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

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 Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Release No. 2016-003, *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* (the "Proposed Standard" and "Proposed Amendments," respectively, and collectively the "Reproposal").

The Board has requested public comment on the Reproposal, which is intended to improve the auditor's report. Overall, we support the Board's initiatives to increase the relevance and usefulness of the auditor's report and reduce the information asymmetry between investors and auditors.

Overview

We continue to support the PCAOB's objectives of enhancing the form and content of the auditor's report to make it more relevant and informative to investors and other financial statement users. Consistent with our comment letter dated December 11, 2013 on PCAOB Release No. 2013-005, *Proposed Auditing Standards - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the "Prior Proposal"), we remain in agreement with the Board that requiring communication of critical audit matters ("CAMs") in the auditor's report would be an effective way to inform investors and other financial statement users of the matters arising from the audit that are of most interest to them, specifically those matters involving especially challenging, subjective, or complex auditor judgment.

In addition, we commend the PCAOB for many of the revisions it made to the Prior Proposal that are now reflected in the Reproposal. Specifically, we concur with the following requirements of the Reproposal:

- Limiting the source of potential CAMs (see additional recommendations below under “Additional Guidance”);
- Adding a materiality component to the definition of CAMs;
- Narrowing the definition of CAMs to only those matters that involved especially challenging, subjective, or complex auditor judgment; and
- Clarifying that CAMs would not be expected to provide original information about the company (see additional recommendation below under “Original Information”).

We also believe that there are additional enhancements the PCAOB should consider to improve investors’ knowledge and understanding of the auditor’s report. Therefore, we request the PCAOB consider revisions to the Reproposal related to (1) how the CAM was addressed in the audit, and (2) adding clarifying language to the auditor’s report. Furthermore, we believe these proposed enhancements would have the added benefit of reducing the risk of unwarranted litigation.

We continue to disagree with the Board’s view that disclosure of auditor tenure within the auditor’s report provides meaningful or relevant information to investors and other users of the financial statements.

Lastly, we offer our views with respect to applicability and the effective date of a final standard, as well as an editorial comment.

Communication in the Auditor’s Report

How the CAM was Addressed in the Audit

We agree with the PCAOB’s revisions to include a requirement that auditors must describe how the CAM was addressed in the audit, and we support the overall non-prescriptive nature of the requirement. In our comment letter on the Prior Proposal, we recommended that the PCAOB develop guidance concerning the auditor’s communication about how the CAM was addressed in the audit (the language used in our prior comment letter was “the CAM’s effect on the audit”).¹ We had suggested that the guidance should indicate that the description of the effect on the audit should be: (1) a brief, high-level summary of the key audit procedures performed (e.g., the auditor’s response to the risk of material misstatement identified in the CAM) to address the principal considerations that led the auditor to conclude that a matter is a CAM; (2) focused only on those assertions (e.g., completeness, valuation) that resulted in the matter being communicated as a CAM; and (3) focused on the most significant assumptions or estimates, if applicable, affecting such assertions.

The Board included the following on page 31 of the Reproposal, which we believe is relatively consistent with the recommendation in our prior comment letter:

¹ KPMG comment letter on the Prior Proposal, December 11, 2013, at 7.

[I]n describing how the critical audit matter was addressed in the audit, the auditor may describe: (1) the auditor’s response or approach that was most relevant to the matter; (2) a brief overview of procedures performed; (3) an indication of the outcome of the auditor’s procedures; and (4) key observations with respect to the matter, or some combination of these elements.

While these elements would not be required, they do provide specific guidance on what type of information the Board is seeking for auditors to disclose regarding the CAM in order to meet the requirement of describing how the CAM was addressed in the audit. We therefore recommend that the Board include such guidance directly in the final standard, as opposed to it being in the release text.

Clarifying Language in the Auditor’s Report

We agree with the Board with respect to the need to make clear that the disclosure of a CAM and the related audit procedures does not provide any assurance as to any particular line item in the company’s financial statements. In the Prior Proposal, the Board raised a concern that investors would read the disclosure of a CAM and related audit procedures as providing such assurance. While we appreciate the Board’s efforts to respond to this concern, we believe the risk of misunderstanding still exists.

Supporting the concern that investors may misinterpret the auditor’s report and indicating the need for such clarifying language are the results of a study that surveyed professional and nonprofessional investors. The study found that “professionals are more likely than nonprofessionals to correctly identify which 10-K components are audited,” and, further, that many investors in both groups believe that unaudited information is, in fact, audited.² While the study focused on understanding the level of assurance investors believe exists on various forms of financial information, including the Form 10-K and company websites, it indicates the average investor (nonprofessional) may not be fully knowledgeable of the extent and nature of the content of the auditor’s report, including the auditor’s responsibilities. This is demonstrated by the fact that participants believed information outside of the financial statements was audited, despite the fact that the auditor’s report (detailing the scope of the audit) was provided to and accessed (via online tracking) by the participants in the study. The intent of the study was not to suggest that auditor responsibilities should be expanded to include providing assurance on Management’s Discussion and Analysis of Financial Condition and Results of Operations or financial information on a company’s website, but rather the study illustrates that more information is required to educate investors on the roles and responsibilities of the auditor as it relates to a company’s financial information. We believe including additional clarifying language in the auditor’s report is the most efficient and effective approach to address this issue.

² Jean C. Bedard, Steve G. Sutton, Vicky Arnold, and Jillian R. Phillips, *Another Piece of the “Expectations Gap”*: What Do Investors Know About Auditor Involvement with Information in the Annual Report?, American Accounting Association, January 2012, at A17.

For these reasons, we continue to have a concern that the description of audit procedures will be read by investors as a form of assurance about the results of the auditor's procedures. While the auditor's report appropriately disclaims any line-item opinion, an investor may well read the description of audit procedures as an implicit assertion that all of the audit evidence obtained from each of these procedures supported the reported amount. In fact, some procedures might have produced results that varied from the company's judgments, or even disconfirming evidence, that the auditor considered. As evidenced in the research study cited above, investors' understanding of language and concepts within an auditor's report is not always consistent with the auditor's intent. We believe this risk of misunderstanding can be mitigated, however, by including an explicit statement that the description of such procedures should not be taken as being indicative of the results of any individual procedure, but instead the auditor considered the totality of audit evidence provided by all such procedures.

Further, as mentioned in our comment letter on the Prior Proposal, we continue to believe the following previously suggested elements should be included in the auditor's report in order to narrow the expectation gap of investors:

- Stating in the basis of opinion paragraph that the procedures performed and the audit evidence obtained provide a reasonable basis for the opinion;
- Highlighting that references to the financial statements throughout the auditor's report relate to the financial statements taken as a whole;
- Providing an expanded discussion of the responsibilities of management and the audit committee with respect to the financial statements;
- Describing the meaning of reasonable assurance in the context of the basis for the auditor's opinion; and
- Highlighting the necessity of using professional judgment in making audit risk assessments and in the selection of audit procedures, and the consideration the auditor gives to the company's internal control over financial reporting when making such determinations, as well as highlighting the auditor's use of professional skepticism throughout the audit.

As noted in another research paper, in order for the auditor's report "to have optimal value it is important that auditors and users have a shared meaning of the responsibilities and limitations of the audit function ... and of technical terms used in the report such as ... 'reasonable assurance'"³ This research paper noted that readers may interpret the same text differently due to their individual backgrounds, motives, wishes, etc., and because of that there is "room to misunderstand, ignore, or selectively interpret the intentions of standard setters who prescribed the language in the [standard auditor's report]."⁴ This was supported by the results of the

³ Stephen K. Asare and Arnold Wright, *Investors', Auditors', and Lenders' Understanding of the Message Conveyed by the Standard Audit Report*, American Accounting Association, September 2009, at 22.

⁴ *Id.* at 8.

research performed, which found that the “objectives and limitations of the [standard auditor’s report] are not well understood or alternatively users and issuers have little shared meaning.”⁵ The study suggests the gap between users (e.g., lenders and investors) and auditors could be reduced through clarifying language in the auditor’s report, which supports our recommendation above to expand the auditor’s report to include additional clarifying language.

In addition, we encourage the PCAOB to work with other regulators to educate investors concerning the audit committee’s responsibilities with respect to the financial statements by way of an expanded auditor’s report. Expanding the discussion of the responsibilities of auditors versus management and the audit committee in the auditor’s report would be beneficial, since evidence exists that investors do not fully understand the role of those charged with governance. This is also supported by a survey of investment professionals that found “[m]any interviewees [investment professionals] have never talked with an audit committee member and don’t fully understand what they do.”⁶ A similar theme was also present at the Audit Committee Leadership Summit that was held in March 2013, where it was recognized that “...many investors would benefit from a more robust understanding of what the public company audit committee does and how it oversees the external audit firm and performs its other responsibilities.”⁷ This insufficient level of understanding may diminish investor confidence concerning audit committees, which serve as an important element in the financial reporting process (along with management and the auditors). Expanding the auditor’s report to include a description of the responsibilities of the audit committee (and management) with respect to the financial statements may contribute to a greater understanding of the role of the audit committees and thereby benefit investors in their investment decisions. Such action would also align with the Securities and Exchange Commission’s (“SEC”) current exploratory project to increase investor knowledge through additional required audit committee disclosures,⁸ with such disclosures focusing on an audit committee’s oversight of the work of the external auditor, among other responsibilities, and which may include discussion and review by the audit committee of CAMs disclosed in the auditor’s report. Further, while it seems any potential additional audit committee disclosures required by the SEC would be aimed at informing investors about *how* the audit committee carries out its responsibilities, such disclosures, coupled with an expansion of the auditor’s report that describes the audit committee’s responsibilities with respect to the financial statements, would significantly increase an investor’s understanding and ability to make informed investment decisions.

We disagree with the Board’s statement on page 52 of the Reproposal that “[s]ince it may not be practical to describe these elements concisely, adding these to the auditor’s report would

⁵ *Id.* at 7.

⁶ PricewaterhouseCoopers LLP, *Assurance Today and Tomorrow*, 2012, at 4.

⁷ Tapestry Networks, Inc., *View Points*, Issue 22, May 2, 2013, at 1.

⁸ Securities and Exchange Commission Release No. 33-9862, *Possible Revisions to Audit Committee Disclosures*, July 1, 2015.

unnecessarily lengthen it without providing additional useful information to investors.” Investors are responsible for understanding the financial statements and the notes therein when making investment decisions. We believe that our suggestions will help investors better understand the financial statements.

As evidenced above, the additional suggested elements are demonstrably relevant and informative to investors. The additional length to the auditor’s report that would result from incorporating these elements is insignificant when compared to the value gained by the investment community, and therefore we strongly encourage the Board to reconsider its position.

Original Information

As noted in our comment letter on the Prior Proposal, one of the overarching principles for consideration when developing possible areas of the auditor’s reporting model for further evaluation was that auditors should not be the original source of information about the company. We stated in that comment letter that we believe the auditor should be precluded from communicating any original information, except in those rare (emphasis added) situations where, in the auditor’s judgment, the communication of such original information is necessary to the auditor’s description of the CAM. We continue to believe that this is the appropriate approach, as management is the party that should be responsible – in almost all situations – for assessing and determining what information should be disclosed in accordance with the applicable rules and regulations.

We observed that Note 2 of paragraph 14 of the Proposed Standard states that “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.” We are concerned that the phrasing used in the Proposed Standard may lead auditors to disclose original information in situations not intended by the Board. For example, it is not unusual for allegations of misconduct to be made against an officer or director, reported to the audit committee, and investigated. Such allegations may prove unsubstantiated. Under the Proposed Standard, an auditor might nonetheless feel compelled to disclose the investigation as a CAM. We believe that such disclosure is likely to create confusion for investors and embarrassment for the parties involved, and was not the result intended by the Board. Furthermore, as it relates to this specific example, the SEC has issued rules that govern when such matters should be disclosed by the auditor, such as under Section 10A of the Securities Exchange Act of 1934, and no evidence exists that would indicate that the SEC’s rules are ineffective or should be expanded (implicitly or explicitly) by the PCAOB. We imagine there are other situations where the auditor may feel compelled to disclose a matter as a CAM even though the company has no legal or regulatory obligation to do so. Accordingly, we request that the Board provide additional guidance to make clear that situations where the auditor would be expected to convey original information would be rare.

Additional Guidance

The Board's Reproposal makes strides toward reducing undue litigation risk, and we appreciate the Board's efforts in that regard. While we support the efforts thus far, we continue to believe that some of the language in the Reproposal could be misused in a litigation context. A matter may appear critical to investors in hindsight merely because it resulted in losses. In such a circumstance, the claim that the matter should have been a CAM, or that a CAM should have had more disclosure, is easily made, whether it is sincere or merely an effort to seek damages not justified by the circumstances. We believe clarification of the Reproposal as suggested below would help reduce the potential for abuse, while at the same time clarifying the intent of the Reproposal and furthering the goals of the Board.

The Reproposal includes in the definition of a CAM matters actually communicated to the audit committee, even if not required. As currently written, the Reproposal is unclear as to what kind of communication would fall into that category. For example, if a matter is included on a slide as background or mentioned in response to a question, is that sufficient to include the matter in the universe of possible CAMs? If simply mentioning a subject to the audit committee could potentially trigger the disclosure requirement, thus exposing the auditor to liability, the Reproposal may act as an incentive to limit discussion to required matters. Moreover, the Reproposal is not clear what benefit investors gain from such matters being included as CAMs, since they are (by definition) those that are not considered necessary to communicate. Therefore, we believe that CAMs should only be drawn from those matters *required* to be communicated to the audit committee.

Additional illustrative guidance about what constitutes a CAM, and what *does not* constitute a CAM, would be helpful in a number of ways. Given a similar fact pattern involving challenging, subjective, or complex auditor judgment, auditors may reach disparate conclusions about whether a CAM exists and is required to be communicated. In this context, it would also be helpful to have illustrative guidance about the number of CAMs auditors should typically expect to communicate. We do not suggest that the Reproposal be modified to set a fixed minimum or maximum, but such guidance would help set expectations for both investors and auditors. Additionally, the examples provided in the Reproposal only pertain to the communication of CAMs that relate to financial statement accounts and not to disclosures. Additional guidance as to what a communication of a CAM related to disclosures would look like would be beneficial to investors and auditors. This guidance also would be helpful to courts and other tribunals trying to distinguish those matters that involved the "most" difficult or complex issues from those that appear critical only in hindsight.

Further, we have some uncertainty about what the Board means by a matter that "relates to" accounts or disclosures that are material to the financial statements. In other contexts, such as civil litigation, the phrase "relates to" can be read broadly. For example, revenue presumably will be a material account in a financial statement. Any matter that is tangentially related to revenue therefore "relates to" a material account, no matter how small the individual matter. Indeed, it may prove difficult to identify anything that would not "relate to" a material account or

disclosure. Our belief is that the matter itself should have significance. Therefore, to remove the potential for misinterpretation or misuse, particularly in the context of litigation, we propose the Board remove the phrase “relates to accounts or disclosure matters that” from paragraph 11 of the Proposed Standard.

When reviewing the recommendations above, we request the Board consider the result of an academic research project that studied the impact on an auditor’s litigation exposure when the disclosure of an issue is more subjective versus more objective. That study looked at increased disclosures similar to the Reproposal, although related to the auditor’s report on internal control.⁹ It found that when a disclosure proved to be in error, auditors are attributed more blame when the situation is subjective. Moreover, that result was seen despite warnings about the risks and uncertainties of the matter. This result suggests that “in subjective situations, auditors must consider that their liability exposure is heightened solely due to the characteristics of the situation itself (not necessarily their actions).”¹⁰ This result provides support for the clarifications discussed above, and the Board should continue to consider the potential for significant liability exposure when finalizing the standard.

Tenure

As discussed on page 49 of the Reproposal, academic research is mixed as to the relationship, if any, between auditor tenure and audit quality. In addition, neither the International Auditing and Assurance Standards Board nor the Financial Reporting Council in the United Kingdom require auditor tenure disclosures. As such, we continue to disagree with the Board’s proposed requirement to disclose auditor tenure in the auditor’s report, since including it may give a false impression to a reader of the auditor’s report that there is a correlation between auditor tenure and audit quality. If the Board believes this information is necessary to meet its objective of assisting investors to make better-informed investment decisions, then we would recommend that the Board modify its Form AP to provide for the disclosure of such information.

Applicability and Effective Date

Applicability

We agree with the Board’s decision to exclude the auditors of certain entities (specifically, broker dealers, investment companies other than business development companies, and benefit plans) from the requirements to determine, communicate, and document CAMs. As noted in our comment letter on the Prior Proposal, benefit plans and investment companies are: (1) designed

⁹ Jillian Phillips, *Do Audit Report Disclosures Lead to Increased Liability Exposure? An Investigation of Jurors’ Consideration of Auditors’ Disclosure of Significant Deficiencies in Internal Control*, March 27, 2015, at 3, <http://ssrn.com/abstract=2586128>.

¹⁰ *Id.* at 23.

for a specific purpose and, as a result, would likely have similar CAMs; and (2) inherently less complex and entail fewer estimates and judgments. In addition, the ownership of broker dealers is primarily closely held, and the direct owners are generally part of the entity's management. Therefore, the information needs of these individuals would typically be different from those of an investor. With respect to emerging growth companies ("EGCs"), we continue to believe that the requirements related to CAMs should be applicable to the auditors of EGCs, and therefore recommend that no exemption from the final standard be provided.

Effective Date

With respect to implementing a final standard, auditing firms will need to ensure that their professional staff are adequately trained on the standard. An even more time consuming task will be the implementation of effective quality control processes, so that an auditing firm has a high degree of assurance that the determination and communication of CAMs are: (1) being done in a manner that is useful and meaningful to the users of the financial statements; and (2) in compliance with the requirements of the final standard. To provide adequate time for auditing firms to train their professionals and put in place the necessary processes to meet the above objectives, we would recommend that the effective date of the final standard be no earlier than two years after final approval of the standard by the SEC. In addition, we believe a phased implementation approach would benefit not only auditing firms but investors, so that they can become accustomed to the changes in the auditor's report. Therefore, we recommend that the final standard be applicable to large accelerated filers in the first year that it is effective, followed by all other filers in subsequent years.

Editorial Comment

Paragraph .01 of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, on page A2-7 of the Proposed Amendments, reflects various revisions. In the second sentence of that paragraph, the word "section" was replaced by "standard"; however a similar revision was not made in the third sentence.

* * * * *

We appreciate the Board's careful consideration of our comments and observations, and support the Board's efforts to update current standards for the auditor's report by enhancing its form and content to make the information it provides more relevant and informative to investors and other financial statement users. If you have any questions regarding our comments included in this letter, please do not hesitate to contact George Herrmann ((212) 909-5779 or gherrmann@kpmg.com) or Rob Chevalier ((212) 909-5067 or rchevalier@kpmg.com).

Very truly yours,

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Public Company Accounting Oversight Board
August 15, 2016
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cc:

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