



Agenda Item 2D

Background of the Task Force & Summary of ASB Discussions to Date

This paper is included for reference to provide new ASB members a brief background on the Task Force and discussions to date. It may also serve as a refresher for continuing ASB members as this Task Force last presented at the May 2015 meeting.

Materials for discussion at the January 2016 ASB meeting are in Agenda Items 2 and 2A.

Note that the Task Force was originally formed to address auditor involvement with municipal security offerings which is the focus of the Background section that follows. The scope of the Task Force was expanded after the January 2015 ASB meeting to incorporate all exempt securities.

Background of the Task Force

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

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>

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. [See chapter 17 of the 2015 SLG Guide]

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.

Summary of Discussions to Date

The following pages are excerpts from the issues papers presented at the January 2015 ASB meeting including the meeting highlights.

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

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 Chapter 17, Auditor Involvement with Municipal Securities Filings, of the AICPA Audit and Accounting Guide, *State and Local Governments*" paragraph 17.11 which provides an illustrative disclosure to clearly indicate when the auditor is not involved in an official statement.

Issue for ASB Discussion:

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

January 2015 Meeting Highlights:

The ASB affirmed the Task Force's recommendation to develop a standard similar to AU-C 925, Filings Under Federal Securities Statutes, to address auditor involvement; however the ASB did not affirm the Task Force's position to limit the scope to municipal offerings. Instead, the ASB suggested the Task Force explore broadening the scope of the project to potentially include other "securities", including but not limited to, offerings exempt from the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

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.

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

⁶ See Item 2A, paragraph 17.07 and related footnotes for further description of the seven situations listed.

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:

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

January 2015 Meeting Highlights:

Understanding that municipal issuers (and potentially other exempt offerings) may include an auditor's report accompanying audited financial statements in official statements without obtaining the auditor's permission, the ASB acknowledged that awareness of an offering would not be sufficient to constitute involvement. Instead the discussion focused on whether the auditor has knowledge that the client is doing something with the auditor's report and that the auditor is doing something related to the offering. In terms of the triggers that may indicate involvement currently included in the SLG Guide, members of the ASB questioned whether, for a specific offering, signing a report for inclusion, providing written agreement for use of the report, and revising an report for inclusion would be considered "involvement" as there likely would be no engagement for these scenarios. The Task Force will consider this as it moves forward.

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 antifraud 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:

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?

January 2015 Meeting Highlights:

The ASB generally agreed with the Task Force's suggestion that procedures similar to AU-C 720 and subsequent event procedures required by AU-C 925 should be considered in the development of a standard.

* * * * *

The following pages are excerpts from the issues papers presented at the May 2015 ASB meeting including the meeting highlights.

Scope: Types of Offerings

The first component of the scope of this project is to identify exempt offerings beyond municipal securities. The Task Force determined that there are two categories of securities: Non-Registered Securities and Franchise Offerings. Agenda Item 2C (January 2016 materials) provides information on the various types of securities.

The expansion of scope raises the question as to how far to extend the scope of a proposed standard. The Task Force believes that the scope should be limited to fundraising efforts in exchange for debt or equity securities and exclude fundraising appeals of a charitable nature and loan solicitations.

The following is a proposed scope for consideration:

This proposed Statement on Auditing Standards (SAS) addresses the auditor's responsibilities when the auditor's report on financial statements of a nonissuer are included or incorporated by reference in documents relating to a non-registered security or

franchise offering, and the auditor is involved with the offering document as specified in this proposed SAS.

Issues for ASB Discussion:

- Does the ASB agree with the expansion of the proposed scope of this standard to include non-registered securities and franchise offerings?
- Are there other types of offerings that should be considered?

May 2015 Meeting Highlights:

The ASB tentatively concluded that expanding the parameters to include both non-registered securities and franchise offerings is generally appropriate. The Task Force was asked to consider the following in its development of a draft standard: citing the auditor's report directly in the scope (exploring "included" versus "incorporated by reference"), refining terminology (exempt versus exempt from registration), and evaluating the list of non-registered securities for completeness (e.g., adding Regulation S offerings).

Scope: Triggers

The second component of the scope of this project is determining and defining the notion of "involvement" with an offering document. At its January meeting, the ASB discussed that awareness of an offering by the auditor would not be sufficient to constitute involvement, based on an acknowledgement that municipal issuers (and potentially issuers of other exempt offerings) may include an auditor's report accompanying audited financial statements in the offering document without obtaining the auditor's permission. Instead the discussion focused on whether the auditor has knowledge that the issuer is doing something with the auditor's report *and* that the auditor is performing procedures related to the offering document. In discussing the triggers that may indicate involvement currently included in the SLG Guide, members of the ASB questioned whether, for a specific offering, providing written agreement for use of the report, revising a report for inclusion, or signing a report for inclusion would be considered "involvement" as there likely would be no engagement for these scenarios.

Consistent with the current SLG guidance, the Task Force determined that two benchmarks should be present to subject the auditor to the requirements of the proposed standard:

1. The financial statements on which the auditor's report was (or to be) issued are included in or incorporated by reference into the offering document, and
2. The auditor performs one of the defined trigger activities.

With regard to Item 2 above, the following activities are triggers related to an offering document the Task Force has considered that would subject the auditor to the requirements of the proposed standard:

- a. Assisting in preparing the financial information included in the offering document
- b. Reviewing a draft of the offering document at the client's request or as required under the terms of the auditor's engagement letter
- c. Issuing a letter in accordance with AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties*, or an attestation engagement report in lieu of a comfort or similar letter on information included in the offering document
- d. Issuing a report on an attestation engagement relating to the offering

- e. Engaging in due diligence discussions with underwriters
- f. Providing written agreement for the use of the independent auditor's report in a specific offering document
- g. Providing a revised independent auditor's report for inclusion in a specific offering document
- h. Signing the independent auditor's report for inclusion in a specific offering document

The Task Force questioned whether triggers should be limited to engagement-driven activities. Items a-e are engagement-driven (activities for which the auditor would be engaged to perform). Items f-h would not require separate engagement; however these activities provide evidence that the auditor was aware of the offering. From a firm point of view, involvement based solely on awareness is a risk management issue.

As the Task Force discussed items f-h in more depth, it questioned whether item h – signing the independent auditor's report for inclusion in a specific offering document – merits being a trigger. In this scenario, it is very possible that the securities related to the offering have already been placed and sold and that the inclusion of the report is done as a compliance issue for the offering file. The auditor would have no recourse at this stage of the process if issues were identified in the original report or in the offering document.

Issues for ASB Discussion:

- Does the ASB agree with the two benchmarks proposed to require involvement: a) The financial statements on which the auditor's report was (or to be) issued are included in or incorporated by reference into the offering document, and b) The auditor performs one of the defined trigger activities?
- Does the ASB believe that the triggers to require involvement should be engagement driven or engagement-driven and awareness-based?
- If the ASB supports the inclusion of awareness based triggers, does the ASB agree item h (signing a report for inclusion in a specific offering) should be excluded from the triggers?

May 2015 Meeting Highlights

The ASB generally supported the two benchmark model. In the discussion of the trigger activities, some members voiced concern about whether a member could unsuspectingly end up in the standard. However, the ASB generally agreed that the triggers either result in an engagement or an acknowledgement that the auditor's report will be used in an offering. As to whether awareness/acknowledgement triggers are appropriate, the general consensus was that acknowledgement driven triggers expose the auditor to liability under securities laws so they would be appropriate to include. The Task Force was also asked to consider situations which could arise due to a change in auditor as to how the proposed standard might impact both auditors (i.e. a predecessor auditor issued an audit report on the financial statements to be included in an offering document and the successor auditor performs a review of interim financial information which is also included in the offering document).