SOCIETY
of Corporate Secretaries
& Governance Professionals

January 21, 2014

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

Re: PCAOB Release (No. 2013-005) on Proposed Auditing Standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information In Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (PCAOB Rulemaking Docket Matter No. 034)

Ladies and Gentlemen:

The Society of Corporate Secretaries & Governance Professionals appreciates the opportunity to provide comments on the Proposed Auditing Standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Auditor Reporting Standard") and *The Auditor's Responsibilities Regarding Other Information In Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Other Information Standard", and together with the Auditor Reporting Standard, the "Proposed Auditing Standards"), PCAOB Release No. 2013-005 issued on August 13, 2013 by the Public Company Accounting Oversight Board .

Founded in 1946, the Society is a professional membership association of more than 3,100 corporate and assistant secretaries, in-house counsel, outside counsel and other governance professionals who serve approximately 1,600 entities, including 1,200 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and the executive managements of their companies on corporate governance and disclosure matters.

General Comment

The Society appreciates the PCAOB's efforts to improve the relevance and quality of public company audits for investors; however, the Society believes that the Release fails to achieve this objective. The Release states that the Proposed Auditing Standards are "intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report" while seeking "a balanced approach that would not unduly burden the financial reporting process." However, the Society believes that the Proposed Auditing Standards—by requiring auditors to disclose "critical audit matters" —would fundamentally change the role of the auditor from an independent analyst to an original source of information for investors. In addition, the significant time and cost burdens to companies under the Proposed Auditing Standards would greatly outweigh any corresponding benefit for investors. For these reasons, the Society cannot support the Release. These and other concerns are discussed in greater detail below.

Critical Audit Matters

Mandatory communication of critical audit matters will alter the fundamental relationship of auditor and audit client; may require the auditor to disclose confidential information of the client, resulting in harm to the client; and may lead to duplicative and potentially conflicting disclosures.

As set forth in the Release, the auditor must: (i) identify the critical audit matter; (ii) describe the considerations that led the auditor to determine that the matter is a critical audit matter; and (iii) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. The Society believes that requiring the auditor to communicate critical audit matters will require the auditor to make substantive disclosures concerning the company and will thus change the role of the auditor in ways that will not benefit companies, auditors or investors.

An essential feature of the public company reporting system is that the company is responsible for disclosure about the company, just as it is responsible for preparing its own financial statements. The company's disclosures are made by management under the oversight of the company's board of directors and the audit committee of the board of directors. The role of the auditor is to attest to certain information provided by management and to report separately to the audit committee. These distinct roles have been a critical part of the audit report since the 1940s.[1] In fact, the Release states that the Proposed Auditing Standards are not intended to change the role of the auditor from attestation to being an original source of disclosure concerning the company, and that the intent of the Auditor Reporting Standard is to require the auditor to discuss matters pertaining to the audit process, rather than making original disclosures about the company.

While the Society appreciates that the auditor's communications of critical audit matters would be based on information known to the auditor and procedures that the auditor has already performed as part of the audit, the auditor's discussion of critical audit matters would likely result in the disclosure of sensitive information such as significant deficiencies, internal

[1] AU Section 508.08 ("A statement that the financial statements are the responsibility of the Company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit").

investigations and going concern considerations that would otherwise not be required by the company to be disclosed, that the company may determine not to disclose and that could damage the company if disclosed. For example, the determination that a deficiency in internal controls is a significant deficiency rather than a material weakness may be deemed a "critical audit matter." By law, depending on the circumstances, the company may not have to disclose a significant deficiency, but the critical audit matter discussion in the audit report may cause that information to be disclosed. Similar non-required disclosures could result in connection with going concern considerations.

Contrary to the stated objective of the Proposed Auditing Standards to promote the informational value of the auditor's report, the Society believes that the Auditor Reporting Standard, if adopted, would have negative unintended consequences. First, we believe the disclosure of critical audit matters will chill communications between the auditor, on the one hand, and members of management and the audit committee, on the other. Companies will be reluctant to discuss matters with their auditors until they have fully considered the implications for disclosure. A company's management or audit committee must be able to raise and resolve matters with the auditor without fear that the communications will be publicly disclosed even if the matter is satisfactorily resolved.

We are also concerned that the Auditor Reporting Standard could result in two sets of disclosures of the same facts, one made by the company and the other made by the auditor. Aside from creating duplicative disclosures and thus exacerbating disclosure redundancy, which is among those issues identified by SEC Staff as problematic and slated for potential reform[2], this poses the substantial risk of inconsistent narratives concerning the company on matters critical to it.

Appendix 5 of the Release illustrates how the reporting of critical audit matters might take place in certain situations. Hypothetical 3 shows the auditor disclosing in the audit report a significant deficiency in the controls employed by the company's pricing and valuation committee, which was not disclosed (or required to be disclosed) by the company. Hypothetical 2 shows the auditor describing in the audit report the competition experienced by a technology company with respect to its "first generation" software products and a determination (by the auditor) that the company's return to profitability will depend on the launch of "next generation" products in the future. Hypothetical 2 reflects how a discussion of critical audit matters causes the auditor to become an independent source of disclosure concerning the company's business and strategy.

Making the auditor, in effect, a source for substantive disclosure about the company may also increase its liability to investors, supporting the misconception (which, ironically, the

[2] See Chair Mary Jo White, Address at the National Association of Corporate Directors - Leadership Conference 2013 (Oct. 15, 2013) available at www.sec.gov/News/Speech/Detail/Speech/1370539878806#.Uq3hN4bTmM8 and Commissioner Daniel M. Gallagher, Remarks at the 2nd Annual Institute for Corporate Counsel (December 6, 2013) available at www.sec.gov/News/Speech/Detail/Speech/1370540462287#.UqXJTYbTmM8.

Release is intended to dispel) that the auditor's role is, in effect, to guaranty the accuracy and completeness of the financial statements. Whatever the nature of the auditor's disclosure, however, the fact that there may be two sets of disclosures about the same matters, driven by differing standards and interests, is likely to create disharmony between the auditor and the company. Investors could be confused as to whether auditors are merely attesting to management's assertions or providing additional information that management has elected not to disclose.

The compilation and disclosure of critical audit matters would require significant time and attention from the auditor, the company's audit committee and management.

The Society is concerned that auditor disclosure of critical audit matters will increase the time burden for the auditor, the company's audit committee, and management during an otherwise already time-constrained period as management is finalizing the issuer's Annual Report on Form 10-K. The Sarbanes-Oxley Act shortened the Form 10-K filing requirement for many public companies to 60 days after the end of the fiscal year. During this compressed period, management must, among other things, compile its financial statements, including financial statement footnote disclosure, prepare its management discussion and analysis, and complete its assessment of internal control over financial reporting. Management must coordinate this process with its auditor while allowing sufficient time to review the proposed disclosures with, and be responsive to input from, the audit committee. The auditor must, among other things, complete its audit of the financial statements and the attestation of the internal control over financial reporting, review its work with the audit committee and management, and finalize its reports.

Adding to this heavy workload, the PCAOB proposal would require the auditor to draft and review internally and with the audit committee very sensitive disclosure. Realistically, this is likely to entail negotiations among the audit committee, management, and the auditor over the proposed substantive content disclosures, not unlike the interactions that often take place today with regard to footnote disclosure, management's discussion and analysis, and risk factors. These additional burdens may diminish the time available to assure the accuracy and completeness of these disclosures in order to devote more time to critical audit matters, in some cases not only adversely impacting the financial statements and management's discussion and analysis but also potentially delaying the filing of the Form 10-K.

For example, under today's regulatory regime, assume that management completes its complex fair value analysis in connection with its goodwill and determines that its fair value exceeded its carrying value. It reviews that determination with its auditor, which concurs, and with its audit committee. Management also drafts appropriate management's discussion and analysis disclosure relating to its critical accounting estimates. As the current rules require, it reviews this disclosure with both its auditor and audit committee. The Auditor Reporting Standard then would additionally require the auditor to assess whether this was a critical auditing matter and, if so, prepare the required disclosure. Due to the nature and content of the auditor's critical auditing matter disclosure as contemplated by the Auditor Reporting Standard, this last step will almost certainly encompass the audit team's review and behind-the-scenes dialogue and negotiation with the auditor's local and potentially national office, presentation of draft disclosures to management and the audit committee, meetings between management and the audit committee to review and discuss, further meetings between the auditor, management and the audit committee to review the issuer's proposed wording changes to the auditor's proposed disclosure and re-review of the document for potential internal inconsistencies based on the inclusion of the auditor's disclosure, etc., which ultimately is likely to add, at a minimum, several days – if not a week or more to the process.

The cost of reporting critical audit matters would greatly outweigh any actual or perceived benefits.

The costs associated with the additional steps described above will greatly outweigh any benefits to investors. The Release states that the discussion of critical audit matters would be "based on information known to the auditor and procedures that the auditor has already performed as part of the audit," which theoretically would significantly limit the increase in audit costs. In practice, however, communication of critical audit matters will increase time spent by the auditor on field work, increase the time and focus of the auditor's national office, and increase the auditor's potential liability on each audit engagement. As we learned from the implementation of the attestation requirement over management's assessment of internal controls, when an auditor must spend more time on an audit and faces increased liability, those costs are passed on to the company to absorb (ultimately reducing shareholder returns).

The cost of an audit will increase to the extent that the auditor communicates more critical audit matters. Magnifying this concern is that auditors will almost certainly be inclined to over-report critical audit matters rather than under-report them for at least two reasons. First, auditors may be fearful of being second-guessed during the PCAOB's review of the audit firm's work.[3] It will be in the auditor's best interest (rather than the best interests of the company or users of the financial statements) to err on the side of over-inclusion. Second, in the event a company declares bankruptcy or finds a material misstatement in its financial statements, if the auditor had not listed the potential financial issue as a critical audit matter, it would potentially face increased malpractice liability regardless of whether the audit was adequately planned and carried out. Thus, the Society foresees each auditor identifying excess critical audit matters just to provide some "cover" in the event a potential risk materializes. To the extent that an otherwise lower risk audit matter is deemed to be "critical" by the auditor, additional field work may have to be performed to demonstrate that sufficient audit evidence was gathered or that the matter was not a critical accounting matter. Both of these will directly increase audit fees.

The Society strongly believes that adding complexity to the auditor report will not simplify or otherwise benefit the users of the financial statements. The disclosure of critical audit matters would frustrate the PCAOB's stated intention that "the Board's proposed auditor reporting standard would retain the pass/fail model." In effect, the disclosure will transform the

[3] See Appendix 1 to the Release ("Note: it is expected that in most audits, the auditor would determine that there are critical audit matters").

current binary pass/fail model into a qualitative report. Depending upon the nature and extent of critical audit matters and the auditor's comments on those matters, the report will constitute and will be perceived as the equivalent of "high pass," "medium pass," "low pass," and "fail" or similar "grades" – which would add complexity and uncertainty for investors that does not exist with the current pass/fail system. Further, if two companies had similar issues that involved auditors' complex judgments or posed difficulty for the auditors to obtain evidence or form an opinion, but one company's auditor elected to over-report critical audit matters, then it would appear that the company with more reported critical audit matters was a riskier investment despite the companies posing substantially similar risks. At a minimum, this would confuse investors.

Finally, we believe that the Auditor Reporting Standard will result in a substantial increase in litigation risk for both the auditor and for the company. As noted above, the role of the auditor is not to be a guarantor of the financial statements. However, the Auditor Reporting Standard will change the perception of the auditor's responsibility, and the auditor's litigation risk is likely to increase accordingly.[4] To the extent that an auditor's legal risk increases, the cost of that risk will be passed on to the issuer in the form of higher rates. In addition, the inclusion of critical audit matters in the audit report will create a "road map" for plaintiffs to sue the company when, in hindsight, a critical judgment turns out to have been faulty. Arming potential plaintiffs with this information will increase the litigation risk for the auditor and the company as well as its management, which will increase costs to the company

The Society strongly supports policies that provide investors timely and accurate financial information; however, the Auditor Reporting Standard would not contribute meaningful data to the mix of information already available to investors. The Society believes that much of the reported critical audit matters will be duplicative to what the issuer already discloses as critical accounting estimates in its financial statement footnote disclosure and in its management's discussion and analysis. Further, providing detailed information to financial statement users "with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts"[5] not only lacks a benefit, but also may be counterproductive. The markets rely on professionally trained certified public accountants to make professional judgments in auditing an issuer's financial statements. Providing additional information to help alleviate information asymmetry about the audit may be a worthy objective if the Auditor Reporting Standard actually required auditor disclosures about the audit rather than requiring the auditor to hone in on, and provide information about, certain auditor-identified aspects of the issuer's financial reporting. If the Auditor Reporting Standard required that the auditor describe the parameters of the audit (e.g., audit procedures employed, what an audit does and does not consist of), then this would enhance users' understanding of the

[4] See Appendix 1 to the Release ("Note: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used").

[5] See Appendix 5 of the Release.

audit and the auditor's role, and ensure that that role is clearly distinguishable from the issuer's financial reporting obligations. Instead, however, the disclosure requirements will create competing issuer and auditor narratives about the same financial reporting matters (whichever critical auditing matters the auditor chooses to discuss), confusing users about the accuracy of the financial statements.

<u>Auditor's responsibilities regarding other information in certain documents</u>

Expanding the auditor's role with respect to "other information" will require auditors to evaluate information in areas where they are not considered experts.

Under existing PCAOB standards (AU Section 550), the auditor has a responsibility to "read and consider" other information in certain documents that also contain the audited financial statements and the related auditor's report; however, there is no related reporting requirement to describe the auditor's responsibility with respect to other information. The Other Information Standard would expand the auditor's responsibilities with respect to certain types of information outside the financial statements, but included or incorporated by reference in annual reports filed under the Securities Exchange Act of 1934, such as the selected financial information, management's discussion and analysis, exhibits and other information incorporated by reference into the filing, and require the auditor to make a public statement that it has affirmatively evaluated that information but did not discover any material inconsistencies or misstatements of fact. The Society believes that expanding the role of the auditor to areas of the annual report for which it does not have expertise puts the auditor at risk and provides false comfort to investors.

As an overarching principle, auditor involvement and attestation should be limited to areas for which an auditor has the appropriate expertise. This Other Information Standard would take the auditors beyond their traditional role of verifying a company's numbers by, among other things, requiring that they "evaluate" (in itself, a new and vague standard) not only numeric information, but also qualitative information. Moreover, the Society is concerned whether an auditor will be able to provide negative assurances on portions of the annual report contained in the proxy statement when that information may not be finalized until after the annual report is filed. Would the auditor be given de facto veto rights as to what can or cannot go into an issuer's proxy statement? If the stated goal of the Release is to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report, then having an auditor provide any comfort on information for which it is not trained to evaluate seems to fall short of that goal (or to miss it entirely).

By expanding the responsibility of the auditor, investor confusion over the role of the auditor is increased, not reduced.

As discussed in the Release, one of the primary motivators for proposing new auditing standards was that "some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the risks of material misstatement in a company's financial statements."[6] The Society supports working to fulfill the need of investors to fully understand what an audit entails and, more importantly, what it does not entail; however, the Other Information Standard does not meet this goal. Any changes to the reporting model should narrow, or at least not expand, the expectations gap between auditors and investors. Instead, in our view, the Other Information Standard substantially widens the gap.

The auditor's responsibilities are limited to basing its evaluation on relevant audit evidence obtained, and conclusions reached, during the audit. Since some of the Other Information that is not directly related to the financial statements may be non-financial in nature or related to the company's operations, the auditor may not have tested that information during the audit.

In our view, most investors will not understand the limited universe of information and documents to which the Other Information Standard would apply, will not understand what the auditor actually did with respect to the Other Information, and will not understand that the auditor is unlikely to have information or audit evidence to substantiate some of the numbers and other information reflected in the Other Information, thus widening the expectation gap.

The concept of the auditor "evaluating" the Other Information has the potential to cause confusion. The auditor's work to "evaluate" the information will not constitute what is normally understood to be an "audit," nor is it the same as a "review." So it is unclear what level of assurance the auditor would be providing by conducting these procedures - which will also serve to increase the expectation gap with investors.

Having an auditor report on information outside of the financial statements adds cost to the audit without providing a clear benefit to financial statement users.

Expanding the current role of the auditor to providing assurance on "the other information included in an annual report" will be costly and not provide a meaningful benefit to financial statement users. Currently, an auditor is required to "read and consider" the Other Information, and, in practice, an auditor reviews parts of the annual report, including the management's discussion and analysis, to verify that the numbers tie to the financial statements and that the explanation is consistent with the evidence gathered in the audit. The Society believes the current standard strikes the proper balance of providing sufficient comfort to investors relative to the additional cost imposed on the issuer.

Ultimately, expanding the responsibilities of the auditor will increase audit fees because of the significant increase in potential liability to the auditor. The Society appreciates the PCAOB's intention that an auditor rely solely on audit evidence obtained and conclusions reached during the audit and would specifically disclaim an opinion on the other information. But requiring an auditor to provide negative assurances to investors will have the unintended consequence of the auditor having to perform significant additional field work in this case. The

[6] See Release, at page 9.

Society believes that the Other Information Standard creates the potential that, under the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders,* the auditor will be subject to a private right of action under Rule 10b-5 predicated on the material inaccuracy of that statement, to which it would not have been subject if such statement were not made.

The Society believes that an auditor would therefore be forced to perform additional specific procedures to provide support for the auditor's conclusion that it could provide the negative assurance. An auditor, whether due to fear from being second guessed by the PCAOB or by a plaintiff in a lawsuit, will be required to plan and perform procedures for each section of the annual report to assure that all information is consistent with the audit. These procedures (presumably similar to the procedures an audit firm performs when issuing a comfort letter to underwriters) will likely require involvement from the concurring partner as well as the audit firm's national office. This will add cost to the audit. Thus, the potential for increased liability will likely cause auditors to err on the side of over-inclusiveness with respect to implementation of evaluation procedures, other information evaluated, and communications and reporting about potential inconsistencies.

While the audit would expand to reach areas of an issuer's annual report not traditionally involving the auditor, the Society sees no benefit – much less a commensurate benefit – from this process. If there is confusion as to the auditor's role with respect to the annual report, the Society believes that it would be more appropriate for an auditor to disclaim all responsibility for any information outside of the financial statements while maintaining the current "read and consider" standard. The "read and consider" standard is an important part of gathering audit evidence to assure that management's discussion and analysis is consistent with its assertions in the financial statements; however, providing assurance to investors on the other information goes beyond what investors should reasonably expect to receive.

Auditor Tenure

The reporting by the auditor of its tenure as the company's auditor in the audit report is not appropriate because it implies that tenure has significance.

Given the lack of evidence associating auditor tenure and audit quality, the Society believes that requiring disclosure in the audit report of the auditor's tenure with the company is inappropriate. The inclusion of this information, together with the negative connotation associated with auditor tenure that the PCAOB acknowledges in its commentary and footnote disclosures in the Release, implies a correlation between tenure and audit quality, and has significant potential to trigger unintended and damaging inferences, including calling into question the independence of the auditor.

Moreover, if auditor tenure is included in the audit report, as proposed, this information coupled with the negative connotations discussed above will prompt issuers to add disclosures (e.g., mandatory audit partner rotation requirements and other independence and quality safeguards) to their Form 10-Ks simply to counter the potential, unwarranted negative implications - thus further exacerbating the information overload problems that have already been identified and the topic of discussion by the Commission.[7] Approximately two decades of information about auditor changes is already publicly available for many companies on the SEC's EDGAR database.

However, to the extent there is deemed to be investor interest in this information that justifies its disclosure in a manner comparable to that contemplated by the PCAOB, it is more appropriately characterized as a governance matter that should be considered by the company and its audit committee, rather than the auditor, for inclusion in the proxy statement as part of the audit committee report or in connection with shareholder ratification of the appointment of the auditor.

We appreciate this opportunity to share our views with you, and would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

Darla C. Stuckey

Darla C. Stuckey, SVP, Policy & Advocacy

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[7] *See* Chair Mary Jo White, Address at the National Association of Corporate Directors - Leadership Conference 2013 and Commissioner Daniel M. Gallagher, Remarks at the 2nd Annual Institute for Corporate Counsel, *supra* note 2.