



Capital Strategy Research, Inc.
333 South Hope Street
Los Angeles, California 90071-1406

thecapitalgroup.com

VIA ELECTRONIC DELIVERY

June 24, 2016

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Release No. 2016-003 Rulemaking Docket #34

Dear Messrs. Doty, Ferguson, Hanson and Harris, and Ms. Franzel:

Capital Group Companies, Inc. (referred to herein as "Capital") is one of the oldest and largest global investment management firms in the nation. We appreciate the opportunity to provide comments on the Proposed Auditing Standard, *The Auditors Report of an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. These comments are informed by our experiences with audited financial statements of portfolio companies in which associates of Capital and its affiliated companies invest. These comments reflect the signers' own views and not necessarily those of Capital or other Capital associates. Capital invests in equities and fixed income securities globally, and has approximately 300 equity and fixed income analysts and portfolio managers around the world. We conduct extensive, fundamental, on-the-ground company research and we rely heavily on financial statements prepared by public companies. Capital buys and holds investments for the long-term.

It is long overdue for auditors of U.S. issuers to provide meaningful information about audits to investors, the customers of independent audits. Audit committees and investors should know about critical audit matters (CAMs) from the perspective of the independent auditor. It's important for investors to have an understanding of the auditor's perspective on the financial statements including their risk assessment and what they ultimately found.

As our former chairman, Paul G. Haaga, Jr., commented at PCAOB's roundtable in September 2011, some of the areas where auditor communication would be useful to investors are: significant issues which arose in the audit and *how they were resolved*, areas of greatest risk, significant estimates and judgments, restatements and materiality assessments.

If auditors had provided their perspective about financial statements, internal controls and audits, this might have provided critical information to investors regarding the banks ahead of the financial crisis, ahead of Chinese company frauds, and other recent examples where investors suffered large losses such as Valeant and Lending Club. Similarly, Mr. Haaga also recommended that PCAOB look at audits which went wrong and determine what the auditors could have usefully pointed out to their investor customers. This is an important recommendation. It's essential for PCAOB inspections and enforcement activities to inform standard setting.

If PCAOB proceeds with a standard which limits disclosure of CAMs to those which the auditor communicated to the audit committee, then PCAOB must address any concerns as to why auditors failed to inform audit committees of significant matters ahead of frauds coming to light such as at Enron, and many more.

Recommendation 1 - Eliminate materiality requirement for CAMs

Many cases of material accounting problems or fraud started as 'immaterial' to the financial statement and built over time. Under current audit standards, if an auditor determines there has been a *proposed adjustment not booked* by a company, the auditor must inform the audit committee irrespective of materiality to the overall financial statements. Additionally, if an auditor uncovers any fraud, it must also be reported to the audit committee. Matters such as these are significant in the eyes of the auditor, and investors should be informed as well.

Would the current proposal compel auditors to deem such issues as 'immaterial'? It is a serious deficiency in the proposal if investors would only hear about critical audit matters after suffering large losses which is the current disclosure paradigm.

Moreover, the auditor should say or address in the auditor's report whether any quantitatively or qualitatively material items, albeit not required by a particular standard, are required to be disclosed in order for the financial statements not to be misleading.

Recommendation 2 - Eliminate reference to subjectivity for CAMs

PCAOB's proposal should state "Regardless of how subjective a matter is, if an auditor feels that an item is a critical matter in the audit and documents it in the engagement closing memorandum, then it should be disclosed to the audit committee and investors."

There are those who argue against transparency by defining it as the release of information about every matter to which auditors devoted attention. We do not agree that transparency is an all-encompassing concept. Rather, transparency should include the vexing issues and they must be shared with investors when they would be relevant to a reasonably-informed investor.

In order for investors to understand the degree of flexibility provided by the subjectivity clause, the board needs to clarify the extent to which CAMs that investors might consider material will fall outside the proposal's disclosure requirement. For instance, under FASB's new revenue recognition standard, companies are clearly not required to have a fixed and determinable price, customer acceptance or sell-through of goods to the customer before recognizing revenues. Moreover, it is not uncommon for material errors to occur in basic accounting areas which do not involve especially challenging, subjective or complex accounting judgment.

We also urge PCAOB to require disclosure of the auditor's perspective on material related party transactions in the auditor's report regardless of subjectivity. As noted in Auditing Standard No. 18, related party transactions can lead to errors in financial statements, and have been used to engage in fraudulent financial reporting or to conceal a misappropriation of assets. Auditors are required to communicate about related party transactions to the audit committee in a timely manner and prior to the issuance of the auditor's report, and, in turn, auditors should communicate about them to investors.

PCAOB must ensure these sorts of risks will be highlighted and discussed in the auditor's report irrespective of subjectivity.

Recommendation 3 - Require disclosure by auditors and management of materiality measures

Investors, including analysts at Capital who responded to the PCAOB Investor Advisory Group's survey have expressed strong support for disclosure by auditors and companies of their materiality measures. It would be constructive to compare materiality over time to trends in restatements and adjustments. Materiality would help inform our proxy voting process for auditor ratification and audit committee members. Materiality disclosure would be a valuable supplement to our audit fee analysis. One would expect if audit fees decrease as materiality rises, it could signal scoping of an audit based on audit fees instead of risk; we don't want to be subject to low quality audits.

Auditors should also be required to disclose what adjustments they make to reported figures in determining materiality thresholds for the audit.

Materiality disclosures, as well as significant discussion of CAMs and any changes, and how the auditor addressed them, are already provided in many auditor reports in the U.K. and other European countries to investors' benefit. Such disclosures inform us as investors better than in the U.S. today. For dual-listed registrants which remove such auditor disclosures from 20-F filings, we currently must look at overseas annual reports for the information.

Recommendation 4 - Address the problem of alternative dispute resolution clauses

Capital strongly opposes any requirement to use alternative dispute resolution. We believe such requirements can have a negative effect on audit quality, just as the SEC has stated auditor indemnification clauses can impact audit quality and independence. We do not believe these provisions are in the best interest of investors and therefore believe they should not be permitted.

There currently is a lack of transparency to investors of when such clauses are part of an audit agreement. We urge PCAOB to require disclosure of these clauses in the auditor's report when this type of provision is included in the audit engagement agreement.

Mr. Haaga previously recommended disclosure by the auditor of these clauses in his written submission to the Treasury's Advisory Committee on the Auditing Profession (ACAP) on February 4, 2008.

Recommendation 5 – Disclose reasons for any change of audit partner prior to mandatory rotation

It is material information for investors to be informed if an audit partner was changed prior to completion of mandatory partner rotation due to disagreement. PCAOB should require disclosure in the auditor’s report of the reason for such a change clarifying if it was or was not due to a disagreement. We recommended this disclosure as well to the ACAP.

Recommendation 6 – Require more of auditors on whistleblower systems and fraud detection

PCAOB standards should be clarified to require the auditor to gain an understanding of a company’s whistleblower system and process, how the whistleblower tips and complaints were resolved by management and the audit committee, and whether the whistleblower program is working effectively and independent of management. A fraudulent financial reporting study (May 2010) sponsored by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) found that in 89% of the cases, the Accounting and Auditing Enforcement Releases (AAERs) named the CEO and/or CFO as being associated with the financial statement fraud.

Many accounting problems and frauds come to light by whistleblowers. Having an effective whistleblower system is an important step towards stopping accounting-related problems earlier, as opposed to waiting until the stage when large losses will ensue for investors.

We appreciate that the proposal would add a statement in the auditor’s report about auditor independence and the phrase "whether due to error or fraud," when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. Unfortunately, this statement is too small a step towards addressing the continuing "expectations gap" discussed under Part VII, Recommendation 4 of the ACAP’s Final Report issued October 6, 2008. It would be more useful to have a statement that the auditor looked for material fraud and what steps the auditors took to gain comfort.

Thank you for considering these comments. Please feel free to contact Elizabeth Mooney, member of the PCAOB Standing Advisory Group, at (415) 646-7620. We invite staff to discuss with us our thoughts on the current proposal in more detail.

Sincerely,

/s/ Elizabeth F. Mooney

Elizabeth F. Mooney
Accounting Analyst
The Capital Group Companies, Inc.

/s/ Dane Mott

Dane Mott
Accounting Analyst
The Capital Group Companies, Inc.