

October 14, 2013

Office of the Secretary
PCAOB, 1666K Street N.W.
Washington, D.C. 20006-2803
www.pcaobus.org

Dear Secretary,

Re: PCAOB Rulemaking Docket Matter No. 034

We are pleased to have this opportunity to provide comments on the proposed *Auditing Standard on The Auditor's Report on an Audit of Financial Statements, as well as the Auditors Responsibilities Regarding Other Information*.

Sincerely,

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Overview

The Discussion Paper identifies two key features that call for adjustments:

- 1) Current audit reports are based on a binary (pass/fail) model, and
- 2) The current “boilerplate” format of reports provides little company specific information.

In addition, the Discussion Paper considers extending the scope of auditor’s report to cover other information already included in regulatory filings, such as the Management Discussion & Analysis section. Three changes are proposed in the wording of audit reports to encompass:

- 1) “Critical Audit Matters” will be a part of the report in which the auditor identifies the issues that were the most difficult, complex, in need of exercising most judgment and/or items for which it was most difficult to gather audit evidence;
- 2) Auditor’s independence, tenure, and responsibility for other information; and
- 3) Additional standardized language such as “Whether due to error or fraud.”

Overall we are disappointed with the half-hearted proposals. This attempt to induce better disclosure, while well meaning, is likely to still produce uninformative boilerplate, albeit longer, reports.

Analysis

The Proposed New Audit Report

We agree that the two key issues with respect to the auditor’s report are its binary (Pass/Fail) format, and the boilerplate nature of their content. We are disappointed that the PCAOB does not propose to move the needle on either of these limitations. If the binary (pass/fail) scale is retained, the auditor will continue not to convey any of the detailed knowledge they acquire during their examination to the investors. They could do so through use of a finer grading scheme, say A+ through D-, or even F. Of course, how these grades are labeled is not important for their informativeness, but the fineness of the grading scheme (number of possible grades) is.

The call for additional reporting of “critical audit matters” is an improvement in the sense that it takes us back to the past when auditors issued a long-form audit report including extensive commentary on the key audit procedures and key risk areas in the audit. However, by its failure to even identify the key areas of risk, the proposed revision appears to be a poor cousin of the long form audit report of the 1920’s. All regulations, no matter how well-meaning, are vulnerable to be reduced to boilerplate

meaninglessness jargon depending on how much room for judgment is allowed in their implementation and enforcement. Mechanical enforcement of such regulations will achieve little more than creating a longer report full of defensive legal verbiage. How many people believe (or believed at the time the law was written) that SOX provisions have (or would) transfer more responsibility for misstatements to the C-suite executives? The addition of proposed commentaries on independence, and its standardized language, also unfortunately belongs in this boilerplate category.

We are disappointed that the PCAOB chose to stick with the binary (pass/fail) system. In government certification, it is common for regulation to set a minimum quality standard (floor) for candidates to get a “pass”. Private certifiers, for the most part, assign a letter or numerical grade to their rating, signalling finer gradations of quality than a pass/fail allows. Some public sector regulators have been courageous in adopting a finer rating system. The Department of Agriculture has many grades of grains and meat (e.g., Grade A Wheat and US Prime Beef). Restaurant hygiene inspections in many cities switched from pass/fail to a letter grading (e.g., A-F) systems. We hope that the PCAOB will also be bolder and strive to create a finer and more informative audit report grading system.

The expansion of the auditor’s report to cover critical audit matters could at least take us back to the level of reporting that occurred in the 1920’s where auditors provided long form reports. Those reports identified the key audit procedures they conducted, and the key risk accounts they identified in the audit. These items are more useful than the vague items required in the current proposal such as “difficult, subjective or complex” items. The proposed requirements lend themselves to be easily reduced to uninformative boilerplate reports where the same set of broad categories can be cited as being the most critical audit matters for all clients to fulfill the new regulations with no additional information whatsoever. The recent (concurrent) proposal by the International Auditing and Assurance Standards Board (IAASB) to require auditors to report the key risks they assessed and the key audit procedures conducted in response to these risks, provide better guidance and are less susceptible to being reduced to boilerplate ritual.

Audit reporting could be more informative if the auditors could convey their expert opinion (preferably via a letter grade) on the quality of the accounting policies and estimates made by management, quality of internal control, quality of governance and quality of disclosure. An alternative

would be to publicly disclose the issues that the auditor reports to the audit committee. This would be more informative to users and would be specific to each entity, rather than boilerplate reports.

Expanding the Scope of Matters Covered by the Audit Report (e.g. MD&A)

A second proposal is to formally require the auditor's report to expand its scope to cover other filings made with regulators, such as MD&A to ensure propriety and consistency of matters reported in all regulatory filings. While we understand this quest to police all management's discussions that include financial numbers, we feel that this step is misdirected. Managerial disclosures are scrutinized extensively so a manager who reports numbers in different ways in different communication channels will have to make sure the narrative is consistent (or at least plausible) at the risk being "self-revealed" to be untrustworthy to the market. There is no need to require an auditor to police all representations of management. Management should have some flexibility in disclosing information about the company and be subject to market scrutiny.

Conclusion

We are disappointed that PCAOB does not propose to move beyond the current pass/fail system to adopt a letter grading system. We are also concerned that the proposed "critical audit matters" don't require the two key items captured in the long form reports of an earlier era, namely, the key audit risks, and key audit procedures performed to mitigate these risks. The proposed disclosures are vulnerable to becoming boilerplate disclosures, except now the audit report would be a lot longer. This appears more like a step back than forward.