section, *When to Require Involvement*, it is not the intent of the Task Force to require involvement in all municipal securities offerings. For all of these reasons, the Task Force is suggesting that procedures related to Other Information be incorporated into a standard addressing auditor involvement with municipal securities.

Subsequent Events. The Subsequent Event procedures required by AU-C 925 stem from a regulatory requirement set forth by the SEC. Some have questioned the basis or theory underpinning the suggestion to require subsequent event procedures when there is no regulatory requirement to do so. The Task Force believes that given the anti-fraud provisions that municipal securities filers are subject to, the auditor, when involved, needs to determine that no material events occurred subsequent to the report date that could call the auditor's report into question.

Issue for ASB Discussion

3. When an auditor is involved in a municipal securities offering, does the ASB agree with the Task Force recommendations to require procedures related to Other Information and Subsequent Events?

Items Presented

Agenda Item 2 – Issues Paper

Agenda Item 2A – Current Guidance in Chapter 16 of the AICPA Auditing and Accounting Guide, *State and Local Governments*

Mr. Smith will refer to the Issues Paper and the current guidance in leading the discussion.