



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

August 15, 2016

**RE: PCAOB Rulemaking Docket Matter No. 034 - *Proposed Auditing Standard - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards***

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB" or "Board") repropoed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "repropoed standard") and related amendments to PCAOB standards (collectively the "repropoal").

As we have expressed previously, we support changes to the auditor's report that will be responsive to the feedback provided by users while also maintaining or improving audit quality. We greatly appreciate the Board's consideration of comments received on the proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "original proposal").<sup>1</sup>

The following are examples of changes to the original proposal which we believe will allow for a more practical approach and mitigate certain unintended consequences:

- Limiting the population of critical audit matters to matters communicated, or required to be communicated, to the audit committee,<sup>2</sup>
- Incorporating an element of materiality in the definition of critical audit matter with the apparent intent of not requiring a critical audit matter itself to constitute original information communicated by the auditor (see our comments below related to this area),<sup>3</sup>
- Revising the definition of critical audit matter to include only those matters that involved especially challenging, subjective, or complex auditor judgment,<sup>4</sup>
- Requiring only the principal considerations that led the auditor to determine a matter is a critical audit matter, rather than all considerations, be communicated in the auditor's report,<sup>5</sup>
- Clarifying the only required addressees are the shareholders and board of directors,<sup>6</sup> and

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<sup>1</sup> See [https://pcaobus.org/Rulemaking/Docket034/Release\\_2013-005\\_ARM.pdf](https://pcaobus.org/Rulemaking/Docket034/Release_2013-005_ARM.pdf)

<sup>2</sup> See repropoed standard paragraph .A2

<sup>3</sup> See Ibid

<sup>4</sup> See Ibid

<sup>5</sup> See repropoed standard paragraph .14b

<sup>6</sup> See repropoed standard paragraph .07



- Delaying considerations of the auditor’s responsibilities regarding other information to allow each project to be properly analyzed.

We agree certain requirements and information in the repropoed standard will provide better clarity for the users of the auditor’s report, including:

- Requiring certain aspects of the auditor’s report, which should be easier for users to navigate,<sup>7</sup>
- Enhancing the description of the auditor’s responsibility,<sup>8</sup> and
- Explicitly stating the auditor is not providing a separate opinion on critical audit matters or on the accounts or disclosures to which they relate.<sup>9</sup>

We appreciate the Board considering standards already established by the IAASB and other standard-setters and regulators in developing the repropoal, and agree there is much similarity between the repropoal and these standards. We also appreciate the Board’s observation that adding additional information not included in the repropoal would have unnecessarily lengthened the auditor’s report without providing additional useful information.<sup>10</sup> However, we would encourage the PCAOB to consider the additional standard language adopted by the IAASB, such as the additional language related to the auditor’s responsibilities, as consistency in the standard language among different standard-setters and regulators would be beneficial to users of audits. Also, this will help considerations of form and content of the audit report when the auditor needs to report under both PCAOB standards and those of another standard-setter, such as the IAASB.

We offer herein other suggestions for the Board’s consideration as it moves to the next phase of this project. Our primary observations are organized into the following topical areas:

- Critical audit matters
- Auditor tenure
- Effective date and costs
- Application to brokers and dealers, investment companies, benefit plans and emerging growth companies
- Legal considerations related to the repropoal

Finally, we have included other specific comments on the repropoal in the Appendix to this letter.

### **Critical audit matters**

#### *Definition of critical audit matter*

Paragraph .A2 of the repropoed standard defines a critical audit matter as “any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit

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<sup>7</sup> See repropoed standard paragraphs .08, .09, and .15

<sup>8</sup> See repropoed standard paragraph .09

<sup>9</sup> See repropoed standard paragraph .15

<sup>10</sup> See page 52



committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.”

As we have said before, we believe if a matter is not important enough to require communication to the audit committee, it seems very unlikely it will be important enough to merit reporting as a critical audit matter.<sup>11</sup> Consistent with this premise, we support the repropose definition insofar as it limits the population of possible critical audit matters to matters communicated, or required to be communicated, to the audit committee. We believe this change<sup>12</sup> will result in the same critical audit matters being communicated in the auditor’s report but will reduce the effort related to identifying potential critical audit matters from a larger population and documenting why certain matters were not a critical audit matter. We also agree with the narrowing that a critical audit matter should be a matter that involved especially challenging, subjective, or complex auditor judgment.

We and others previously expressed concern about the potential to require the auditor to communicate original information about the entity.<sup>13</sup> We believed, and continue to believe, this would blur the line between an entity’s disclosure and auditor reporting, which is a fundamental distinction in our view. Part of our concern is having the auditor communicate information that otherwise would not have been required disclosure under the existing financial reporting standards or SEC reporting requirements.

While the reproposal’s discussion of materiality appears to resolve much of the concern about a critical audit matter itself being original information, it does not appear to resolve all of the concern related to the auditor reporting original information about the entity. More importantly, it appears the PCAOB’s intent is a critical audit matter should not be something the entity itself is not required to disclose. For example:

- Note 2 to paragraph .14 says, “When describing critical audit matters in the auditor’s report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.” (See our comments on page 5 related to the second part of Note 2 discussing the principal considerations and how the matter was addressed in the audit.)
- The release text explains materiality was included in the definition of critical audit matter in response to concerns the auditor may be required to communicate information management is not required to disclose under the applicable financial reporting framework and SEC reporting requirements.<sup>14</sup>
- Board member Ferguson expanded on this intent stating, “Company information, both financial and otherwise, and its disclosure is the responsibility of management, not the auditor. To blur that responsibility by putting part of it on the auditor could only lead to confusion and mischief.”<sup>15</sup>

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<sup>11</sup> See [https://pcaobus.org/Rulemaking/Docketo34/143b\\_PwC.pdf](https://pcaobus.org/Rulemaking/Docketo34/143b_PwC.pdf)

<sup>12</sup> In addition to required audit committee communications, the original proposal also discussed the source of critical audit matters could be items documented in the engagement completion document and/or reviewed by the engagement quality reviewer

<sup>13</sup> See [https://pcaobus.org/Rulemaking/Docketo34/143b\\_PwC.pdf](https://pcaobus.org/Rulemaking/Docketo34/143b_PwC.pdf)

<sup>14</sup> See page 20

<sup>15</sup> See <https://pcaobus.org/News/Speech/Pages/Ferguson-statement-ARM-051116.aspx>



By including the concept of materiality - specifically by requiring a critical audit matter to “relate to accounts or disclosures that are material to the financial statements” - it appears the Board intended to be responsive to the concern. For example and as described by the PCAOB on page 20 of the release text, a loss contingency determination in which the entity appropriately concludes there is no accrual and no disclosure in accordance with the related FASB standard would not relate to a material account or a material disclosure, and so would not be a critical audit matter under the proposed definition. We agree this is appropriate. We also agree with the discussion on page 20 of the release text and other commentary, including from Board members<sup>16</sup>, that original information would not by itself constitute critical audit matters under the repropoed definition.

However, the phrasing of the repropoed definition - specifically, that a critical audit matter “relates to accounts or disclosures that are material to the financial statements” - may still result in a critical audit matter itself being something that is not required for management to disclose resulting in the auditor communicating original information about the entity. Specifically, there may be a matter that would “relate to an account” that is material but that is not actually required to be disclosed by the entity. For example, a significant deficiency is a required audit committee communication not related to a required disclosure, but would most likely relate to a material account, and so the auditor could be in the position of disclosing the significant deficiency when management would not be required to do so. We also believe the definition should be revised to make it clear that materiality relates to the financial statements taken as a whole to be consistent with the auditor’s opinion as described in paragraph .01 of the repropoed standard. Based on the above, we suggest the Board revise the definition of a critical audit matter as follows:

A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) ~~relates to accounts or disclosures that are~~ is material to the financial statements **taken as a whole** and (2) involved especially challenging, subjective, or complex auditor judgment.

We agree a critical audit matter could relate to an element of an account or disclosure and does not necessarily need to correspond to an entire account or disclosure in the financial statements. We also agree a critical audit matter might not relate to a single account or disclosure but could have a pervasive effect on the financial statements or relate to many accounts or disclosures.<sup>17</sup> We believe by stating a critical audit matter is material to the financial statements taken as a whole, the entity would have disclosure regardless of whether it related to an element of an account or disclosure or was pervasive in nature. If the Board believes these concepts need to be emphasized, a note in the standard could explain a critical audit matter might not be an entire account or disclosure, could be pervasive, or relate to many accounts or disclosures.

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<sup>16</sup> See Board member Hanson’s remarks at the open meeting in which he stated, “Finally, preparers should feel more comfortable that CAM disclosures under the reproposal would start with a reference to disclosures made by management in material financial reporting areas and otherwise focus on the work of the auditor. This should generally eliminate the need for auditor’s [sic] to disclose any original information about the company, except to the extent the auditor’s stated reason for identifying a CAM involves reference to facts not already disclosed by the company. I would hope that such circumstances will be infrequent.”  
<https://pcaobus.org/News/Speech/Pages/Hanson-statement-ARM-051116.aspx>

<sup>17</sup> See page 20



The suggested change would also seem to be consistent with Board’s intent and the requirement to refer to both the relevant financial statement accounts “and” disclosures that relate to the critical audit matter (i.e., the reporting requirement seems to indicate both would apply). Under our proposed definition, the example of a significant deficiency would not be material to the financial statements taken as a whole; therefore, it would not be a critical audit matter. This would seem to align with the Board’s intent to not have a critical audit matter itself be a source of original information about the entity.

The second part of Note 2 to paragraph 14 discusses the possibility that information not made publicly available by the company may be communicated by the auditor to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit. We believe original information in describing the principal considerations or how the matter was addressed should be limited to audit information and not original information about the entity, and suggest the Board consider clarifying this point in Note 2 and elsewhere. As discussed above, our concern is that if the auditor is the first to disclose original information about the entity, that information by definition goes beyond what the entity either (i) was required to disclose under existing financial reporting standards and SEC reporting requirements, or (ii) chose to disclose. Accordingly, the entity may view some or all of the information as confidential or privileged (in states that recognize the accountant-client privilege).

Although some state confidentiality laws may permit an auditor to report confidential information when required by law or auditing standards, it is unclear whether the reproposal would authorize an auditor to report original information about the entity, because it does not specifically identify the information that must be communicated in the auditor report. Rather, the auditor would apply its judgment to determine which information falls within the reproposal’s reporting requirements. State-by-state analysis would be necessary to determine whether under these circumstances the auditor would violate confidentiality obligations or the accountant-client privilege. We believe the only way to avoid these concerns is to make clear that the auditor should not communicate original information about the entity in the auditor’s report.

#### *Illustrations of critical audit matters and how the critical audit matters were addressed in the audit*

While we appreciate the PCAOB providing illustrations and the caveats related to the illustrations provided in the release text,<sup>18</sup> we are concerned they may be viewed as templates by entities or auditors and, as such, we have concerns about some of the content in these examples. The reproposed standard requires the auditor to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter and how the critical audit matter was addressed in the audit,<sup>19</sup> but both examples include information that does not seem unique in the circumstances; therefore, may result in boilerplate language and unnecessary length that would not benefit the users of the financial statements. For example, the first illustration includes a lengthy background paragraph which then leads the illustration to summarize, in a separate paragraph, the principal considerations (instead of the background paragraph clearly and succinctly articulating the principal considerations). Additionally, both examples discuss testing of controls, which is not unique to the critical audit matters reported. Therefore, we suggest, to the extent the PCAOB intends to include such illustrations in any final standard, it tailor the illustrations to focus on just the principal considerations. In addition, in order to avoid lengthy recitations within critical audit matters of most of the procedures the auditor performed in connection with the

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<sup>18</sup> See pages 32-35

<sup>19</sup> See reproposed standard paragraph .14b



critical audit matter (which we believe would be of limited benefit to users of the financial statements), we also suggest limiting the requirement of describing how the matter was addressed in the audit to just the *principal* ways in which it was addressed. This would be consistent with the requirement to communicate the principal considerations.

### **Auditor tenure**

While we have previously commented on communicating auditor tenure in the audit report, we felt it appropriate to reiterate our concerns since the reproposal has not changed in this respect.<sup>20</sup> As acknowledged in the release text, research continues to be divided on the relationship between audit quality and auditor tenure.<sup>21</sup> Consistent with our response to the original proposal, we believe including auditor tenure in the audit report would create the false impression such a relationship exists and would give undue prominence to this information. Moreover, the responsibility for hiring and dismissing the auditor rests with the audit committee, not the auditor. Accordingly, we do not believe that auditor tenure should be included in the audit report. However, if audit committees and management believe it is useful information given their specific facts and circumstances, we would not object to disclosure by them of tenure elsewhere. This would allow for the disclosure to be provided in the proper context for why management chose to make the disclosure.

### **Effective date and costs**

The release text notes the Board has not yet concluded on potential effective dates. We believe the first year of reporting under the reposed standard will be a significant undertaking. Audit firms internally will need to make methodology changes, revisions to reporting guidance and templates, and training. Further, audit firms will incur time discussing the new report with audit committees and it is likely many firms, including ours, will put National Office consultation requirements in place to drive consistent and effective implementation potentially requiring additional resources to do so.

While we acknowledge the United Kingdom implemented their enhanced reporting model in one reporting cycle, the new auditor report in the UK applied only to companies reporting under the UK Corporate Governance Code, which is principally the FTSE 350. As a point of reference, we alone audit close to 1,000 issuers for whom reporting of critical audit matters would apply.

As it relates to the reporting of critical audit matters, we believe two years from when the standard is finalized and approved by the SEC would be appropriate for the reporting of critical audit matters, as this will allow firms sufficient time to train and develop quality control policies, including National Office consultations, to review the audit reports. Additionally, it is expected there will be initial and ongoing efforts in explaining audit reports to management and the audit committee, including consideration of their input in describing the facts around the critical audit matter. If the Board wanted to adopt other parts of the standard earlier as outlined in question 44, we would be supportive of that approach. Also, in order to achieve a successful transition, we suggest a phased implementation approach. One such approach would be to require reporting of critical audit matters for large accelerated filers two years after the SEC approval and accelerated and non-accelerated filers would adopt one year later.

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<sup>20</sup> See reposed standard paragraph .10b

<sup>21</sup> See page 49



As discussed in connection with the effective date, we believe the first year of reporting under a new standard will be a significant undertaking, and the activities firms will need to perform to prepare for, implement and execute on a new standard will result in significant up-front and ongoing costs. On a recurring basis, additional coordination among management, the audit committee, and the auditor (including National Office consultations) will be required to address critical audit matters included in the auditor's report. Although critical audit matters will be identified from matters that are already required to be documented, there will be incremental costs in analyzing and documenting which matters should be reported as a critical audit matter, drafting communications about the critical audit matter, and consulting with the National Office. While these costs should decrease over time as reporting of critical audit matters becomes more familiar, it is difficult to estimate what the ongoing recurring cost will be, as the cost will fluctuate engagement-to-engagement based on the number and complexity of critical audit matters identified and reported.

### **Application to brokers and dealers, investment companies, benefit plans and emerging growth companies**

We agree with the exclusion of communication of critical audit matters from audits of brokers and dealers, investment companies (other than business development companies), and employee stock purchase, savings, and similar plans (benefit plans). We believe the repropoed standards should apply to audits of emerging growth companies.

### **Legal considerations related to the reproposal**

In questions 10-12,<sup>22</sup> the Board asked about potential effects the communication of critical audit matters may have on private litigation and private liability. In our comments to the original proposal, we cautioned that the proposed standard would have significantly increased litigation risk for the profession. The reproposal includes positive changes which make the risk of increased litigation less severe. The revised definition of a critical audit matter, which focuses on "especially challenging, subjective, or complex auditor judgment," should help limit the number and type of statements which will be attributable to the auditor. Under the federal securities laws, an auditor can be subject to suit only for statements that are made by and properly attributed to it. Statements reflecting the exercise of judgment (i.e., statements of opinion) are less vulnerable to challenges that they are false or misleading. Thus, these changes may help limit the scope of claims made against auditors.

However, the reproposal includes requirements that still could significantly increase litigation risk over current reporting standards. As discussed above, the auditor may still be required to disclose original information about the entity. Among other things, the auditor will be required to communicate the principal considerations supporting its determination of critical audit matters, which may include "the nature of audit evidence obtained regarding the matter."<sup>23</sup> Additionally, the auditor will be required to disclose "how the critical audit matter was addressed in the audit."<sup>24</sup> This information could be used to attack the audits performed by, among other things, alleging that professional standards required additional or different audit evidence to have been obtained, or audit procedures to have been performed. In our prior comments, we cautioned that plaintiffs will be able to parrot and mischaracterize additional

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<sup>22</sup> See page 42

<sup>23</sup> See repropoed standard paragraph 14(b) and 12(f)

<sup>24</sup> See repropoed standard paragraph 14(c)



statements regarding critical audit matters to create an incorrect appearance of specificity as required to plead scienter and survive dismissal. These risks still exist.

Finally, if these cases are not dismissed at the outset, the litigation and particularly discovery costs often drive a settlement regardless of merit. Though improved, the reproposal will likely mean more spurious claims will be brought, fewer meritless cases will be properly dismissed at an appropriate stage, and more unwarranted settlements will need to be reached. The further changes we suggest in this comment letter will help mitigate some of these risks; however, any enhanced reporting requirement will likely increase litigation risk to the profession.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Leonard L. Combs (973-236-5265) or Neil A. Weingarten (617-530-6225) regarding our submission.

Sincerely,

*PricewaterhouseCoopers LLP*





## APPENDIX

This appendix provides additional comments on specific requirements in the reproposal for the Board's consideration.

### *Qualified opinions*

The reproposal would create auditing standard AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances* and create a note referring the auditor to AS 3101 to determine if the matter for which the auditor qualified his or her opinion is also a critical matter.<sup>25</sup> When the auditor's opinion is qualified, we believe the most important communication is the disclosure of the substantive reasons for the qualification, as discussed on page A2-14. If an auditor were to also report the qualification as a critical audit matter, the description of how the auditor addressed the matter may imply audit work was performed that was sufficient and appropriate (when in fact there was a scope limitation) or the accounting might be appropriate (when there is a departure from GAAP). Consistent with the Board's determination to not include critical audit matters when there is an adverse opinion<sup>26</sup> and disclaimer of opinion,<sup>27</sup> we believe the item that is driving a qualified opinion should not be a critical audit matter.

### *Explanatory paragraphs*

The reproposal notes that a required explanatory paragraph (such as going concern) may also be considered a critical audit matter.<sup>28</sup> We believe that if an otherwise required explanatory paragraph is also a critical audit matter, disclosure in the auditor's report should be limited to one place in the audit report. If the Board believes it is important for users to understand the matter met both an explanatory paragraph and a critical audit matter, we agree it can be achieved by cross referencing within the separate sections.<sup>29</sup> Page 55 of the release text continues to discuss that alternatively the auditor may choose to provide the information in both places. We agree the reporting requirements for both an explanatory paragraph and a critical audit matter should be met but including discussion of the information in both places may become redundant, as acknowledged on page 55 of the release text. We recommend the PCAOB require the communication for both a critical audit matter and an explanatory paragraph be reported in the critical audit matter section of the auditor's report with a cross reference in the explanatory paragraph section if the Board believes it is important that it is included in both locations. If the Board believes certain items should be included in a separate section regardless if a critical audit matter or not that could also be reflected in the repropose standard (for example, going concern).

### *The auditor has not been engaged to audit internal control over financial reporting*

In situations in which management is required to report on the entity's internal control over financial reporting ("ICFR") but such an assessment is not required to be audited, the reproposal would require a statement that the auditor did not audit ICFR.<sup>30</sup>

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<sup>25</sup> See page A2-15

<sup>26</sup> See page A2-30

<sup>27</sup> See page A2-32

<sup>28</sup> See page 55

<sup>29</sup> See page 55

<sup>30</sup> See page A2-44



While we do not believe such a requirement is necessary, we do not object to its inclusion; however, if the Board is to keep this requirement, we suggest it be expanded to all instances in which the auditor is not engaged to opine on ICFR, and not limited to when management is required to report on ICFR.

#### *Financial statement schedules*

The reproposal adds a requirement that the auditor's report include a statement identifying each financial statement and any related schedule(s) that has been audited.<sup>31</sup> We ask that the final standard clarify that when the schedules are finalized separately from the financial statements, auditors may, consistent with current practice, issue a separate report.

#### *AS 3305*

The reproposal includes proposed amendments to AS 3305.12. The proposed amendment may be misconstrued that, for special reports in which the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with GAAP, the auditor need only refer to the opinion in AS 3101 and AS 3105. We recommend the proposed amendment be further modified as follows:

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. The standards of the PCAOB are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. If the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles, the auditor's reports~~opinions~~, as described in AS 3101 and AS 3105, are applicable.

#### *Other periods presented*

In question 4<sup>32</sup>, the Board asks if there are specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period. We do not believe there are specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented. The current year is the most relevant to users, and it is likely many critical audit matters in earlier periods will be repetitive to those in the current period.

#### *Referring to disclosures outside the financial statements*

In question 7<sup>33</sup>, the Board asks if it would be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter. We do not believe it would be appropriate for the auditor to refer to relevant disclosures outside of the financial statements as this information is not audited and doing so may further the expectation gap on the auditor's involvement with other information.

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<sup>31</sup> See reproposed standard paragraph .8b

<sup>32</sup> See page 28

<sup>33</sup> See page 38



*Ability to determine there are no critical audit matters*

In question 8<sup>34</sup>, the Board asks if it is appropriate to retain the possibility of the auditor determining there are no critical audit matters. We agree with retaining this ability, as there are certain companies for which there may be no critical audit matters.

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<sup>34</sup> See page 38